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Mary Jo Mullan  
Vice President, Programs  
F.B. Heron Foundation  
100 Broadway, 17th Floor  
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Dear Ms. Mullan:

It was a pleasure to speak with you in October and to read about the Heron Foundation's core values and programs. You asked me to think about an intriguing hypothetical: If I were charged with directing the Heron Foundation's programs, how would I shape the strategies?

Families across America are working harder than ever and slipping behind. This year one in every seven families will deal with a debt collector. Almost as many people will file for bankruptcy as will graduate from college. Half of all Americans say they are worried that if they became sick or injured that they could not pay their medical bills. People across a broad economic spectrum, from the poor to the low income to the middle class, are struggling to create and retain wealth in today's economy.

Help is needed, and Heron is uniquely positioned to provide that help. It could be the foundation that leads the way by providing backing for new ways for families to grapple with the economy of the 21<sup>st</sup> century, and pointing the way for the larger non-profit community to help working Americans build wealth.

### **Section 1: The Problem**

In order to have the greatest possible impact, a group with resources and a will to help should start by developing a strong, independent and nuanced view of the

economic problems facing families in America. By truly understanding the problem, a group such as the Heron Foundation will be uniquely positioned to target its grants to the highest impact. This section outlines what I see as the three most significant barriers to wealth creation among working today's Americans.

**Fixed costs overwhelming the family budget, with no room to save.** Never before have families worked so hard just to break even, and the struggle has worsened considerably for working and middle-class Americans over just a single generation. What families pay for housing, health insurance, child care, transportation and taxes has increased dramatically over the past thirty years. For those lucky enough to have employer-sponsored health insurance, inflation-adjusted out-of-pocket costs are up 74%. For those without health insurance or those buying it on the open market, costs have risen even faster. Childcare has become another unavoidable cost as working families increasingly send both parents into the workforce. Transportation costs are on the rise, as average inflation-adjusted expenditures have climbed 22% over the past generation. The cost of homeownership has risen sharply in many areas. Inflation adjusted mortgage payments for an average couple with children have shot up 76% over the past generation. The housing costs are particularly worrisome because of the substantial number of families who are currently within the "teaser rate" period on home mortgages that were taken out or refinanced within the past two years. In 2007, about 11% of all outstanding mortgage debt will reset, and millions of homeowners are seeing their mortgage payments increase substantially.

All in, we estimate that the total fixed costs for a typical family with young children, including taxes, mortgage, child care, transportation, and health insurance, has increased by a whopping 165% over the past generation. As a result, even a solidly middle-class family has less money for food, clothes, school expenses, entertainment and -- most significantly -- savings and long-term wealth building. Even more important, if anything goes wrong-- a layoff, an illness, a divorce or separation -- they cannot cut back quickly. When a woman loses her paycheck, she typically stops eating out or buying new clothes, to help cut expenses. But there is no way to return an extra bedroom to the mortgage lender or "cut back" on health insurance costs. These expenses are big and fixed, so that families find that they have no flexibility in their budgets when they need it. With no ability to cut back, and no savings in the bank, families are finding that even a modest financial hurdle can leave them financially devastated.

**Rising risk of financial calamity.** At the very moment that family budgets are strained even during ordinary times, the risk that something would go seriously wrong has risen sharply. In his book, *The Great Risk Shift*, Jacob Hacker calculates that the average drop in income in the 1970s was 25%; today it is 40% of family income. And those drops come faster. Today's families face a risk of income loss that is about two and a half times of that faced by a family thirty years ago.

Other forms of risk have increased as well. The number of families with no health insurance has risen sharply over the past decade leaving about 46 million people with no coverage at all. In addition, even families lucky enough to have health insurance are learning that insurance coverage can be inadequate for serious illness or accidents. Since 2000, approximately 5 million families have filed for bankruptcy in the financial aftermath of a medical problem. Three-quarters of those families – about 3.75 million – had health insurance at the onset of their medical problems. Co-pays and uncovered expenses for drugs, physical therapy, and medical supplies can leave even a family with insurance in a deep financial hole. Those in bankruptcy are just the most visible edge of the problem. According to the Commonwealth Fund, 77 million Americans age 19 and older – nearly two of five (37%) adults – have difficulty paying medical bills or have accrued medical debt within past three years.

Families also break apart. The psychological blow of divorce is well recognized, but its financial impact – particularly among low and moderate income families – can be devastating. Federal Reserve data revealed that one in eleven single parents are more than 60 days past due on their bills (compared with one in thirty married couples without children). Single mothers are also more likely to lose their homes. When we analyzed unpublished data from the Department of Housing and Urban Development, we found that among single parents who had purchased a home in the 1980s with a mortgage backed by the Federal Housing Administration (FHA), more than one in ten had lost their home by 2002 because of foreclosure. The data about who will be hurt from the subprime mortgage meltdown are just now coming in, but no one thinks the news will be good for single parents.

