MORE THAN JUST A BOON TO WEALTHY DEBTORS: HOW TEXAS HOMESTEAD LAW HELPED INSULATE TEXAS FROM THE FORECLOSURE TYPHOON

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I. INTRODUCTION

Commentators often criticize Texas homestead law as being nothing more than a way to allow wealthy debtors to escape liability in bankruptcy.[1] In fact in 2005, Congress amended the bankruptcy code to, among other things, deal with this alleged defect.[2] This comment attempts to rehabilitate the reputation of Texas Homestead Law by investigating its possible impact on the recent foreclosure crises.

The last five years have added a number of strange words and phrases to America's collective vocabulary. For instance, Collateralized Debt Obligations and Mortgaged Backed Securities are no longer only meaningful to an investment banker. In today's post-"Great Recession" world,[3] these phrases evoke nightmares about financial collapses and bursting bubbles. It is commonly accepted that the bursting of the real estate bubble was the major cause of the recent recession. Why the bubble burst is not quite so clear.[4] However, many commentators have used the word

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[1] *See, e.g.*, Ryan P. Rivera, *State Homestead Exemptions and Their Effect on Federal Bankruptcy Laws*, 39 REAL PROP. PROB. & TR. J. 71, 86 (2004).

[2] *See* Margaret Howard, *Exemptions Under the 2005 Bankruptcy Amendments: A Tale of Opportunity Lost*, 79 AM. BANKR. L.J. 397, 399 (2005).

[3] A term used by many commentators to describe the recent economic downtown. *See* Catherine Rampell, Economix, *'Great Recession': A Brief Etymology*, N.Y. TIMES, Mar. 11, 2009, http://economix.blogs.nytimes.com/2009/03/11/great-recession-a-brief-etymology/. Interestingly, it is also a term that has been used to describe every recession or downturn of the last several decades. *Id.*

[4] *Compare* Marvin N. Bagwell, *Can't Live Without Air: Title Insurance and the Bursting of the Real Estate Bubble*, 30 PACE L. REV. 180, 183 (2009) (discussing how securitization was an essential factor in the formation of the bubble) *with* Shelby D. Green, *Disquiet on the Home

"contagion" to describe the crises.[5] A contagion is "[a] disease that is or may be transmitted by direct or indirect contact; a contagious disease."[6] Contagious diseases are "very communicable disease[s] capable of spreading rapidly from one person to another by contact or close proximity."[7] These types of diseases are typically dealt with in three ways: isolation, quarantine, and prevention.[8] Comparing the recent financial crises to a contagious disease is an apt metaphor because of the way different financial problems spread between closely related economic sectors. Specifically: (1) poor lending practices led to a high number of foreclosed homes;[9] (2) the proximity (or indirect contact) of a foreclosed home to a neighboring home negatively impacted the price of the neighboring home, which in turn made additional foreclosures more likely;[10] (3) inside a mortgaged backed security, as more mortgages went into foreclosure more securities collapsed;[11] (4) financial organizations that were heavily invested

Front: Disturbing Crises in the Nation's Markets and Institutions, 30 PACE L. REV. 7, 40 (2009) ("The fault lies not in securitization, but in ourselves—in our abuses, carelessness, and cupidity.").

[5] These references are legion. *See, e.g.*, Bagwell, *supra* note 4, at 198; Hsien-Yi Lee, *Contagion in International Stock Markets During the Sub Prime Mortgage Crises*, 2 INT'L J. OF ECON. & FIN. ISSUES, no. 1, 2012, at 41, *available at* http://www.econjournals.com/index.php/ijefi/article/download/87/pdf; Randall Dodd & Paul Mills, *Outbreak: U.S. Subprime Contagion*, FIN. & DEV., June 2008, at 14, 18 *available at* http://www.imf.org/external/pubs/ft/fandd/2008/06/pdf/dodd.pdf; Francis A. Longstaff, *The Subprime Credit Crisis and Contagion in Financial Markets*, 97 J. OF FIN. ECON. 436, 436, *available at* www.elsevier.com/locate/jfec.

[6] *Contagion Definition*, THE AMERICAN HERITAGE DICTIONARY, http://www.ahdictionary.com/word/search.html?q=contagion&submit.x=35&submit.y=20 (last visited Dec. 7, 2012).

[7] *Controlling the Spread of Contagious Diseases: Quarantine and Isolation*, THE AMERICAN RED CROSS (last updated Jun. 7, 2005, 11:15 AM), http://www.redcross.org/email/testing/cdc_english/IsoQuar.asp.

[8] *See id.*

[9] *See* Bagwell, *supra* note 4, at 181 ("How could a security guard clearing $35,000 annually afford a half-million dollar mortgage?").

[10] *See* Green, *supra* note 4, at 13–14 ("Foreclosures depress the housing market, leading to more foreclosures and inevitably resulting in net losses to lenders, since these forced sales commonly net only fifty to sixty-five percent of the property's real value."). *See id.* at 33 ("[H]igh foreclosure rates reduce property values, prompting still more foreclosures, leading to a downward spiral in property values, and thereby hurting lenders and contributing to further reduction in mortgage failures.").

[11] *See* Bagwell, *supra* note 4, at 184–85.

in these financial instruments collapsed;[12] (5) the volatility caused by the financial collapse of these financial organizations spread to other financial markets;[13] and (6) finally to international markets.[14] These are just a few examples, and this metaphor can be extended further. Certain acts of legislation can be analogized to treatment methods. For instance, federal legislation like TARP and HAMP can be viewed as forms of isolation or quarantine.[15] However, as with any disease, "[i]t is always better to prevent a disease than to treat it."[16] Texas Homestead law can be analogized to a form of regulatory prevention through immunization or vaccination. This comment will argue that Texas Homestead law immunized the Texas real estate market, and helped to prevent the worst effects of the recent foreclosure crises.

It will do so by analyzing the effect of Texas Homestead Law on the Texas real estate market. Specifically, it will focus on the regulatory effect Homestead Law has had on secondary lien products. It will argue that Texas Homestead Law's regulatory effect on secondary lien products has insulated the Texas real estate market by preventing a sufficient level of speculative toxic debt.[17]

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[12] *See* Green, *supra* note 4, at 16 ("The year 2008 can also be remembered for the collapse and disappearance of venerable banks and financial institutions: Bear Stearns (bought out by J.P. Morgan Chase), Merrill Lynch (bought by Bank of America), Lehman Brothers (filed for bankruptcy), Wachovia Bank (bought by Wells Fargo) and Countrywide Financial, the country's largest loan originator (bought by Bank of America). The Federal Deposit Insurance Corporation ("FDIC") took over many banks that had over-extended themselves, such as IndyMac and Washington Mutual. These institutions had amassed so much debt that it threatened to overwhelm them. That debt was largely from investments in the secondary market—that is, they bought and sold mortgage-backed securities.").

[13] *See supra* note 5 and accompanying text. *See also* Green, *supra* note 4, at 27.

[14] *See* Green, *supra* note 4, at 27 ("The crisis hit worldwide, as financial systems across the globe are highly interconnected."); Mark A. Edwards, *Nationalization, De-Nationalization, Re-Nationalization: Some Historical and Comparative Perspective*, 30 PACE L. REV. 124, 125 (2009) ("What started as a domestic problem with irrational lending secured by obscure mortgage instruments has spread with such force and power that the most powerful banks in the world, not to mention several nations, stand on the brink of economic collapse.").

[15] In a sense, the federal government "quarantined" the toxic mortgage backed securities when it used TARP funds to purchase billions of dollars of these securities from distressed financial institutions. *See* Green, *supra* note 4, at 29 n.112.

[16] *Vaccines & Immunizations*, CENTERS FOR DISEASE CONTROL AND PREVENTION, http://www.cdc.gov/vaccines/vac-gen/howvpd.htm (last modified Apr. 25, 2012).

[17] In immunological sciences, there is concept known as "herd immunity." *See* T. Jacob John

II. METHODOLOGY

Homestead Law is unique in Texas. The cliché that everything is bigger in Texas holds true to this area of law. However, it is not just the size of the deduction that is unique. Texas is not the only state with an unlimited homestead exemption.[18] For instance Florida, Iowa, and Kansas also have unlimited exemptions.[19] However, Texas homestead law is unique because of the strength of the Texas homestead protection. In addition to being unlimited in value, it is also mostly impregnable.[20] An individual who lives in a homestead with the intent to remain indefinitely is protected from all but eight specifically enumerated encumbrances.[21] Unlike many other states, this protection cannot be waived.[22] It is this inalienable protection that has produced an effective regulatory effect on the Texas home lending market. Specifically, it has done this through its effect on the secondary mortgage market.

This comment will begin with a brief explanation of the recent real

& Rueben Samuel, *Herd Immunity and Herd Effect: New Insights and Definitions*, 16 EUROPEAN J. OF EPIDEMIOLOGY 601, 601–02 (2000). Basically, immunizing a sufficient level of a group to a disease will afford protection to the members of the group who have not been immunized. *Id.* In a way, restricting both the types of secondary lien products that financial institutes may extend to consumers and the method in which these products may be offered serves as a sort of regulatory herd immunization for the Texas real estate market.

[18] Charles J. Tabb, THE LAW OF BANKRUPTCY 888 n.25 (2d ed. 2009).

[19] *Id.*

[20] *See* Tex. Const. art. XVI, § 50.

[21] *Id.*

[22] There is case law that says a homeowner can be estopped from claiming property as a homestead. *See, e.g.*, Estate of Montague v. Nat'l Loan Investors, L.P., 70 S.W.3d 242, 247 (Tex. App.—San Antonio 2001, pet. denied). However, this caselaw is all at the appellate level, and its applicability is very narrow. It requires that the homeowner own two homes. *Id.* Additionally:

> A claimant may be estopped under those circumstances from claiming the homestead exemption where physical facts open to observation lead to a conclusion that the property in question is not the homestead, the use of the property is not inconsistent with the claimant's representations that the property is disclaimed as the homestead, and the representations were intended to be and were actually relied upon by the lender.

Id. (citations omitted) (internal quotation marks omitted). A homestead is abandoned when a homeowner stops using a property as a homestead and intends to abandon the homestead. *Id.* at 248. One might argue that the elements for estoppel (no objective evidence of use and statements that the home is not a homestead) are merely a method for objectively proving the elements of abandonment (cessation of use and intent to abandon).

estate bubble. It will focus on the inter-connected nature of the financial markets. By showing how exposed each linkage of the financial chain was to the contagion of speculative bubble formation, the efficacy of inoculating financial markets through preventative regulation will become clear.

Next, this comment will briefly look at foreclosure and home price data in five jurisdictions: Michigan, Arizona, California, Florida, and Texas. Aside from Texas, these jurisdictions have been selected because of their exposure to the worst consequences of the foreclosure crises: high foreclosure rates and plummeting home values. More specifically, the California and Florida markets have been selected for their demographic similarities to Texas.[23] This comment will contrast the volatility in both foreclosure rates and home prices in the first four jurisdictions with the relative stability of foreclosure rates and home prices in Texas. Subsequently, it will look at national data and research related to secondary lien lending.[24] It will discuss how the prevalence and nature of second-lien lending contributed to the financial chaos during the crises. Next, it will contrast the homestead law in each jurisdiction with Texas Homestead Law. Specifically, it will point out how the homestead law in the non-Texas jurisdictions had no effect on any of the causal factors that lead to the recent financial crises.

While analyzing Texas Homestead Law, the focus will be on this area of law's particular effect on secondary mortgage lending. It will look at foreclosure data for Texas and analyze the effect homestead protection has had on the home lending market of Texas. Specifically, it will focus on how Texas Homestead Law may have impacted a number of the recent foreclosure crises' causal factors: speculation, availability of cheap credit, and a lack of federal mortgage-lending regulation.[25] By curbing these causal factors, homestead law provided a sufficient level of "immunization" to the Texas real estate market. Thus, Texas was able to weather the foreclosure

[23] *See 2010 Census Interactive Population Search*, U.S. CENSUS 2010, http://2010.census.gov/2010census/popmap/ipmtext.php?fl=06:48:12 (last visited Dec. 7, 2012).

