The Strategy of Default—Liquid Foundations in the House of Finance

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Liquid Foundations—Debt, Default and the Limits of Epistemology

The critique of epistemology has assumed an unusually prominent role in academic reflection on the recent financial crisis. As the consequences of the subprime debacle continue to unfold in fiscal crises of the state, austerity measures, currency wars, and mass unemployment, attention has turned to the role played by financial models in predicting (and failing to predict) the economic risk inherent in complex financial instruments such as mortgage-backed securities [MBSs], collateralized debt obligations [CDOs] and credit default swaps [CDSs]. Retrospective analyses have focused, in particular, on the failure of economic models to predict failure - the mass delinquency, that is, of subprime borrowers whose unanticipated levels of default set off the chain of events that led to a full-blown liquidity crisis in the summer of 2007. Since the AAA ratings assigned to CDOs had been based on sophisticated mathematical models of credit risk, it is inferred that critical reflection on the financial crisis must be concerned with economic knowledge, its limits, and the possibility of its reform.

Without a doubt, it was the assumptions of neoclassical finance and the efficient market hypothesis that underwrote the overwhelming certitude of economic knowledge during this period. For economists within this tradition, the liquidity of transactions is ensured by the fact that in perfectly competitive markets, full and complete information would allow each market participant to price and trade products at their correct value. Within this perspective, liquidity requires a certain standardization of knowledge about the future - the ability, that is, to offer an objective, mathematical evaluation of future risks.
Efficient markets assume a world in which information may in fact be incomplete (or less than liquid) while remaining perfectible (liquifiable) in principle. In the best of all possible worlds, all uncertainties would be priced as predictable risks, thereby rendering them perfectly hedgeable—and thus neutralized. Neoclassical finance imagines a world in which the market, through financial innovation, is able to hedge against an infinite spectrum of risks, including it would seem, the risk of market failure itself, appropriately figured as the ‘end of the world’ in eponymous bond markets. In 2003, Federal Reserve chairman Alan Greenspan was looking forward to the imminent perfection of possible worlds, announcing that ‘financial transactions [would] slow as we approach[ed] the world in which financial markets are complete in the sense that all financial risks can be transferred to those most willing to bear them.’ One of the virtues ascribed to ‘financialization’ was its ability to transform previously unpriced and therefore illiquid assets, such as the home, into the fully priced, tradable, and infinitely liquid form of quantifiable risk, through the creation of ever more sophisticated forms of financial innovation. It was therefore assumed that financial derivatives such as the credit default swap (designed to hedge against the credit risks inherent in collateralized debt obligations) could only serve to neutralize the risks of highly leveraged investments. In no respect could these instruments generate knock-on effects of their own.

An alternative perspective on the crisis can be found in the work of economic sociologists and heterodox economists who question the positivism of neoclassical models of knowledge. For these theorists, the liquidity of money rests ultimately on the credibility of the promise it embodies—that is, on the social conventions of trust, contract and creditworthiness that vouch for its future value. These factors are all the more pertinent when one considers the complexity of promises circulating in financial markets, promises whose extension into the future is marked by the irreducible uncertainty of time (as Keynes famously theorized). The weaker version of this hypothesis can be found in the work of Bruce Carruthers and Arthur Stincombe, who remark that the liquidity of financial transactions requires knowledge that is not so much infallible as credible enough to sustain consensus. ‘Thus liquidity is a problem of knowledge, of how to create a public consensus about value’ (1999, 357). A stronger version can be found in the work of regulation theorist André Orléan (2009) who analyses all estimations of value as a function of affective passions and contagion. In either case, the critical perspective on market consensus understands financial crisis as a failure of confidence. The market for structured mortgage finance came to a standstill when the standardized knowledge produced by credit-rating agencies failed to correlate with actual levels of default on the part of subprime borrowers. The breakdown of this ‘cognitive machinery’ introduced a corrosive element of doubt into the fragile edifice of financial promises constituted by CDOs [collateralized debt obligations]. All of a sudden, investors no longer knew how to evaluate assets on their balance sheets since they no longer trusted (and could no longer be sure that others trusted) the public knowledge generated by credit-rating agencies. It was not so much a ‘factual error’ in risk calculation that led to a liquidity crisis, but rather a collapse of confidence in the creditworthiness of public knowledge.
In both perspectives, however, liquidity remains within the bounds of epistemology—a question, that is, of more or less credible, or more or less accurate knowledge about the possible future states of the world. Neither of these perspectives captures the complexity of competing and antagonistic investments in the appreciation of wealth, much less the possibility of wholesale disinvestment from the social and contractual relations that sustain the edifice of contemporary finance. In a word, neither of these perspectives entertains the prospect that the conventions of knowledge, trust and credibility that ensure the liquidity of financial transactions could come undone as it were ‘from below,’ from within the world of ‘household’ investment. Whether it subscribes to the mathematical epistemology of neoclassical financial models or the critical philosophy of trust, faith and convention, reflection upon the failures of the financial crisis has remained curiously monological.