These three reasons – job loss, illness, or family breakup – account for nearly 90 percent of bankruptcies. Approximately twelve million families have faced financial ruin in the past decade alone. And while these problems have always been with us, the risks are increasing. More important, just as the world is getting riskier, families' ability to cope is worsening. Thus, a job loss or illness that might have once posed a minor bump in the road, easily managed with savings, has translated into a huge debt burden, a burden that puts the family at risk for complete economic collapse.

**Predatory debt.** Today's families face a much riskier financial marketplace than did their parents a generation ago. From Colonial times through the late 1970s, the consumer credit market was tightly regulated, and state usury laws protected Americans from high interest rates and hidden fees. Mortgage practices were scrutinized, and default rates were low. Just a generation ago, car loans averaged less than three years, and car leases didn't even exist. Credit cards were unavailable to anyone without a sterling credit rating. And payday lending, with its triple-digit interest rates, was unthinkable to anyone outside of organized crime.

As a result, a typical family with an average income could pretty much rely on the fact that if they were approved for a mortgage or car loan, that meant they could actually afford the loan.

Today every aspect of consumer lending has changed. Redlining, which once kept families in poorer neighborhoods from accessing mortgages and other forms of credit, has been replaced by greenlighting – flooding poor and minority neighborhoods with the worst financial products. A family living in an *upper* income African American neighborhood is twice as likely to end up with a subprime mortgage as a family living in a *low-income* predominately white neighborhood. Mortgage brokers often charge families a “yield spread premium” to steer them into worse products. How they decide who gets the worst products was revealed in litigation against Citibank’s mortgage subsidiary: “If someone appeared uneducated, inarticulate, was a minority, or was particularly old or young, I would try to include all the [additional costs] CitiFinancial offered.”<sup>1</sup>

Even the most careful families are constantly bombarded by credit offers that often range from incomprehensible to deceptive. According to the Wall Street Journal, credit card agreements that averaged one page in the late 1970s are now 30+ pages long. Last year, credit card issuers took in about \$90 billion dollars in interest and fees from families struggling to make ends meet.

Payday lenders have peddled short-term cash to millions of people. For about one in ten families that visit a payday lender, the result is a nightmare of fees and interest rates that often hit 2000% or more.

Car loans now stretch as long as eight years, resulting in higher interest and fees taking up a far higher proportion of transportation costs. Many families remain “upside down” on their car loans for as long as four years – owing more on the car than it would be worth if it were sold. Not only does this mean higher costs, it also means higher risks. If a family gets into financial trouble, selling the car is often not even an option for cutting costs.

In the midst of deregulation of consumer lending products and the aggressive marketing of consumer financial products, the credit industry lobbied hard to reduce bankruptcy protection for families in trouble. The move was successful. In 2005, Congress passed laws to make bankruptcy more expensive and more complex, pricing it out of the reach of the poorest families that otherwise could have used it as a tool to cope with overwhelming debt.

It is important to note that this is not simply business as usual. These debt products are ever more complicated and are deliberately designed to obfuscate their real terms and lure in unsuspecting customers. Debt loads among middle and working-class Americans have increased to record levels. The fastest rise has been among families in lower income groups. The families that carry this debt are vulnerable to any financial hiccups, and, more importantly, they are not building toward long-term wealth creation.

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<sup>1</sup> Paul Beckett, “Citigroup’s ‘Subprime’ Reforms Questioned,” *Wall Street Journal*, July 18, 2002.

**Summary of the problem:** A generation ago, the core impediment to wealth-building for working families was lack of capital and lack of opportunities to build wealth. Today, the situation has changed dramatically. Capital abounds, as do opportunities to build wealth. The profound threats to wealth-creation are more subtle, but also more dangerous. First, families are stretched to the limit with basic expenses, and have little left over to put towards wealth building. Second, high fixed costs make it far more difficult to cope with even small financial setbacks. Third, the risk that something will go wrong and obliterate any wealth that might have been created has skyrocketed. Last, an increasingly predatory and deceptive credit industry is systematically draining away whatever financial advances millions of families can make.

## Section 2, Creative Solutions

### Capital.

The old problem – lack of access to capital – has largely disappeared. Instead, the new problem is lack of access to affordable capital. Or, perhaps more importantly, an abundance of unaffordable capital has pushed most providers of “good” capital to the margins, so that it is profoundly difficult for consumers to find good capital, or even to know the difference. An organization aimed at making families more economically secure should focus on finding new and innovative ways to 1) expand access to low cost capital, and 2) to help consumers make better choices.