[24] Research analyzing the prevalence and effect of secondary lending on a state level is sparse. However, based on available national research, there is a correlation between heavy secondary lending and foreclosure rates. The implication of this trend is that a state by state analysis might be a fruitful endeavor for any future state regulatory planning.

[25] *See* Bagwell, *supra* note 4, at 182.

storm in a relatively healthy fashion.[26] Finally, this comment will suggest ways in which this preventative approach might be extended.

III. THE CRISIS

Commentators have written extensively about the causes of the recent financial crises.[27] The commentary has been extensive across a number of disciplines.[28] An extensive discussion of the causal factors is outside of the scope of this comment. However, a brief discussion of the "contagious" nature of the crises is necessary.

While there is a great deal of disagreement about the consequences of some of the more complex and esoteric factors (like securitization),[29] commentators agree that the prevalence of sub-prime mortgages was a major factor.[30] An essential element to the prevalence of sub-prime lending was the "lax underwriting standards" that made these loans possible.[31] A borrower was able to get a loan with no documentation, so long as the borrower agreed to pay back a loan at exorbitant rates and byzantine rate structures.[32] Complex amortization schedules and adjustable rate mortgages were extended to borrowers who could barely afford the teaser (or temporary/introductory) rates.[33] When rates ballooned, there was a typhoon of foreclosures. In a sense, the contagion started with poor lending practices and spread to a rising number of foreclosures.

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[26] Relative is an important component to this definition of success. The data suggests that Texas had one of the worst foreclosure rates pre-2006. *See National Foreclosures Increase 17 Percent in Third Quarter*, REALTYTRAC (Oct. 30 2006) http://www.realtytrac.com/content/press-releases/foreclosures-in-the-third-quarter-of-2006-1863 (noting that Texas was in the top ten in number of foreclosure filings). During the crisis years, Texas's foreclosure rate relative to other jurisdictions actually improved. *Id.* It is important to understand that this comment does not suggest that Texas completely avoided any consequence of the mortgage crisis. Rather, it suggests that Texas was somewhat insulated from the crisis. In other words, absent certain regulatory policies, the situation could have been worse.

[27] *See, e.g.*, Symposium, *Real Property, Mortgages, and the Economy: A Call for Ethics and Reforms*, 30 PACE L. REV. 1 (2009).

[28] *See supra* note 5 and accompanying text.

[29] *See supra* note 4 and accompanying text.

[30] *See supra* note 4 and accompanying text.

[31] *See* Bagwell, *supra* note 4, at 207; Green, *supra* note 4, at 22.

[32] *See supra* note 31.

[33] *See* Green, *supra* note 4, at 10 n.14.

Home prices are intimately tied to neighboring home values.[34] Homes that are sold through the foreclosure process typically sell for 50% to 65% of their fair market value.[35] When one house in a neighborhood goes into foreclosure, it has little effect on neighboring home values.[36] However, when a high number of homes go into foreclosure in a neighborhood, this has a catastrophic effect on the general value of homes in that neighborhood.[37] During the crises, plummeting home values destroyed homeowner equity.[38] Commentators point out that the less equity a person has in her home the more likely she is to default on her home loan.[39] Thus, the problem became self-reinforcing. There is a great deal of debate over who deserves more of the blame: the consumer (who purchased a house she couldn't afford) or the lender (who extended the "predatory" loan).[40] However, no one blames the average homeowner who saw her equity disappear when the foreclosure contagion destroyed the fair market value of her home.

By now, Americans are relatively familiar with the term mortgage-backed security, or the practice of transforming mortgages into bonds.[41] As one commentator points out, however, these types of bonds have existed for decades.[42] But recently, these financial products have been transformed into a more complex type of investment known as a collateralized debt obligation (CDO).[43] Here, commentators generally agree that poor rating practices contributed to the bubble.[44] However, there is disagreement over whether the poor ratings were caused by a mere rating misevaluation (due

[34] *See supra* note 10 and accompanying text.

[35] *See* Green, *supra* note 4, at 13–14.

[36] *Supra* note 10 and accompanying text.

[37] *Supra* note 10 and accompanying text.

[38] *Supra* note 10 and accompanying text.

[39] *See, e.g.*, Laurie S. Goodman et al., *Second Liens: How Important?*, THE J. OF FIXED INCOME, Fall 2010, at 19, 19.

[40] *See supra* note 4 and accompanying text.

[41] Bagwell, *supra* note 4, at 184.

[42] Green, *supra* note 4, at 17.

[43] *Id.* at 18 n.51. ("CDOs [or collateralized debt obligations] are defined as mechanisms for converting mortgage securities and corporate bonds from large, illiquid assets into liquid financial instruments. They are structured financial products, usually backed by pools of mortgages, and typically sliced into tranches with varying degrees of risk and projected returns.") (citations omitted) (internal quotation marks omitted).

[44] *See* Green, *supra* note 4, at 17–18.

to the unfamiliarity with the product)[45] or a perverse incentive, which was created by an intrinsic conflict of interest between banks and rating agencies.[46] In either case, systematic deregulation generally eroded the disclosure requirements for both the investors and rating agencies.[47] This permitted either an intentional misevaluation of CDOs (which was caused by an inherent conflict of interest), or an unintentional but systematic misevaluation (based on inaccurate mathematical data modeling)[48] to go unnoticed until it was too late.[49] As sub-prime mortgages began to collapse, CDO's made up of sub-prime mortgages began to collapse.[50] As an increasing number of foreclosures eroded general home equity, even "prime" mortgage backed securities began to collapse.[51]

However, none of this explains how the foreclosure crises spread from the mortgage industry to threaten some of the largest financial institutions in the country.[52] Logically, billions of dollars in lost value might threaten isolated financial institutions. However logic dictates that this amount of toxic debt should not have threatened the entire financial industry, the largest economy in the world, or the general world economy. How this financial contagion spread between institutions and economies is generally beyond the scope of this comment. However, to grossly oversimplify a very complicated problem, there was one main culprit: the credit default swap.[53] To compound matters further, there were no

[45] *See id.* at 18.

[46] *See* Bagwell, *supra* note 4, at 186.

[47] *See id.* at 206–208.

[48] Both theories have been posited by commentators as explanations for how poor ratings fueled the crises. *See supra* note 45–46 and accompanying text.

[49] *See* Bagwell, *supra* note 4, at 186.

[50] *See* Vincent Di Lorenzo, *Unsafe Loans in a Deregulated U.S. Mortgage Market*, 30 PACE L. REV. 154, 174 (2009).

[51] *See* Bagwell, *supra* note 4, at 214.

[52] *See supra* note 12.

[53] A credit default swap is a sort of insurance policy. *See* Bagwell, *supra* note 4, at 188. Essentially, one financial institution promises to pay another institution if a security (like a CDO) collapses. *Id.* In return, the default swap holder pays a percentage fee. Kristin N. Johnson, *Things Fall Apart: Regulating the Credit Default Swap Commons*, 82 U. COLO. L. REV. 167, 195 (2011). The major problem is that these default swaps are often bought and sold by people completely unrelated to the underlying security. *See* Bagwell, *supra* note 4, at 188. For instance (hypothetically), if Bank of America owns a certain CDO filled with sub-prime mortgages (worth say one million dollars), it might take out a credit default swap from Deutsche Bank. BOA would

requirements about how capitalized the credit default swap insurer needed to be.[54] These credit default swaps were incredibly profitable in the short term, which led to an explosion of these policies being issued.[55] When CDOs started to collapse, the insurer's lack of capital was exposed.[56] The contagion spread from the mortgage lending industry to the broader banking industry.[57] As banks became increasingly illiquid, the availability of credit dried up.[58] This spread the contagion to the broader economy.[59] As the broader economy began to enter a recession, consumer confidence took a major hit.[60] This led to the largest stock-market dip since the depression.[61] Additionally, American banks weren't the only ones involved in purchasing mortgage backed securities and derivative insurance policies.[62] Foreign lending and investment was, in fact, another hugely important factor to the crises.[63] Essentially, an influx of foreign lending helped keep interest rates low, which helped fuel the bubble.[64] When the bubble collapsed, these

then pay a small percentage based "premium" of the value of the security for the policy. However, Chase might decide that this security was particularly risky. So they might also take out an insurance policy from Deutsche Bank. To Chase, the fee of a few thousands of dollars a year was small change when it anticipated a million dollar payout when the security collapsed. Conversely, if the CDO did collapse, Deutsche Bank was suddenly on the hook for not one, but two million dollars. This derivative market turned billions of dollars of debt into trillions of dollars of debt. *Id.* The credit default swap industry was a trillion dollar international industry. *Id.* ("If AIG collapsed, lenders throughout the world, including sovereign governments and lenders to the United States such as China, Japan, Saudi Arabia, and South Korea, all of whom held billions in U.S. debt, would have to immediately recognize trillions of dollars of loses.").

[54] Bagwell, *supra* note 4, at 207 ("[T]he 2000 Commodity Futures Act . . . exempted derivatives-like credit default swaps from regulation."). Thus, to extend the previous hypothetical, Deutsche Bank might hold billions of dollars of credit default swaps. However, Deutsche Bank had complete control over how much cash it needed to hold in reserves.

[55] *See id.* at 188; Johnson, *supra* note 53, at 195.

[56] *See* Bagwell, *supra* note 4, at 188.

[57] *Id.*

[58] David Leonhardt, *Can't Grasp Credit Crisis? Join the Club*, N.Y. TIMES, March 19, 2008, http://www.nytimes.com/2008/03/19/business/19leonhardt.html?pagewanted=all ("[F]irms are now hoarding cash instead of lending it.").

[59] *Id.*

[60] *See id.*

[61] *See id.*

[62] *See* Bagwell, *supra* note 4, at 196.

[63] *See id.*

[64] *See id.* at 195.

foreign lenders were exposed in two ways: from credit-default swap investment, and direct investment in CDOs. Thus, the financial contagion that started in America spread to international markets.[65]

There are a number of repeated themes throughout the development of the recent crises: (1) unchecked subprime[66] lending; (2) deregulated markets; (3) transformation (or securitization) of relatively simple financial products (mortgages) into increasingly complicated financial products (bonds cut into tranches secured by derivative insurance policies); and (4) the interconnected nature of the national and international financial industry and the overall economy.[67] What has emerged from this situation is a familiar story: a terrible recession, and a volatile economy.[68] Specifically, the data shows that in many of the hardest hit states, the real estate market was extremely volatile.[69] There was a true bubble, and when it popped home prices collapsed and the number of foreclosures increased exponentially.[70]

IV. DATA CORRELATION

Before the real-estate bubble burst, Texas had one of the highest foreclosure rates in the country.[71] Additionally, there was a population boom.[72] Rates were affordable, like most jurisdictions.[73] Similar to states like California and Florida, Texas seemed poised for a real estate market

[65] *See id.*

[66] Freddie Mac defines the subprime mortgage market as a "[m]arket niche that finances mortgages that do not meet traditional underwriting standards. This market serves borrowers who have past credit problems or unconventional borrowing needs." FREDDIE MAC, http://www.freddiemac.com/smm/n_r.htm#P (last visited Dec. 7, 2012).

[67] *See supra* note 4.

[68] *See supra* note 4.

[69] *See Green, supra* note 4, at 11–12.

[70] *See Bagwell, supra* note 4, at 198.

[71] *Supra* note 26.

[72] The population grew from roughly 21 million to over 25 million during this time. Federal Reserve Bank of St. Louis, *Resident Population in Texas*, FRED ECONOMIC DATA (Feb. 8, 2012, 5:46 PM), http://research.stlouisfed.org/fred2/series/TXPOP.

[73] *See* Danielle Reed, *Home Building To Slow, Despite Storm Recovery*, HOUS. CHRON., Sept. 22, 2005, http://www.chron.com/news/hurricanes/article/Home-building-to-slow-despite-storm-recovery-1940672.php; Bagwell, *supra* note 4, at 195.

collapse.[74] However unlike other similar jurisdictions, the real estate market in Texas remained relatively stable.[75] In other words, Texas escaped the market volatility and price collapse that so damaged the rest of the country.