### Areas for research:

It is well documented that millions of families are systematically steered into paying far more for their credit than their credit scores imply they should. A Fannie Mae study showed, for example, that about half of the families with high-cost subprime mortgages would have qualified for lower-cost prime mortgages.<sup>2</sup> The differences would cost these families tens of thousands of dollars, and, in some cases, drive them out of their homes. And yet, surprisingly little is known about *why* one of the largest free capital markets would be failing so miserably for critical populations. Heron could play a unique role in supporting research that would answer these critical questions:

- It is well-known that certain communities – particularly African American and Latino neighborhoods, along with the elderly and enlisted military personnel – are singled out for predatory loans. Why is the free market for capital failing these communities so badly? What makes them so vulnerable to predatory practices?
- Which predatory lending practices are most detrimental? For example, which loan conditions have the highest correlation with default and foreclosure? What can be done to combat these practices?

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<sup>2</sup> James Carr and Lopa Koluri, *Predatory Lending: An Overview*, at 7 Fannie Mae Foundation (2001).

- Which homeowners are most vulnerable to predatory loans? Is there a triggering event or moment when that makes a homeowner particularly vulnerable to taking on a predatory loan or re-financing? (e.g., job loss, death of a spouse) Are there certain kinds of interventions that could target vulnerable homeowners during those moments?
- Many well-intentioned consumer unions and non-profit organizations offer high-quality, low cost mortgage funding for qualified buyers. Why aren't more consumers turning to these sources? How can alternate sources of high quality credit compete more effectively against richly funded, aggressively marketed predatory lenders?

The answers to these questions could have a profound impact on the effectiveness of Heron's investments to expand access to cost-effective mortgages. The answers to these questions could help thousands of community organizations and foundations reorient toward more effective support for millions of homeowners.

### **Solutions of interest:**

Creating new sources for capital has many difficulties: it is very, very capital intensive, quite limited in the number of consumers it can reach, and has great difficulty competing with the intensive marketing expenditures of for-profit providers of capital. Instead, Heron could consider focusing on finding new ways to help consumers better use existing capital markets. Examples might include:

- Proactive outreach to help qualified homeowners refinance from high-cost, subprime mortgages into lower-cost mortgages
- Support for organizations that provide low-cost short-term loans that will compete with payday loans
- Marketing support for existing non-profit banks and consumer unions to better reach their target homeowners

**Success metrics.** As Heron invests in programs that provide capital, it could build in success metrics that reward moving families toward debt reduction. This is critical because it is not just about how many loans are issued or how many loans are in good standing, but how many families can totally free themselves from debt and begin to move toward savings and long term wealth creation.

### **Housing security.**

Housing is the greatest opportunity for wealth-building for poor and middle-class families. Most housing programs focus on helping renters become buyers – even if they are financially unstable or otherwise stretching themselves into committing to a mortgage they might not otherwise have qualified for. The result can be disastrous. People sink all their assets – and often the assets of members of their extended

families – in a home, only to lose that home to foreclosure and wipe out everything they had.

**Areas for research:**

- Even as foreclosure rates have climbed dramatically over the past generation, surprisingly little research has been done to find out which families are losing their homes to foreclosure and what events trigger these losses. The common assumption right now is that people lose their homes when teaser rates run out on subprime mortgages. But mortgage foreclosure rates had already doubled before the subprime crisis arrived, and the current foreclosures include a mix of prime and subprime. Heron could lead important research into these questions: Which demographic groups face the highest rates of foreclosure? What is the best predictor that a family will lose their home to foreclosure? (e.g., predatory loan, job loss, high debt-to-value ratio, etc.)
- Which programs are most effective in ensuring housing security? Are there ways to intervene when families are most vulnerable?

**Solutions of interest:**

- Focus on helping homeowners on the edge. Consider sponsoring programs to offer alternative sources of debt to cover mortgage payments during a temporary setback, such as a job loss or serious medical problem. A small amount of help can be a low cost way to keep a family in their home, so they can build wealth over the long run. Also consider programs that help families that are behind on mortgage payments negotiate with mortgage lenders.
- Zero in on the moment of greatest risk – when a family re-finances. Support programs that help homeowners make better refinancing choices.

**Success metrics.** Whenever investing in programs that help renters become owners, build in success metrics that:

- Reward programs that keep families in owned homes for the long run.
- Reward programs that keep families paying down mortgage debt for the long run, and prevent “cashing out” of equity.
- Reward programs that treat homeownership in a holistic wealth-building approach; i.e., programs that help families own a home while continuing to build other forms of savings and avoid other forms of debt.