The foreclosure data for this analysis comes mainly from RealtyTrac.[76] Specifically this analysis will use: (1) the number of new foreclosures in the third quarter of each year from 2006 (the year before the crises began) to 2010; (2) the ratio of homes sold normally to homes sold through the foreclosure process during that quarter; and (3) the percent of households in foreclosure in the third quarter of each year.[77] This comment will contrast the trends from the non-Texas jurisdictions with the data from Texas. This comparison will establish that Texas escaped the volatile foreclosure rates caused by the bursting of the real estate bubble.

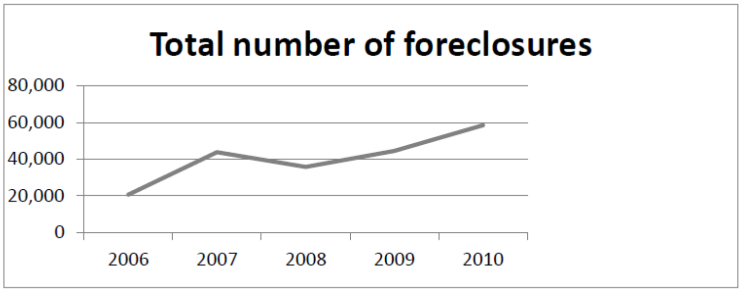
[74] The increasing population created an increase in demand. *See supra* note 72. Additionally, the low interest rates made investing and purchasing real estate attractive. California and Florida also experienced similar rates of population growth. *See* Federal Reserve Bank of St. Louis, *California and Florida Population Growth*, FRED ECONOMIC DATA, http://research.stlouisfed.org/ fred2/graph/?graph_id=83621&category_id=0 (last visited Dec. 7, 2012). These graphs show that Florida's population grew roughly 3 million while California's population grew roughly 3.4 million from 2000 to 2010. In similar economic conditions (an increasing demand for property fueled by a growing population and record low interest rates), Florida and California experienced both the formation and collapse of a real estate bubble. Conversely, Texas generally escaped this real estate bubble. *See* Floyd Norris, *A Law Shielded Many Texans When the Housing Bubble Burst*, N.Y. TIMES, May 25, 2012, http://www.nytimes.com/2012/05/26/business/texas-lending-law-shielded-many-homeowners-from-housing-bust.html.

[75] *See infra* Part IV.E–F.

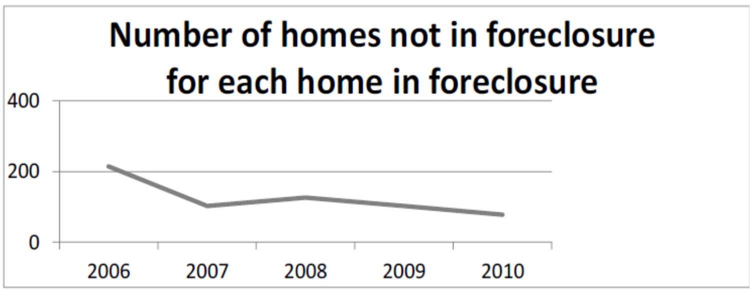
[76] As one commentator has noted, RealtyTrac has received some criticism for the method it uses in counting the number of foreclosures in a given state. *See* Ann Graham, *Where Agencies, the Courts, and the Legislature Collide: Ten Years of Interpreting the Texas Constitutional Provisions for Home Equity Lending*, 9 TEX. TECH ADMIN. L.J. 69, 112 n.319 (2007). Specifically, its method involves counting reported foreclosure filings in each stage of the foreclosure process. *Id.* This can lead to counting one property multiple times. *Id.* However, the RealtyTrac data is being used to show trends over time. Because the data has used a consistent method of counting over time, it is an accurate portrayal of the foreclosure trend in the given jurisdiction. While the data may be overstated, the trend lines the data produce are reasonably accurate.

[77] See *infra* Part VII.

A. *Michigan*[78]

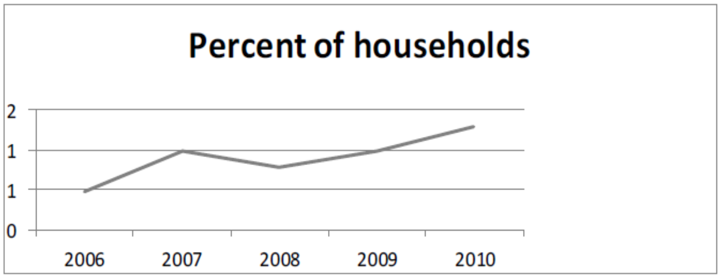


2006: 20,666
2007: 43,819
2008: 35,749
2009: 44,383
2010: 58,409



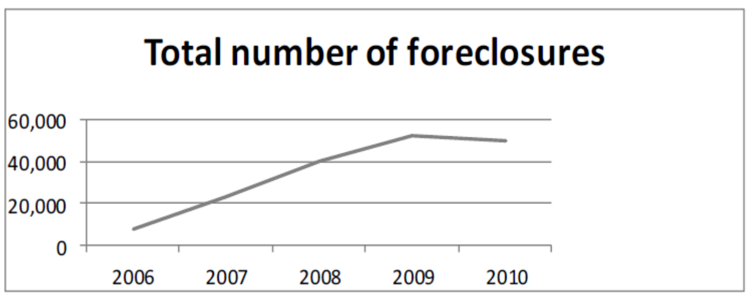
2006: 214.46/1
2007: 102.20/1
2008: 126.26/1
2009: 102.01/1
2010: 77.65/1

[78] *Supra* note 77.



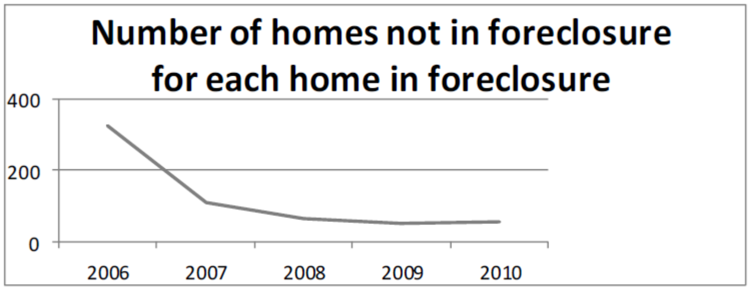
2006: 0.47%
2007: 0.98%
2008: 0.79%
2009: 0.98%
2010: 1.29%

B. Arizona[79]

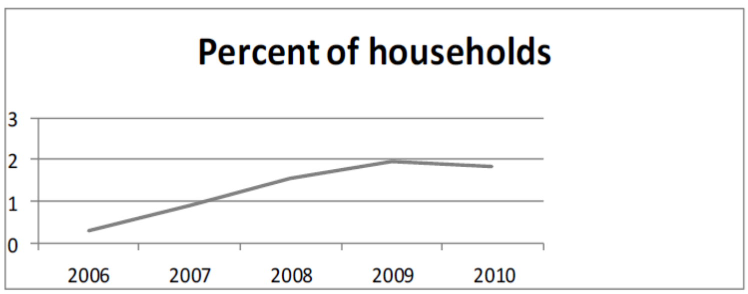


2006: 7,483
2007: 22,769
2008: 40,663
2009: 52,428
2010: 49,925

[79] *Supra* note 77.

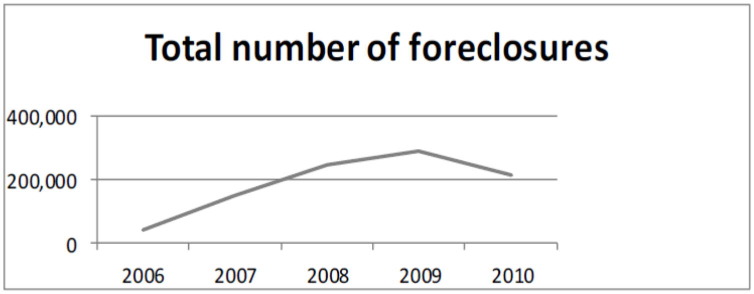


2006: 325.46/1
2007: 110.53/1
2008: 64.07/1
2009: 50.88/1
2010: 54.54/1

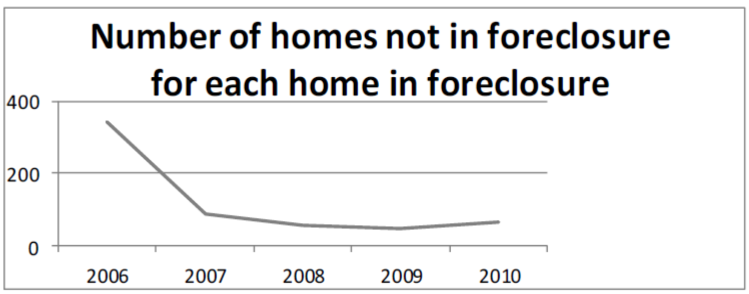


2006: 0.31%
2007: 0.9%
2008: 1.56%
2009: 1.97%
2010: 1.83%

C. California[80]

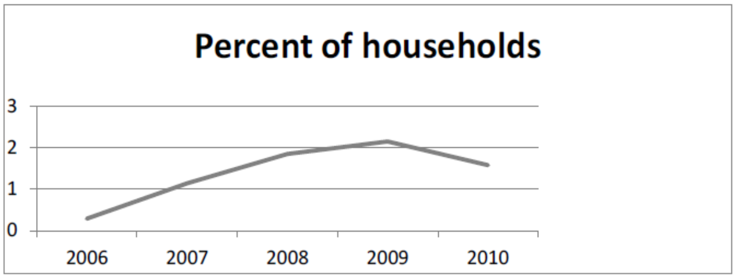


2006: 37,448
2007: 148,108
2008: 243,557
2009: 286,767
2010: 211,257



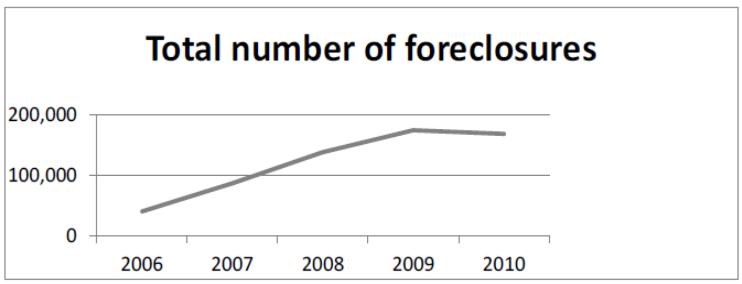
2006: 342.14/1
2007: 87.73/1
2008: 54.09/1
2009: 46.41/1
2010: 63.40/1

[80] *Supra* note 77.



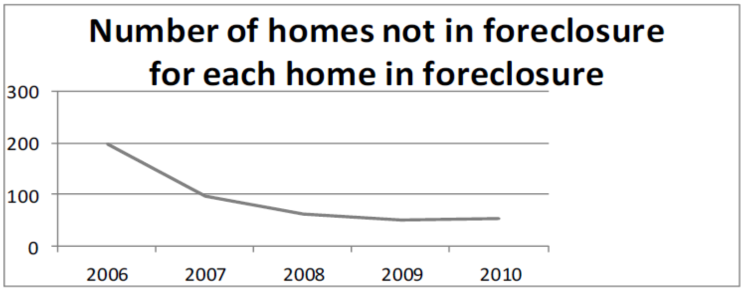
2006: 0.29%
2007: 1.14%
2008: 1.85%
2009: 2.15%
2010: 1.58%

D. Florida[81]

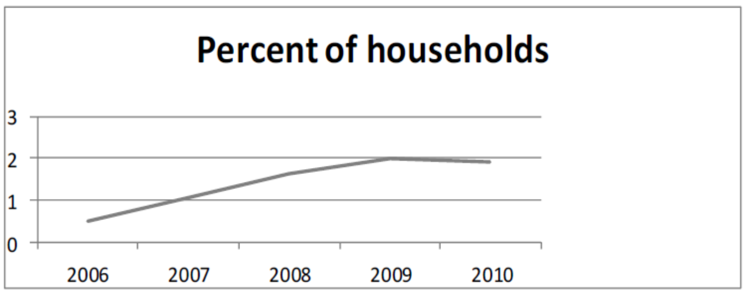


2006: 40,293
2007: 86,583
2008: 137,840
2009: 173,923
2010: 167,948

[81] *Supra* note 77.

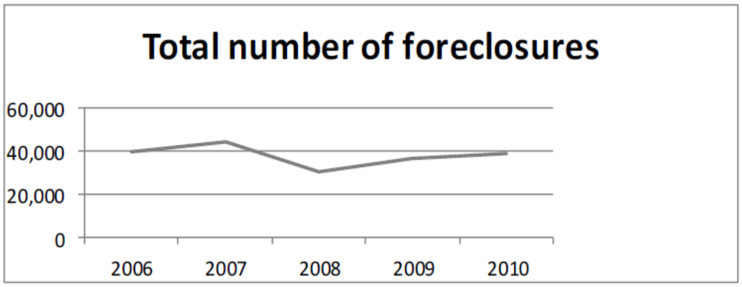


2006: 198.88/1
2007: 95.40/1
2008: 61.91/1
2009: 50.13/1
2010: 52.40/1



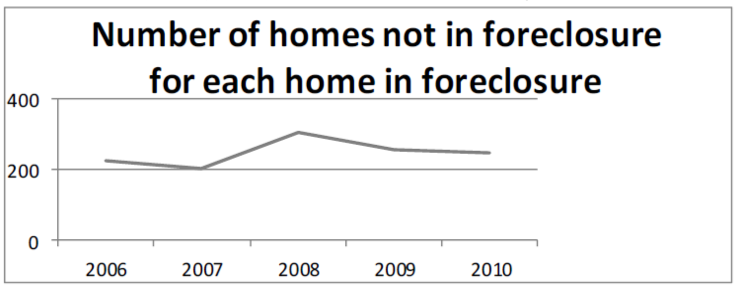
2006: 0.5%
2007: 1.05%
2008: 1.62%
2009: 1.99%
2010: 1.91%

E. Texas Foreclosure Data[82]



2006: 39,328
2007: 44,185
2008: 30,415
2009: 36,554
2010: 38,786

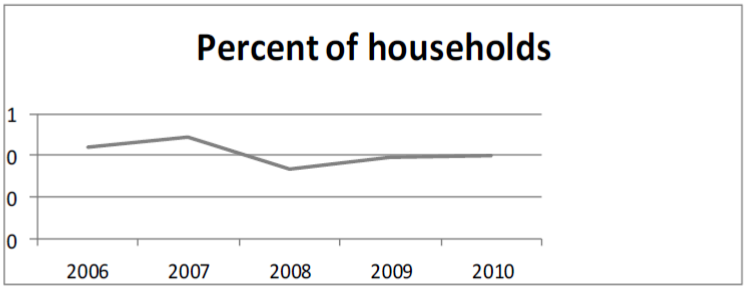
This trend line is relatively flat. Conversely, the total foreclosure trend lines for the other jurisdictions were extremely volatile.



2006: 224.95/1
2007: 204.27/1
2008: 303.28/1
2009: 258.05/1
2010: 247.48/1

Again, it is important to recognize that the ratio in Texas is: (1) much more stable than the other jurisdictions, and (2) more closely aligned with the ratios the other jurisdictions possessed just before the bubble burst.

[82] *Supra* note 77.

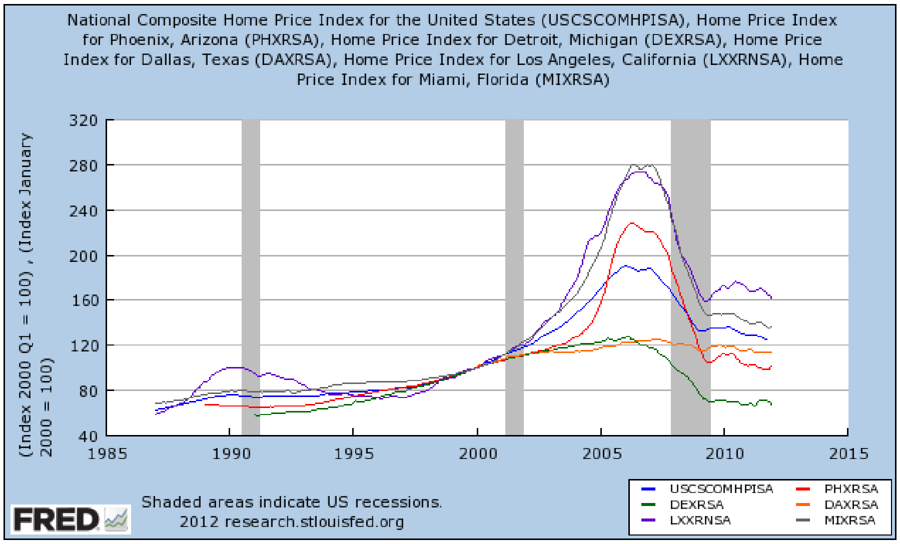


2006: 0.44%
2007: 0.49%
2008: 0.33%
2009: 0.39%
2010: 0.40%

Here, it is important to understand that this comment is not making the case that Texas was unaffected. Rather it is arguing that Texas was insulated from the worst consequences of the crises. This comment posits that these numbers might have been higher absent Texas Homestead Law.[83] As previously mentioned, Texas had one of the highest foreclosure rates in the country prior to the foreclosure crisis. However, as the Texas market stayed relatively stable, its rates relative to other chaotic jurisdictions begin to appear much more reasonable.

[83] *See supra* notes 71–75 and accompanying text.

F. *Home Prices*[84]



These data are a perfect example of a bubble: a general picture of home prices increasing dramatically over a short period of time, which is followed by a large collapse in value.[85] Specifically in Los Angeles, Phoenix, Miami, and America in general, this graph is a perfect example of a price bubble.[86] This data begs the question: how did Dallas, and Texas more generally, escape both the overvaluation of home prices (the

[84] The graph is from the FRED data tool service provided by the federal reserve bank of St. Louis. It allows users to create custom graphs using available Federal Reserve data. Fed. Reserve Bank of St. Louis, *Home Prices*, FRED ECONOMIC DATA, https://research.stlouisfed.org/fred2/graph/?graph_id=69951&category_id=0 (last visited Dec. 7, 2012).

[85] *See id.* This is the general trend. This can be seen in the trend lines for the U.S. in general; Phoenix, Arizona; Los Angeles, California; and Miami, Florida. The two exceptions are Detroit, Michigan and Dallas, Texas. In Detroit, there was not a sharp increase in property value followed by a collapse in value. There was merely a collapse in value. Conversely, home prices in Dallas rose slightly, and then dipped slightly. Home prices in Texas remained essentially constant when compared to these other jurisdictions. *See id.*

[86] "A bubble may be defined loosely as a sharp rise in the price of an asset . . . with the initial rise generating expectations of further rises and attracting new buyers—generally speculators interested in profits from trading in the asset rather than its use or earnings capacity." Jeremy J. Siegel, *What Is an Asset Price Bubble? An Operational Definition*, 9 EUR. FIN. MGMT. 11, 11–12 (2003).

formation of the bubble), and the collapse of home values (the collapse of the bubble)?

Logic dictates that, based on the causal factors behind the recent financial crises, Texas should have experienced a drop in home values.[87] To recap: Banks were routinely extending poorly underwritten loans.[88] The riskiness of these loans was not properly evaluated by credit raters.[89] These loans were poured into complex securities, which were incredibly profitable in the short term.[90] This drove up demand for more mortgages.[91] This led to a further incentive to cut loan underwriting corners.[92] Next, houses began to foreclose when adjustable rate mortgages matured.[93] Suddenly, highly leveraged financial institutions that were highly invested in CDOs and credit-default swaps began to collapse.[94] Credit dried up, driving down home mortgage demand.[95] An increasing number of cheap foreclosure properties appeared on the market and drove down home prices.[96] These factors are essentially all national in origin. Texas cannot adequately regulate or prevent the securitization of residential mortgages that are originated in its jurisdiction. Texas cannot stifle the national market forces that drive supply and demand. The data shows that (even in jurisdictions where speculative price bubbles did not form such as Detroit) the prevailing market factors encouraged a price collapse.[97] But the data tells us that: (1) home values in Texas remained relatively stable; (2) foreclosure rates in Texas remained constant; and (3) Texas escaped the most harmful property-related effects of the foreclosure crises.[98] The next step is to try to understand why Texas escaped these consequences.

[87] *Supra* notes 71–75 and accompanying text.
[88] *Supra* part III.
[89] *Supra* part III.
[90] *Supra* part III.
[91] *Supra* part III.
[92] *Supra* part III.
[93] *Supra* part III.
[94] *Supra* part III.
[95] *Supra* part III.
[96] *Supra* part III.
[97] *Supra* part III.
[98] *See supra* notes 71–75 and accompanying text.

V. ESTABLISHING CAUSATION

The data shows that there was a difference between Texas and other jurisdictions.[99] The next logical question is why. From 2000 to 2010, Texas experienced a population boom.[100] Both residential real estate and interest rates were low.[101] All of the prevailing national and international factors that led to the formation of the national bubble existed in Texas.[102] The state-level attitude toward bank regulation was also not different than the federal attitude.[103] Obviously there are other potential explanations than this comment's thesis. For instance, one might argue that the Texas supply market was so inundated with residential real estate that this supply glut prevented the formation of a real estate bubble.[104] In other words, there was so much supply that it kept prices too depressed to affect the mortgage crises. But, this explanation fails. Data shows that there was a substantially similar increase in supply in Texas,[105] Florida,[106] and California.[107] Texas is not unique in its huge supply of residential real estate.[108] It is unique in the way it avoided the explosion in foreclosure rates and price volatility.

One area that is different than the other jurisdictions is homestead

[99] *Supra* Part IV.

[100] *Supra* note 72.

[101] *See supra* note 73.

[102] *See* Norris, *supra* note 74.

[103] *See* Di Lorenzo, *supra* note 50, at 154–55 (noting that "most state legislatures followed the lead of the Congress" in deregulating the financial lending industry).

[104] From 2000 to 2005, data shows that the census region in which Texas is located experienced an increase in new home construction. Federal Reserve Bank of St. Louis, *Privately Owned Housing Starts Authorized by Building Permits: 1-Unit Structures for Texas*, FRED ECONOMIC DATA (last updated Nov. 29, 2012 8:31 AM), http://research.stlouisfed.org/fred2/series/TXBP1FHSA. The phrase "housing starts" (which is the data-point presented in this graph) generally refers to new home construction. *See New Residential Construction*, U.S. CENSUS (June 28, 2012), http://www.census.gov/construction/nrc/.

[105] *See supra* note 104.

[106] Federal Reserve Bank of St. Louis, *Privately Owned Housing Starts Authorized by Building Permits: 1-Unit Structures for Florida*, FRED ECONOMIC DATA (last updated Nov. 29, 2012 8:33 AM), http://research.stlouisfed.org/fred2/series/FLBP1FHSA.

[107] Federal Reserve Bank of St. Louis, *Privately Owned Housing Starts Authorized by Building Permits: 1-Unit Structures for California*, FRED ECONOMIC DATA (last updated Nov. 29, 2012 8:32 AM), http://research.stlouisfed.org/fred2/series/CABP1FHSA.

[108] *See supra* notes 104–107 and accompanying text.

law.[109] More specifically, the way that Texas Homestead Law regulates the secondary lending market in Texas is different than any other jurisdiction. To establish that this difference had an effect on the Texas real estate market, this comment will first establish that secondary liens had an effect on fueling the recent foreclosure crises nationally. Next, it will establish how Texas Homestead Law prevented this effect from occurring in Texas.

A. The Importance and Prevalence of Second Liens

> The largest single problem in the U.S. mortgage market is the number of borrowers who owe more money on their home than it can be sold for. These borrowers with negative equity are exponentially more likely to default than borrowers with zero or positive equity.[110]

A borrower taking out a second lien necessarily decreases the equity in her home. There has been very little scholarship on the effect of second liens during the recent foreclosure crises. However, both the scholarship that is directly on-point and the scholarship related to the crises more generally have pointed out the prevalence of secondary lending.[111] One study concludes that at least 51% of all American homeowners have both a first and a second mortgage.[112] This investigation also found that properties with both a first and a second lien defaulted at a higher rate than properties with only a first lien.[113] Additionally, these borrowers had a combined loan to value (CLTV)[114] that tended to be higher than a corresponding LTV.[115]

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[109] *See supra* note 20.