By extension, discourage programs that put people in homes they can't afford, or that treat homeownership in isolation without considering a family's overall financial wellbeing.

**Financial planning.** A generation ago, financial stability might not have been easy, but it was not very complicated. Families earned what they could, and they spent

what they earned. It just was not possible to sign up for hundreds of thousands of dollars in debt, because excessive debt just wasn't available to ordinary families. Moreover, if a family got behind on a mortgage or car payment, default interest rates and penalty fees were modest, and did not pile up so fast that they had no hope of catching up. Today, financial stability is much harder, and surviving economically requires much great savvy.

#### **Areas for research:**

- Thousands of well-intentioned organizations have offered various forms of consumer education, ranging from broad information to highly individualized financial counseling. But little is known about which methods are most effective, and which actually help guide families toward better choices. Heron could help answer the critical question: Which forms of consumer education are most effective in helping families obtain the lowest cost credit from the free market? Which forms of education help families hold onto their homes and build wealth? Which forms of education are best suited to which populations?

#### **Solutions of interest:**

Wealthy people have long turned to financial advisers to help them manage their money wisely. Heron could help working people help themselves with low-cost variations that provided individually tailored and highly targeted financial planning. This is not the standard, off-the-shelf education (who could possibly learn everything one might need to learn?). It is unique advice, given by a professional, when needed. Making financial advising available might help a whole new market open up to help people navigate through their most difficult financial choices. Heron could also support experiments with different types of budgeting classes and education, thus helping create the future leaders of financial education. These experiments should be combined with rigorous metrics for measuring success and determining which are the most effective.

Examples might include:

- Support for faith-based debt-reduction classes or general financial planning programs, such as a new initiative from Thrivent or programs that have grown popular in some African American churches
- Financial counseling for families with serious medical problems. There are plenty of programs that help with the medical and emotional aspects of illness, but very little to help with the financial ramifications. Such programs could help explore alternative ways to pay for medical costs. Ultimately, if successful, this kind of program could help thousands of families keep their homes and avoid bankruptcy.

- Develop financial counseling programs for couples – especially couples with children -- going through a divorce or separation. A single parent is nearly three times as likely as his or her childless counterpart to end up in bankruptcy. Timely counseling on critical issues -- such as creating a realistic budget for a newly single household, collecting (and paying) child support, and downsizing critical expenses such as housing and transportation – could provide a badly needed roadmap for thousands of newly single families to stabilize and get back on the path to wealth creation.
- Offer student loan counseling. There are several possible intervention points: First, at the time of taking on debt to programs could help young people and their families understand the full costs of college, shop for the cheapest debt alternatives, and focus on strategies to avoid falling into credit card debt during the college years. Second, at the time of leaving school when the debts come due, programs could help young people make appropriate budgets. Third, after a few years of debt payments, as a young person is beginning to think about buying a home or starting a family. The student loans would be the trigger, but this could easily morph into more expansive financial counseling.

I could continue to spin out programs, but I realize I am already well past your suggested five pages. You might consider programs that focus on risk mitigation, identifying solutions that balance against the risks that derail a family's wealth creation. Programs that provide support during job loss or that that provide support for the financial ramifications of medical calamities could be very useful. Your current work in employer-based child care solutions could be very helpful to families by relieving one of their biggest financial pressures.

As you can see, I found the assignment intriguing, and the five pages you asked for quickly doubled. The reason is straightforward: many of the programs in the non-profit realm are still predicated on an economic world that no longer exists. A broader range of families face more pressure than ever before, and the rate of failure is climbing rapidly. A foundation that is strategic in opening up new areas of research and new programs to help families could reshape both the charitable world and the world for millions of struggling families.

I would be glad to discuss any of these ideas in greater detail. I hope this letter will be useful to the foundation.

Sincerely,



Elizabeth Warren  
*Leo Gottlieb Professor of Law*

## About the Author

**Elizabeth Warren** is the Leo Gottlieb Professor of Law at Harvard University where she teaches contract law, bankruptcy, and commercial law. In addition to numerous legal publications, she has written two books (co-authored with Amelia Warren Tyagi): The Two-Income Trap: Why Middle Class Mothers and Fathers are Going Broke and All Your Work. She is an outspoken critic of the consumer lending industry and discusses a range of deceptive and unfair practices employed by credit card companies and their impact on low and moderate-income working families. Her research interests include: policy work in bankruptcy and commercial law; financially distressed companies; and women, the elderly and working poor in bankruptcy.