[110] Goodman, *supra* note 39, at 19.

[111] *See id.* at 20. *See also* Di Lorenzo, *supra* note 50, at 165 ("By the end of 2006, thirty-two percent of home purchase borrowers relied on piggyback [second] loans to finance their purchases.").

[112] Goodman, *supra* note 39, at 21. However, this study only looks at a subset of borrowers, those who received loans from private label lenders. *Id.* Private label loans are mortgages that are not guaranteed by a quasi-governmental agency like Fannie Mae. FREDDIE MAC, *supra* note 66.

[113] *See* Goodman, *supra* note 39, at 21.

[114] Loan to value refers to the ratio of debt to appraised value in a mortgaged property. FREDDIE MAC, *supra* note 66. Combined loan to value refers to the ratio of both primary and secondary liens to the appraised value of a mortgaged property. *Id.*

[115] *See* Goodman, *supra* note 39, at 22 ("The non-performing percentage is much higher on first lines with a second than it is on a first lien without a second. (That's logical; CLTV is the single most important determinant of default.)"). However, this also seems to indicate that the two

Importantly, the Goodman study concluded that the previously referenced 51% estimate was likely on the low side.[116]

It seems strange that such a possibly important contributing factor has escaped extensive study. One possible explanation might be the fact that second liens seem to default at a lower rate than primary mortgages.[117] This finding seems, at first, to be counterintuitive. The study reaching this conclusion notes that a borrower with both a primary and a certain type of secondary mortgage often chooses to let the primary mortgage default before the secondary mortgage.[118] However, this behavior also makes psychological and economic sense.[119] It is similar to a consumer choosing to make a credit card payment over a car payment, or some other longer term obligation.[120] Essentially it all boils down to a single word: liquidity. The consumer is faced with a difficult decision: choosing between short term survival and long term security. On one hand, a house payment allows the consumer to ensure shelter for a specified period of time.[121] However, if the consumer elects against paying the primary mortgage, the immediate consequence will not be homelessness.[122] On the other hand, a consumer

factors may be independent. In other words, it is not just the high CLTV that correlates to higher than normal default rates; it might also simply be the prevalence of second liens. Or, a borrower who has a 95% LTV, but only a single lien, may be less likely to default than a similarly situated borrower (who also has a CLTV of 95%) with both a primary and secondary mortgage. To put it more eloquently:

> [B]orrowers with piggyback second liens tend to default at a higher rate than otherwise—for example, a borrower with a 95 percent LTV on the first lien would be less likely to default than another borrower with a 95 percent CLTV (85 percent LTV on the first lien and 10 percent LTV on the piggyback second lien).

Julapa Jagtiani & William W. Lang, *Strategic Default on First and Second Lien Mortgages During the Financial Crisis*, THE J. OF FIXED INCOME, Spring 2011, at 7, 9.

[116] Goodman, *supra* note 39, at 21 ("Thus, the percentage of first liens backing non-agency deals that have a second mortgage is well in excess of the measured 51%.").

[117] *See* Jagtiani, *supra* note 115, at 9.

[118] *Id.* at 8–9.

[119] *See* Goodman, *supra* note 39, at 28.

[120] *See id.*

[121] Add to this the fact that Banks encourage this behavior by stating that "if [the borrower] want[s] the remaining credit to remain available, timely payment is required." *Id.* Banks encourage payment of the second while stating that the first might be modified. *See id.*

[122] Even in Texas where non-judicial foreclosures (which are necessarily quicker than judicial foreclosures because there is no docket delaying the process) are the norm, it would take a

has the choice of paying a nominal amount to a second lien, like a HELOC,[123] which allows her to retain more cash for her immediate use (because the payment on a HELOC is likely smaller than the corresponding first mortgage loan payment). It also allows her to almost immediately recover most of the payment (less only interest) in the form of an additional withdrawal of revolving credit.[124] The consumer will choose the later in the hope that tomorrow will be a new day with new opportunities.

Thus, the mere presence of a second lien indicates that default is more likely. Additionally, as the second lien and first lien move closer to depriving a homeowner of any equity in her home, default on the first lien becomes exponentially more likely.

B. How Second Liens Helped Fuel the Bubble

These sorts of liens helped fuel the bubble in two ways: (1) by making it more difficult for financial institutions to properly evaluate risk; and (2) by making it much easier for consumers to speculate on the value of their homes.

Commentators generally agree that the risks associated with CDOs were significantly understated.[125] Even mortgages with quality ratings[126]

creditor, at minimum, forty-two days to foreclose on a defaulting consumer. *See* TEX. PROP. CODE ANN. § 51.002 (West 2007 & Supp. 2011). First, a creditor would need to send a notice of default and allow the consumer twenty days to cure. *Id.* Only then could a creditor send a notice of foreclosure. *Id.* And even after this second notice, the soonest a foreclosure could occur would be an additional twenty-one days. *Id.* However, the day of the foreclosure sale cannot be included in the twenty-one day timeframe (which adds an extra day to the calculation). *Id.* Additionally, foreclosures may only take place on the first Tuesday of every month. *Id.* This makes it almost certain that the notice of foreclosure will provide more than twenty-one days' notice. This is because a borrower would need to default exactly forty-two days before the first Tuesday of a month. Additionally, the lender would need to send out notices without any delay.

[123] Or a home equity line of credit. This is a second lien that allows the consumer to borrow against the equity in their home through an open-ended, or revolving, credit line. *See* Jagtiani, *supra* note 115, at 7. The more traditional type of second lien is a closed-end home equity loan, where equity is loaned in a single lump sum. *See id.*

[124] *See id.*

[125] *Supra* note 31 and accompanying text.

[126] Mortgages are given a variety of ratings. The lowest grade mortgages receive is subprime. *See supra* note 66 and accompanying text. Conversely, the highest rated mortgages receive a prime rating. The Prime Mortgage market is a "[m]ain residential mortgage market, which primarily deals with lending business that is highly creditworthy and therefore represents the least

defaulted at significantly higher rates during the crises.[127] It's likely that second liens contributed to this rating difficulty. A borrower who has good credit, and who takes out a second lien, is likely to have her primary mortgage placed in a highly-rated CDO.[128] However, a high CLTV is the single biggest predictor of future default.[129] Taking on a second lien increases CLTV.[130] Thus, the issuance of second liens both increased the likelihood of default and made default more difficult to predict, even with safe borrowers. To briefly reiterate the crises causal factors, the crises involved a complicated relationship between high rates of foreclosures, collapsing home prices, securitized mortgages, and over-leveraged banks.[131] Second liens represent approximately 13.3% of the value of the overall mortgage market.[132] So it is unlikely that they single handedly caused the financial industry to become overleveraged.[133] Additionally, second liens are rarely securitized, which indicates that they didn't have a large impact on the securitization and over-leveraging factors.[134] However, second liens do seem to have a direct impact on default rates and the collapse of home values. For instance, second liens made it more likely that a homeowner was in over her head.[135] This is because any homeowner with both a primary and any type of secondary mortgage is much more likely to have a high CLTV.[136] During the crises, as home values began to collapse and financial conditions became more stressed, such a homeowner was less able to deal with the financial stress of a highly leveraged home. Thus, the prevalence and nature of second liens caused more homes than otherwise

risk of borrower default." *Supra* note 66.

[127] Goodman, *supra* note 39, at 23–24. Goodman noted that in 2004, prime mortgages were current 96.7% of the time. *Id.* Conversely, in 2007 the rate had decreased to 90.25%. *Id.*

[128] Ratings were primarily concerned with creditworthiness. *See supra* note 126 and accompanying text. If a creditworthy borrower used a second lien to extract the equity in a home, this would not be reflected in a mortgage rating.

[129] Goodman, *supra* note 39, at 22

[130] *Id.* at 20.

[131] *See supra* Part III.

[132] Goodman, *supra* note 39, at 25.

[133] However, second liens represent over one trillion dollars of outstanding mortgage debt. *Id.* So they are certainly not insubstantial.

[134] *See id.*

[135] *See id.* ("For properties with second liens, the contribution to CLTV of the 2nd was a larger number than we thought.").

[136] *See id.*

would have to go into foreclosure. As has been discussed, this was a self-perpetuating cycle: as more foreclosures occurred, home prices continued to collapse.[137] Like the banking industry in general, consumers with multiple mortgages were overleveraged, and they were unable to deal with the financial stresses caused by a downswing in the residential real estate industry.

A final important component of the second lien puzzle is the prevalence of HELOC liens. As of 2010, approximately $436 billion of the roughly $1 trillion of outstanding second liens were on the books of the four largest banks.[138] Of that $436 billion, $358 billion of the seconds were HELOCs.[139] One major problem during the crises was rampant consumer speculation.[140] HELOCs are uniquely susceptible to this type of consumer behavior.[141] Thus, because HELOCs were so highly represented during the crises,[142] and because they are so susceptible to consumer speculation, they were also a contributing factor to the crises.

All of this points out that the second lien market had an effect on the most localized factor of the foreclosure crises: home values. Secondary lending affected the foreclosure rates and home values inside of communities. Unlike national and international factors such as securitization, this is an area where state level regulatory policy can have the greatest impact.

VI. ENTER TEXAS HOMESTEAD LAW

Texas homestead law is truly unique.[143] A simple analysis of homestead law in other jurisdictions, followed by a discussion of homestead law in Texas will highlight this fact. Subsequently, this comment will conclude by discussing how the unique nature of Texas homestead law

[137] *See supra* Part III.

[138] Goodman, *supra* note 39, at 26.

[139] *Id.*

[140] *See, e.g.*, Bagwell, *supra* note 4, at 195 ("Sure of ever-increasing home values, Americans started to view their homes as ATM machines.").

[141] *See supra* note 123 and accompanying text. A HELOC loan product that is an open-ended line of credit and that is accessible at will is much more susceptible to "being treated like an ATM" than a closed-end lump sum home equity loan.

[142] *See supra* note 139 and accompanying text.

[143] *See supra* Part II.

helped immunize Texas from experiencing some of the problems created by the prevalence and nature of second liens.

A. Homestead Law in Most Jurisdictions

The following jurisdictions serve as a good example of how homestead law stands in most jurisdictions. They all follow a similar trend: early in the history of the state, they served a similar purpose to Texas homestead law, protecting the home from seizure. However, in all of these jurisdictions, homestead protection has been steadily eroded, either through legislative action or judicial interpretation. As the following examples show, homestead law serves the purpose of providing a debtor some protection from creditors. But clearly none of these jurisdictions have utilized homestead law quite like Texas: as a method to protect consumers from risky lending practices.

1. Michigan Homestead law

Michigan's constitution provides that a "homestead[,] in the amount of not less than $3,500 . . .[,] shall be exempt from forced sale on execution or other process of any court. Such exemptions shall not extend to any lien thereon excluded from exemption by law."[144] The Michigan homestead started out as a Constitutional right that was:

> intended to secure against creditors a homestead to every family in the State. Not as a personal privilege of the debtor which, to be made effectual, would have to be claimed by him—placing him in an attitude to have his motives suspected, but as an absolute right, necessary to the welfare of the household, of which the debtor should not be deprived.[145]

This description could easily have come from a Texas court describing Texas homestead law.[146] However, this original justification has been completely eroded. An important distinction between Texas and Michigan homestead law is the constitutional language. Texas's constitution provides

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[144] MICH. CONST. art. X, § 3.

[145] Dye v. Mann, 10 Mich. 291, 298 (1862).

[146] *See infra* Part VI.B.

an unlimited exemption.[147] Michigan's constitution provides an exemption of not less than $3,500.[148] The legislature has set the homestead exemption at this constitutional minimum of $3,500.[149] However, in the modern context, this amount is relatively inconsequential.[150]

This subtle difference in language shows just how important the constitutional nature of the unlimited exemption provision in the Texas constitution is. This constitutional nature means that it remains impactful regardless of the desires of the Texas legislature or the pressures imposed by lobby groups. Under the Michigan constitution, the state legislature had the ability to water down homestead protection. It took this opportunity, and this action is consistent with most states. However, by constitutionally mandating that any home be exemptible regardless of value, the Texas homestead protection has remained free from such legislative erosion.

Logically "this exemption does not apply to any mortgage on the homestead, lawfully obtained."[151] Absent some such provision, homestead law would effectively prevent a consumer from ever purchasing a home. However, the problem comes from the fact that second liens are statutorily defined as mortgages.[152] This allows a second mortgage to attach to a homestead free of any homestead protection. As has been discussed, unrestricted secondary mortgage lending had an effect on the mortgage crises.[153] Michigan's homestead protection had no effect on the secondary mortgage market in that state.

2. Arizona Homestead Law

Seemingly, Arizona provides a homestead exemption that actually affords a borrower some level of equity protection. It provides an exemption "not exceeding one hundred fifty thousand dollars in value."[154] But, the homestead law in Arizona:

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147 TEX. CONST. art. XVI, § 50.

148 MICH. CONST. art. X, § 3.

149 MICH. COMP. LAWS SERV. § 600.6023(h) (LexisNexis 2004).

150 For instance, it is significantly less than the federal bankruptcy homestead exemption of $21,625. 11 U.S.C.A. § 522 (West Supp. 2012).

151 MICH. COMP. LAWS SERV. § 600.6023(h) (LexisNexis 2004).

152 *See* MICH. COMP. LAWS SERV. § 493.51 (LexisNexis 2008 & Supp. 2012).

153 *See supra* note 4 and accompanying text.

154 ARIZ. REV. STAT. ANN. § 33-1101 (2007).

> is not self-operating, as in some other states. The homestead is not provided for by the Constitution, but is a creature of statute . . . . A person entitled to homestead, however, does not have to claim it, and, if he does not do so, the court cannot and will not declare it a homestead.[155]

Logically, it follows that "[f]rom a review of the Arizona statutes governing homestead exemptions, it is abundantly clear that the exemption may be voluntarily waived."[156] Thus, Arizona Homestead Law does not protect the average consumer from predatory mortgage lending. Practically speaking, allowing a consumer to waive homestead protection is equivalent to allowing a lender to force a consumer to waive such protection (which might be seen as an impediment to the lender's security interest) as a condition to extending credit. It would be a poor business decision for the lender to not take this step. Any reasonable second lien lender would make sure that there was no impediment to its security interest in a piece of property. It would certainly take the simple step of placing a boiler-plate provision in each second lien contract that required the consumer to waive any homestead protection. Thus, Arizona homestead law had no effect on the prevalence or nature of second liens.

3. California Homestead Law

The California constitution states that "[t]he Legislature shall protect, by law, from forced sale a certain portion of the homestead and other property of all heads of families."[157] Using this constitutional mandate, the California legislature has created two types of homestead protections: protection that automatically attaches to the property and protection that must be affirmatively declared by the occupant.[158] "[T]he automatic homestead exemption, applies when a party has continuously resided in a dwelling from the time that a creditor's lien attaches until a court's determination that the exemption applies."[159] The other form of

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[155] First Nat. Bank v. Reeves, 234 P. 556, 559 (Ariz. 1925).

[156] State v. Smith, 628 P.2d 65, 67 (Ariz. Ct. App. 1981) (footnote omitted). *See also In re* Blair, 79 B.R. 1, 2 (Bankr. D. Ariz. 1987) ("There is no fundamental public policy in Arizona which prohibits waiver of the homestead exemption.").

[157] CAL. CONST. art. XX, § 1.5.

[158] *In re* Kelley, 300 B.R. 11, 17–18 (B.A.P. 9th Cir. 2003).

[159] *Id.* (citations and quotations omitted).

"exemption requires that a party record a declaration stating that the residence is the principal dwelling of the declarant or his or her spouse."[160] Additionally, the legislature has capped the exemption at $75,000, $100,000, or $175,000, depending on certain factors (mainly duration and whether the occupant is single or married).[161] This at least leaves the possibility that California homestead law provides a consumer some level of protection.

But, a homestead declaration does not restrict or limit any right to convey or encumber the declared homestead.[162] "The exemptions provided by this chapter or by any other statute do not apply if the judgment to be enforced is for the foreclosure of a mortgage, deed of trust, or other lien or encumbrance on the property."[163]

Essentially, the California homestead protects a person's home from a tort creditor or an unsecured creditor. It seems counterintuitive that the California legislature has chosen to provide homestead protection to a consumer against a nonconsensual creditor.[164] However, consensual creditors may require that a consumer waive any homestead protection. Thus, California homestead law has no effect on the nature or pervasiveness of second liens.

4. Florida Homestead Law

Florida's homestead law is often compared to Texas homestead law.[165] The comparison typically produces an unfavorable review.[166] The basic criticism is that the unlimited homestead exemption allows a wealthy debtor to defraud a creditor with impunity.[167] In fact, on its face Florida law

[160] *Id.* at 17–18 (citations and quotations omitted).

[161] CAL. CIV. PROC. CODE § 704.730 (West 2009 & Supp. 2012).

[162] *Id*. § 704.940.

[163] *Id.* § 703.010.

[164] *See supra* note 161160 and accompanying text. A tort creditor is nonconsensual in that a tortfeasor has no choice in deciding whether or not to interact with the homeowner. Thus, someone who has no choice but to deal with, and potentially be injured by, the homestead occupant might be left remediless. However, the voluntary party has the option of requesting that homestead protection be eliminated.

[165] *See, e.g.*, Rivera, *supra* note 1, at 86.

[166] *See id.*

[167] This criticism is not without validity. *See* Havoco of America Ltd. v. Hill, 197 F.3d 1135 (11th Cir. 1999), *certifying questions to* 790 So.2d 1018 (Fla. 2001), *aff'd*, 255 F.3d 1321 (11th

seems to provide even more protection than its Texas counterpart.[168] Where Texas provides for eight permissible liens,[169] Florida provides for a mere three.[170] These are: a purchase money lien, a tax lien, and a mechanic's lien.[171] However, "the exemption can be waived in a mortgage."[172] While the Florida Supreme Court has made it clear that this protection cannot be waived as to unsecured creditors,[173] what is abundantly clear is that it can, and must, be waived for a secondary lien to attach.[174]

The policy behind the Florida homestead is to "promote the stability and welfare of the state by securing to the householder a home, so that the homeowner and his or her heirs may live beyond the reach of financial misfortune and the demands of creditors who have given credit under such law."[175] This is sound policy, and it is very similar to the policy justifications for most homestead jurisprudence. However, in making this protection waivable, it effectively eliminates it as to any type of second lien.

B. Texas Homestead Law

Thus far, this comment has attempted to point out two things: (1) unchecked secondary lending by financial institutions caused damage to the financial system during the recent financial crisis; and (2) in the four jurisdictions surveyed, the homestead jurisprudence provided no form of

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Cir. 2001). Here, a Tennessee resident paid $650,000 in cash for a home in Florida, which was ruled his homestead. *Id.* at 1019. This transaction occurred three days before a $15,000,000 judgment became enforceable against him. *Id.* The homestead protection applied regardless of any specific intent to defraud creditors. *Id.* at 1028. Outcomes like this spurred a number of amendments to the bankruptcy code in 2005. *See* Howard, *supra* note 2, at 399.

[168] FLA. CONST. art. X, § 4.

[169] TEX. CONST. art. XVI, § 50.

[170] FLA. CONST. art. X, § 4.

[171] *See id*; *see also* Osborne v. Dumoulin, 55 So. 3d 577, 582 (Fla. 2011).

[172] *See* Chames v. DeMayo, 972 So. 2d 850, 852 (Fla. 2007).

[173] *See id.*

[174] There is a possibility that the Texas Supreme Court will take the route that Florida has taken, and make homestead protection waiveable. Currently a decision is pending with the Court under a certified question from the Fifth Circuit about whether a creditor can estop a consumer from claiming a homestead exemption. Allowing such a claim would effectively eliminate decades of carefully crafted constitutional and legislative enactments. Practically, if a mortgage lender could estop a borrower from asserting a homestead right, it would attempt to do so in every case possible. *See In re* Villarreal, 402 Fed. App'x 28 (5th Cir. 2010).

[175] Chames, 972 So. 2d at 853–54 (citations omitted).

consumer protection against secondary liens. Next, this comment will transition to solutions to these problems by discussing the ways in which Texas Homestead Law drove responsible secondary lending practices. Texas Homestead Law does so in a number of ways: (1) it prevents a subsequent second lien from driving CLTV into dangerous territory; (2) it provides consumer protection through other closed-end lien regulation; (3) it regulates HELOCs in a such a way as to make them less like an ATM machine; and (4) it mandates a number of disclosures that help the borrower understand just how serious a second lien is.

Texas homestead law starts and ends with the following constitutional command: "[t]he homestead of a family, or of a single adult person, shall be, and is hereby protected from forced sale, for the payment of all debts except for" eight specifically enumerated liens.[176]

Compared to the other surveyed jurisdictions (and homestead law in general), Texas affords much greater protection. It does not require an express voluntary designation.[177] Instead, "when fixed, it is an estate in land."[178] Homestead character is impressed upon property through the actions of the homeowner, not by the knowledge and words of the homeowner.[179] Once property acquires its homestead status, the property only loses this status if the owner abandons the property.[180]

Additionally, Texas homestead law directly impacts even permissible liens.[181] While it permits mortgages and many different types of secondary liens to attach, it severely restricts the freedom of financial institutions to offer these loans.[182] Additionally, rather than being a hybrid between constitutional protection and statutory application, the Texas homestead protections are almost purely constitutional.[183] Finally, the

[176] TEX. CONST. art. XVI, § 50(a).

[177] *See* Cocke v. Conquest, 35 S.W.2d 673, 678 (Tex. 1931).

[178] *Id.*

[179] *See id.*

[180] *See* Garrard v. Henderson, 209 S.W.2d 225, 229 (Tex. Civ. App.—Dallas 1948, no writ).

[181] *See, e.g.*, Graham, *supra* note 76, at 113; Charles C. Boettcher, *Taking Texas Home Equity for A Walk, but Keeping It on A Short Leash!*, 30 TEX. TECH L. REV. 197, 200–01 (1999).

[182] *See* Boettcher, s*upra* note 181, at 229–31.

[183] Although recently, as the protection relates to home equity lending, Texas has taken a unique hybrid approach: it has become a hybrid of constitutional and regulatory law. *See* Graham, *supra* note 76, at 101 (discussing how certain regulatory agencies now have a constitutional mandate to interpret constitutional ambiguities).

protection is unlimited.[184]

All of this is basic fundamental law. The more difficult question is how did any of this insulate Texas from the real estate bubble? Homestead law very directly regulates the secondary home lending market. Specifically, the 20% equity cap has had the largest effect. This simple, yet direct, method of regulation goes to the heart of the local real estate problem: speculation. The homeowner is prevented from gambling that her equity will never decrease by limiting how much equity she may access.

As previously stated, there is relatively sparse research on the prevalence and importance of second liens. However, one commentator concludes that at least 50% of homeowners had a second lien during the crises years.[185] At the high point of the bubble, the outstanding domestic mortgage debt was roughly ten trillion dollars.[186] The secondary lien market made up roughly 13.3% of this debt, according to some estimates.[187] Effectively, if these predictions are correct, 86.7% of all mortgage debt was spread evenly across all borrowers. However, according to data, at least 51% of all borrowers carried an additional 13.3% of the mortgage related debt burden.[188] If roughly half of the borrowers in America carried an additional trillion dollars of debt, this makes this class of homeowner a much riskier borrower. This is true because this class of borrower was much more highly leveraged. Consequently, they were much likelier to default on their debt.

Homestead law prevents or ameliorates these problems by regulating how leveraged a consumer can become through use of a second lien; regulating and restricting HELOC flexibility; mandating detailed and specific disclosure requirements; and completely preventing a borrower from having more than one second lien at a time.

Additionally, protecting a homestead through regulation of mortgage lending is consistent with the policy objectives of homestead jurisprudence in general. Homestead law in Texas has a threefold purpose: (1) to protect the wife and children of the debtor from losing their home; (2) to protect the debtor from losing his home; and (3) to protect society as a whole by

[184] TEX. CONST. ART. XVI, § 50; TEX. PROP. CODE ANN. §§ 41.001–08 (West 2000).

[185] Goodman, *supra* note 39, at 20.

[186] *Id.* at 25.

[187] *Id.*

[188] *Id.*

preventing the debtor and his family from becoming dependent on others after losing their home.[189] Regulating second liens certainly helped keep homeowners and their families in their homes by helping to limit foreclosure rates.

1. The 80% Equity Cap

Texas homestead law prevents a homeowner from tapping into equity beyond the 80% cap.[190] In other words, the most equity that can be extracted through a second lien is 80% of a home's value. This 80% equity cap also effectively prevents a homeowner from becoming incredibly overleveraged through the use of a second lien. While a homeowner can certainly exceed this 80% LTV ratio with a primary lien, she cannot do so through the combination of a primary and secondary lien.[191] The data shows that a homeowner who has a secondary lien that is higher than the primary is more likely to default than a simple primary only borrower (or a borrower with a second that is smaller than her first).[192] For a borrower to hold a subsequent lien that is higher than her primary lien under Texas homestead law, she would need to have a 61% equity stake in her home. This would allow her to have a primary mortgage worth 39% of her home's value, and a second mortgage worth 41% of her home's value. Most homeowners do not possess this much equity.[193] Thus, homestead law effectively limits the prevalence of this risk factor.

2. Other Important Regulatory Provisions

The 80% equity cap is not the only restriction that has a relevant regulatory effect on some of the previously discussed causal factors. For instance, some other relevant regulatory restrictions are that: only one

[189] Bridget M. Fuselier, *Home Sweet Homestead? Not if you Are Subject to a Mandatory Homeowners' Association!*, 42 ST. MARY'S L.J. 793, 797 (2011) (citing 1018-3rd St. v. State, 331 S.W.2d 450, 453–54 (Tex. Civ. App.—Amarillo 1959, no writ)).

[190] TEX. CONST. art. XVI, § 50(a)(6)(B). *See also* Graham, *supra* note 76, at 78–79.

[191] *Supra* note 190.

[192] Goodman, *supra* note 39, at 23–24.

[193] The average homeowner has a 38% equity stake in her home. Associated Press, *American Homeowners' Equity Nears Record Low*, AUGUSTA CHRON., June 9, 2011, http://chronicle.augusta.com/ life/home/real-estate/2011-06-09/american-homeowners-equity-nears-record-low.

secondary lien can be placed on a home at a time;[194] only one new lien may extended per year;[195] and home equity loans are precluded from having balloon payments or negative amortization rate structures.[196] All of these restrictions also help keep LTV/CLTV at a more manageable level. Additionally, these are only some of the multitude of restrictions and regulations imposed on home equity lending by the constitution.[197]

Another important protection is the non-recourse nature of a home equity loan.[198] This helps ensure that risk is properly evaluated. A home equity loan is almost always going to have second lien position. A home equity loan would be in first lien position only if the homeowner did not have a purchase money mortgage. Most homeowners have a purchase money mortgage. Non-recourse lending means that a defaulted home equity loan may only be satisfied by foreclosure.[199] This means that a lender has an incentive to ensure that a home is properly valued because the house is the only way that a lender can get paid in the event of a default. Thus, a lender might avoid extending a lien in a volatile market. And, a lender might take extra care to ensure that the value secured by a home equity loan is actual solid equity.

A further restriction on lenders is the 3% fee cap.[200] Basically, this regulation limits the initial fee that a lender may charge to three percent of the original principal value of the loan.[201] This restriction incentivizes safer lending practices. This is because it limits the amount that a lender may charge up front. In turn, this encourages a lender to make up for this lost revenue in some way. One obvious way to do so is to ensure that these loans have lower default rates. A lower default rate leads to an increase in interest payments, and more profit. Thus, this is an incentive to extend safer, or less speculative, home equity loans.

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[194] TEX. CONST. art. XVI § 50(a)(6)(K). *See also* Graham, *supra* note 76, at 79.

[195] TEX. CONST. art. XVI § 50(a)(6)(K); TEX. CONST. art. XVI § 50(a)(6)(M)(iii). *See also* Graham *supra* note 76, at 79–80.

[196] TEX. CONST. art. XVI § 50(a)(6)(L)(i). *See also* Graham, *supra* note 76, at 84.

[197] Many of the regulations and restrictions are outside of the scope of this article. For an excellent description of all of the different regulations on home equity lending imposed by homestead law, *see generally* Graham, *supra* note 76.

[198] TEX. CONST. art. XVI § 50(a)(6)(C).

[199] *See* Graham, *supra* note 76, at 77.

[200] TEX. CONST. art. XVI § 50(a)(6)(E).

[201] *See id; see also*, Graham, *supra* note 76, at 78.

One area that was heavily criticized during the financial crises was the complicated rate and payment structures.[202] The phrase "balloon payments" has become a sort of vulgar phrase, similar to credit-default swaps.[203] Essentially, this occurs when an initial teaser rate is offered.[204] After a specified period of time, this initial rate balloons, or increases substantially.[205] These types of payments are completely prevented in a home equity loan.[206] The problem during the crises was that a homeowner purchased a home, or borrowed against a home, with a faulty understanding of the eventual balloon payment.[207] When the homeowner was unable to make the balloon payment, foreclosure often resulted.[208] This problem, at least as to home equity lending, is prevented by homestead law.

Another exotic rate structure involves negative amortization. This involves extending a loan that includes payments that do not even cover the interest on a loan.[209] It logically only makes sense if a homeowner believes that the value of a home will increase more rapidly than the interest rate. As with balloon payments, this type of rate structure is expressly prohibited by homestead law.[210]

Some might ask what business the state has in preventing a consumer from getting in over her head. The easy answer is that once a consumer gets in over her head she becomes the state's responsibility anyway.[211] There is also a more complicated and contextually important answer. The state has spent the last half a century perpetuating the myth that property was the soundest investment a person could make.[212] This myth

[202] *See* Graham, *supra* note 76, at 84.

[203] *See id.*

[204] *See id.*

[205] *See id.*

[206] *See id.*

[207] *See id.*

[208] *See id.*

[209] *See id.*

[210] *See id.* at 85.

[211] In fact, this is essentially the policy justification for all homestead exemptions in the first place. *See supra* note 189 and accompanying text. If allowing the exception in the first place is sound public policy then it must also be sound policy for homestead law to regulate secondary lien products.

[212] *See* Bagwell, *supra* note 4, at 195 ("The fact that Fannie Mae and Freddie Mac were on a mission, spreading homeownership as much as possible, added nourishment to the contagion.").

helped fuel the bubble that nearly bankrupt the entire financial industry. The perpetuators of this myth have a responsibility to ensure that this catastrophe is not repeated. Requiring responsible lending practices helps safeguard against this exact eventuality. While there may be a higher up-front cost for the financial industry, the payoff is more than worth any hypothetical costs imposed by additional regulation.[213] Additionally, this type of regulation helps both consumers and lenders because lenders also lose a great deal in the event of a defaulted second lien.[214]

3. Disclosure and Formality Requirements

There are a number of provisions and interpretations that help prevent speculative borrowing by ensuring that the borrower understands the seriousness of the loan she is accepting. This might make a borrower less likely to "view their homes as ATM machines."[215] For instance, loans can only be closed at financial institutions, title agencies, or a lawyer's office.[216] There are "plain language" notice requirements.[217] These types of liens can only be extended by certain types of financial institutions (banks, credit unions, etc.).[218] Additionally, a borrower has a right of rescission for several days after the loan has been extended.[219] Next, there is a twelve-day "cooling off" period between when the loan is offered and when the closing can occur.[220] Finally, a borrower has to receive copies all documents related to the loan at closing.[221] All of these requirements underscore the formality

[213] Such costs are almost invariably inflated in any case. *See generally* Richard W. Parker, *Grading the Government*, 70 U. CHI. L. REV. 1345 (2003) (arguing that highly publicized and politically charged regulatory "cost-benefit" analyses, which claimed to "conclusively" establish how unreasonably burdensome regulation was to industry, were typically nothing more than conjecture and speculation).

[214] *See* Special Comment, *Second Lien Debt, Historical Recovery*, MOODY'S CORP. FIN., Sept. 2007, at 1, http://www.moodys.com/sites/products/AboutMoodysRatingsAttachments/2007000000441703.pdf (noting that the collection rates for defaulted second liens are vastly inferior to collection rates of defaulted primary liens).

[215] Bagwell, *supra* note 4, at 195.

[216] *See* Graham, *supra* note 76, at 77 ("The legislature . . . intended this provision to protect unsophisticated borrowers from having shady lenders pressure borrowers in their own homes.").

[217] *See id.* at 80.

[218] *See id.* at 74–75.

[219] *See id.* at 82.

[220] *See id.* at 81–82.

[221] *See id.* at 83.

and importance of taking out a second lien. Essentially, they require that: (1) the lender tell the consumer that borrowing against a home's equity is serious; (2) the loan be extended with a certain amount of formality; and (3) the decision be made after at least some amount of personal reflection.[222] If a consumer is forced to take twelve days to consider the loan, have three days to rescind the loan, hear about how serious the loan is, receive all documentation related to the loan, and sign the loan in a formal atmosphere, they might be less likely to treat the equity accessible through the loan as an "ATM machine."

Additionally, a lender must have the voluntary consent of the homeowner and any spouse of a homeowner.[223] This is true regardless of whether the spouse has any ownership interest in the home.[224] This might help ensure that a family unit has a meaningful conversation about whether to borrow against the equity in their home before taking out an equity loan. It also helps curb speculative behavior on the part of one family member.

Disclosure requirements are not the only method used by Homestead law to ensure that a homeowner knows how serious a home equity loan is. A further set of regulations fall along the lines of formalizing this type of lending. For instance, only certain types of lenders may extend home equity loans.[225] These approved lenders are banks, savings and loan associations, savings banks, credit unions, lenders licensed by the Texas Office of Consumer Credit Commissioner, seller-financiers of individual homestead property, certain close relatives of the homestead owner, or Texas regulated mortgage brokers.[226] Aside from the close relative lender and the seller-financier, all of these lenders share one thing in common: they are regulated financial institutions.[227] Limiting (for the most part) home equity lending to regulated financial institutions helps ensure that a loan is being extended by a formal lender. This also helps ensure that a consumer understands how serious the transaction is.

Disclosure and formality requirements help underscore how serious the second lien transaction is. Thus, consumers are less likely to use second

[222] *See supra* notes 219–221 and accompanying text.
[223] TEX. CONST. art. XVI § 50(a)(6)(A).
[224] *See id.*
[225] *See id.* § 50(a)(6)(P).
[226] *Id.*
[227] *See id.*

liens in an abusive or speculative fashion.

4. HELOC Regulation and Consumer Speculation

Consistent with the effects of the disclosure requirements, the home equity provisions related to HELOCs are also an effective method for preventing consumer speculation on the value of their homes. In the vast majority of jurisdictions, a HELOC turns the equity in a home into a revolving line of credit.[228] An easily accessible HELOC makes it easy and painless to drain a home of equity.[229] This equity accessibility brings both benefits and risks. On one hand, many Americans use HELOCS to treat their homes like credit cards by using them to make mundane, every-day purchases.[230] On the other, it allows homeowners to turn equity (normally a very illiquid investment) into an easily accessible and liquid asset at a relatively low cost.[231]

A HELOC under Texas homestead law is a totally different animal. A lender is precluded from using credit or debit card like products to give a consumer access to this equity.[232] A lender is also prohibited from using preprinted checks (or solicitation checks) and other similar devices.[233] Additionally, a consumer must withdraw the equity in $4,000 increments.[234] The justification for this is that borrowing against your home is a very serious decision.[235] Another important impact is the limit-on-future-advances provision.[236] This provision trades in equity liquidity for a cap on

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[228] *Home Equity Line of Credit*, THE TRUTH ABOUT MORTGAGE, http://www.thetruthaboutmortgage.com/ home-equity-line-of-credit-heloc/ (last visited Dec. 7, 2012) ("In other words, a HELOC is a lot like a credit card.").

[229] *See id.*

[230] *See id.*

[231] *See id.*

[232] *See* Graham, *supra* note 76, at 87.

[233] *Id.* However, this has led to litigation over the construction of "preprinted [solicitation check] and other similar device" portion of this prohibition. *See id.* This is another example of how states that choose to implement homestead law provisions might take advantage of Texas's experience. A state may look at how the courts and the legislature have resolved these issues and place definitions in their codes or delegate interpretive power to a regulatory agency, like Texas has.

[234] *Id.*

[235] *See id.*

[236] *See id.* at 87 ("After the initial advance from the lender to the borrower under a HELOC,

casual equity stripping.[237] A lender is also prevented from charging cash advance fees and unilaterally amending the extension of credit.[238] The scheme also changes the line of credit structure of the loan.[239] Under the two-staged Texas structure, there are two periods of activity: the draw stage and the repayment period.[240] The two periods are mutually exclusive. Meaning during the draw phase you can draw up to your permissible limit. Next, during the repayment phase you must pay down what you drew, and the payment must be made in equal installment payments. Finally, the 80% cap and one second at a time rules also apply to HELOC loans.[241]

Again it's important to put this area of law in context. Some commentators estimate the prevalence of these types of liens at roughly 47%, with a disproportionate share sitting on the books of the four largest banks in the United States.[242] The Texas legislature well understood the seriousness of this type of lending.[243] Thus, when it altered the Constitution to allow this type of lending, it created a very complicated and regulated method of extending home equity loans.

Homestead regulation of HELOC lending has had the following (non-exclusive) effects: decreasing borrower liquidity; increasing understanding of the gravity of loan; decreasing the available pool of borrowers; decreasing a lender's exposure to risk; and incentivizing lenders to seek most of their profit from interest payments. For instance, requiring that a consumer take out at least $4,000 makes it clear to the consumer that the decision has serious ramifications.[244] The consumer is less likely to casually dip into her equity.

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the constitutions contemplates that the lender not give any more advances to the borrower until the borrower pays the HELOC down to fifty percent of the value of the homestead property at the time the HELOC was originally extended.").

[237] Practically, lenders tend to avoid this equity flexibility problem by simply limiting most HELOCs to 50% of the value of the home, thus ensuring that "the borrower can make subsequent draws up to the original maximum amount extended without ever triggering this prohibition." *Id.*

[238] *Id.* at 87–88.

[239] *See id.*

[240] *See id.*

[241] *Id.* at 86–87.

[242] *See supra* notes 138–141 and accompanying text.

[243] This is underscored by the fact that this type of second loan took even longer than traditional closed-end seconds to become constitutional. HELOCs were impossible under Texas law until 2003. Graham, *supra* note 76, at 89.

[244] *See id.* at 87.

As an illustration for how this scheme works, consider the following hypothetical: a potential HELOC borrower (Ann) owns her home outright. It is valued at $100,000. She can only draw up to $80,000 under her HELOC. Additionally, if she draws up to $80,000, she cannot reenter a draw phase until she pays off $40,000 of the loan. Further, she can only take out advances in $4,000 increments. After the draw period closes, she must pay off her entire draw amount in equal installments. Ann takes out a HELOC. The bank decides to extend a line of credit of $40,000, to ensure that the line is as liquid as possible. Ann uses $20,000 to add a pool to her home. Several months later, Ann starts making $1,000 payments. She will pay off the loan in 20 months. She draws an additional $4,000 dollar extension. Several months later, she is paying an additional $200, for a total of $1,200. At this point she only has $16,000 left to draw on, but at least $76,000 in equity.

Obviously, in the above hypothetical, Ann's equity is much less liquid than it would be absent any restrictions. If Ann was not subjected to these restrictions, she could draw up to $100,000 in as many incremental withdrawals as she wanted. However under Texas law, Ann cannot just treat her home like an ATM. Each extension must be a significant amount of money. Additionally, payment cannot be deferred. Further, a borrower cannot simply make minimum, interest-only payments. A borrower has to be cognizant of limits, as borrowing caps might freeze future liquidity. As the hypothetical shows, Ann would need to be much more careful and reflective when she uses her loan to preserve future liquidity. Thus, it feels much more serious to her.

These restrictions also take a HELOC out of the hands of many risky borrowers. A borrower who owns more than 20% of her home is inherently safer than a borrower who owns less than 20%. Thus, the borrowers who can qualify for a HELOC are less likely to default on the HELOC. Consistently, there is a smaller risk for lenders in extending a HELOC.

Restrictions on the unilateral change in interest structure and the limitation of draw fees also limit the short-term profitability of the loan. Consequently, these and other restrictions incentivize a borrower to increase long term profitability. If a lender cannot make as much up front in fees and complicated rate structures, the lender must ensure that it will make more in interest rate payments. Thus, the lender is incentivized to ensure that borrowers are more likely to make as many interest payments as possible.

The Texas legislature decided to make a HELOC less flexible.

However, this had the effect of making a HELOC a safer loan product for both the consumer and the lender. Thus, when HELOCs in other states started to fold in record numbers, Texas HELOCs were much less likely to implode. This limited the number of HELOC-caused foreclosures, and helped keep home prices more stable.

C. Texas Law as a Model for Other Jurisdictions

Texas homestead law can be broadly applied in other jurisdictions. While one might argue that the constitutional aspect is very important in insulating the consumer protection aspects of the law from erosion through lobbying efforts, it has also caused problems to the financial industry.[245] It is not easily adjusted, as the ten year history of home equity lending has shown.[246] However, home equity law in Texas has arrived at a workable compromise.[247] The cure provisions contained in the scheme, and the delegation of interpretive authority to various regulatory agencies, provide the scheme with much needed flexibility, and an ability to retain the consumer protection aspects of the regulatory scheme without completely preventing the home equity industry from existing.[248] As this comment has shown, there are good reasons to limit home equity lending. However, home equity lending, if conducted responsibly, can provide much needed liquidity to a homeowner.[249] As previously mentioned, a person's home is often the biggest asset a consumer purchases during her life.[250] It often contains a significant portion of the consumer's savings.[251] Using home equity to provide access to those savings is a very justifiable goal.[252] But, short-sighted consumer and lender speculation can have very serious consequences.[253] The Texas homestead scheme served the regulatory function of helping to prevent a significant amount of consumer and lender

[245] *See id.* at 71.

[246] *See id.*

[247] *See id.* at 112–113.

[248] *See id.* at 99–101.

[249] *See* Boettcher, *supra* note 181, at 200.

[250] *See Bricks and Slaughter*, ECONOMIST, Mar. 3, 2012, at A Special Report on Property 4.

[251] *See id.*

[252] In fact, in the late 1990's, there was over $123.4 Billion in home equity in the state of Texas alone. Boettcher, *supra* note 181, at 200.

[253] *See supra* Part III.

speculation. This helped insulate the Texas residential real estate market from the rise and collapse of home values and the wave of residential foreclosures, which many other jurisdictions experienced. This legislative scheme has a place moving forward in helping to prevent the formation of a second real estate bubble.

The Texas homestead law's relationship to home equity law is, to say the least, lengthy.[254] When it was instituted in 1997, it constitutionalized what was effectively an incredibly complex regulatory scheme.[255] Typically, when a legislature regulates an entire industry, or a segment of an industry, it creates enabling legislation and delegates some level of authority to an agency. Here, the legislature simply placed the entire scheme in the constitution. For a number of years, the apparent remedy for a violation of this regulatory policy was a complete failure of the lien.[256] However, this harsh result has been softened recently.[257] Now, under the current law, the lender has the opportunity to cure many defects.[258] With these cure provisions in place, Texas homestead law currently strikes a good balance between protecting homeowners and not over-regulating lenders.

Even taking the constitutional nature out of the equation, some of the regulatory policies might be easily adopted by other jurisdictions. Imposing an equity cap on home equity borrowing is effective and simple. And a state need not adopt an 80% cap to retain efficacy. Other jurisdictions might try a 90% cap, or an 85% cap. Additionally, another simple and effective procedure might be limiting the number of second liens available to a consumer at a time. The previously discussed notice and disclosure requirements are also relatively straightforward. Burdens from these disclosure requirements would most likely be minimal because these types of requirements already exist with primary mortgage lending. Further, adopting some of the restrictions related to HELOCs might also be beneficial. Accessing equity in your home is important. But it doesn't have to be as easy as using a credit card. Many of these policies are straightforward and unambiguous. While there are a great deal of additional

[254] *See* Graham, *supra* note 76, at 71.
[255] *See id.* at 73.
[256] *Id.*
[257] *See id.* at 89.
[258] *See id.* at 99–104.

restrictions that have created burdens on financial institutions, the decade and a half of struggles in Texas with these provisions can provide other jurisdictions with an opportunity to learn from Texas's mistakes.

VII. CONCLUSION

Texas homestead law prevents existing home-owners from using secondary liens to over-extend themselves, which might increase their CLTV to dangerous levels. HELOC regulation and disclosure requirements also help prevent consumers from treating their homes like ATM machines. Consequently, Homestead law served as a financial "herd immunization" during the crises, which helped prevent the spread of the foreclosure contagion in Texas. This preventative form of regulatory policy should be further analyzed and more widely adopted.

VIII. APPENDIX—REALTYTRAC'S FORECLOSURE ACTIVITY REPORT DATABASE

This data comes from the foreclosure activity report database, which is gathered by RealtyTrac. It is from the third quarter of each listed year, which is a period that runs from July through September.

2006

State	Population	Households	One per Household	Percent of Households	NOD	LIS	NTS	NFS	REO	Total
AZ	5,745,674	2,435,428	325.46	0.31	0	749	0	6,477	257	7,483
CA	35,841,254	12,812,472	342.14	0.29	31,928	0	4,804	0	716	37,448
FL	17,366,593	8,013,587	198.88	0.50	0	34,078	0	5,363	852	40,293
MI	10,093,398	4,432,001	214.46	0.47	473	0	11,873	0	8,320	20,666
TX	22,517,901	8,846,812	224.95	0.44	454	0	34,861	0	4,013	39,328

2007

State	Population	Households	One per Household	Percent of Households	NOD	LIS	NTS	NFS	REO	Total
AZ	5,953,007	2,516,563	110.53	0.90	73	0	19,200	0	3,496	22,769
CA	36,154,147	12,993,870	87.73	1.14	103,043	0	24,366	0	20,699	148,108
FL	17,768,191	8,260,451	95.40	1.05	0	67,113	197	13,802	5,471	86,583
MI	10,100,833	4,478,354	102.20	0.98	8,619	0	20,539	0	14,661	43,819
TX	22,928,508	9,025,865	204.27	0.49	792	0	31,996	0	11,397	44,185

2008

State	Population	Households	One per Household	Percent of Households	NOD	LIS	NTS	NFS	REO	Total
AZ	6,166,318	2,605,283	64.07	1.56	86	0	26,402	0	14,175	40,663
CA	36,457,549	13,174,378	54.09	1.85	102,316	0	57,257	0	83,984	243,557
FL	18,089,888	8,533,419	61.91	1.62	0	89.229	194	29,669	18,748	137,840
MI	10,095,643	4,513,726	126.26	0.79	9,122	0	12,022	0	14,605	35,749
TX	23,507,783	9,224,361	303.28	0.33	415	0	17,263	0	12,737	30,415

2009

State	Population	Households	One per Household	Percent of Households	NOD	LIS	NTS	NFS	REO	Total
AZ	6,338,755	2,667,502	50.88	1.97	29	0	37,760	0	14,639	52,428
CA	36,553,215	13,308,346	46.41	2.15	129,032	1	105,448	0	52,286	286,767
FL	18,251,243	8,718,385	50.13	1.99	1	106,953	1	44,655	22,313	173,923
MI	10,071,822	4,527,655	102.01	0.98	15,934	0	12,226	0	16,223	44,383
TX	23,904,380	9,432,672	258.05	0.39	158	4	23,075	0	13,317	36,554

2010

State	Population	Households	One per Household	Percent of Households	NOD	LIS	NTS	NFS	REO	Total
AZ	6,500,180	2,722,725	54.54	1.83	40	0	31,416	0	18,469	49,925
CA	36,756,666	13,393,878	63.40	1.58	88,303	0	76,109	0	46,845	211,257
FL	18,328,340	8,800,294	52.40	1.91	0	64,280	0	67,295	36,373	167,948
MI	10,003,422	4,535,323	77.65	1.29	19,420	0	20,469	0	18,520	58,409
TX	24,326,974	9,598,579	247.48	0.40	64	0	22,722	0	16,000	38,786