Yet in a context where the everyday life of personal finance is so closely integrated with and critical to the geopolitical fortunes of high finance, it cannot be assumed that the liquidity of financial promise depends solely upon the implicit norms of public knowledge invisibly circulating amongst professional investors. The world of high finance is also increasingly dependent on the conventions of trust, obligation and faith that enlist everyday investors, willingly or not, into the appreciation of asset value, conventions that can and do break down. This article investigates what happens when personal investors disinvest from the implicit deontic contract of indebtedness. What happens, it asks, when consumer debtors begin to default strategically, before due time? When the uncertainty of contract, title and ownership leads to mass trespass? When student debtors decide to abscond rather than pay off loans that cannot be discharged in bankruptcy? These are some of the strategies—deliberate or otherwise, legal and semi-legal - that personal debtors have resorted to en masse in the ‘aftermath’ of the financial crisis. This paper argues that such mass delinquency not only makes manifest the truism that the liquidity of financial relations is based on trust—the legal credibility and thus enforceability of financial promises—but also that the normal relations of trust can be radically contested from below.

Historical Excursus—Home Ownership, Default and Household Norms

In her historical overview of American town plans, the urbanist Keller Easterling notes that during the New Deal, the suburban household was integrated into the ideal of mass production, becoming, in the post World War II era, as critical to the economic recovery as the automobile industries. The standardization of suburban space that was brought about by New Deal housing programs was less a conscious planning decision, she observes, than the consequence of insurance calculations. By insuring lenders against default on single-family mortgages, the creation of the Federal Housing Administration (FHA) in 1934 for the first time made home ownership an affordable option for the burgeoning American middle class. The more standardized the partition of suburban space, infrastructure and housing, the easier it was to value the household against the risk of mortgage default. A homogeneous division of urban space went together with a standardized metric for underwriting credit default risk, and thus the creditworthiness of borrowers.
It is important to nuance Easterling’s history of urban space by observing that the New Deal institution of home ownership was shaped by the norm of the Fordist household and the exclusion of African-Americans from this very norm. Through the medium of the family wage and limitations on women’s salaries, Fordism defined white men as a privileged middle class of industrial workers, relegating middle class women to the space of household consumption and reproduction. This sexual division of labour was inscribed in the very terms of Fordist housing policies, which until the early 1970s excluded women from obtaining credit in their own names. Like the Fordist family wage then, access to federal mortgage credit and suburban home ownership was a privilege reserved for the white, male industrial worker. African-Americans - both women and men - were systematically denied this privilege through the urban risk ratings of the Federal Housing Administration, which accorded every urban and suburban space in the United States a credit risk score expressed by the letters A, B, C or D - D being marked by the color red (hence the term ‘redlining’). These ratings took into account the age and quality of housing stock, the racial demographics of neighborhoods, and ‘adverse influences’ such as crime rates, as criteria for selecting which loans to underwrite, all of which ensured the exclusion of African-Americans from home insurance loans in suburban areas.

The structural discrimination which shaped home ownership after World War II was phased out only gradually, under pressure from the civil rights and feminist movements. The Fair Housing Act of 1968 and the Equal Credit Opportunity Act of 1974 extended racial anti-discrimination norms to housing and credit markets, respectively. The Home Mortgage Disclosure Act (HMDA) of 1975 and the Community Reinvestment Act (CRA) of 1977 explicitly outlawed redlining and introduced systematic procedures to monitor the demographic profile of bank loans. Regulation B of the 1974 Equal Credit Opportunity Act enabled married and unmarried women to obtain full access to credit in their own names. All of these legislative reforms called for a more inclusive welfare state, one whose privileges were no longer defined by the sexual and racial hierarchies of the Fordist household.

The final ‘democratization’ of finance, however, would not, in the end, be achieved by the expansion of the welfare state but rather, after three decades of declining social welfare, by the dramatic liberalization of the consumer credit market which occurred in the early 90s. This period also saw the promotion of ‘asset based welfare’ as an ideological alternative to the ‘income-based welfare’ of the New Deal. Informing neoliberal policy interventions both in the US and overseas, and heavily marketed by the Ford Foundation, asset-based social reform dictated that welfare should no longer function as a substitute for the wage but as an instigation to participate, as fully fledged investors, in the speculative appreciation of capital. In an era defined by stagnant and declining real wages, home ownership was therefore reconfigured as a form of privatized welfare, allowing the individual asset-owner to leverage home equity as a way of hedging against multiple life risks. George W. Bush’s call for ‘universal home ownership’ was felicitously abetted by foreign investors’ seemingly insatiable appetite for US debt (bills, bonds or securities), highly liquid capital markets and cheap credit, all of which created the conditions for the mass marketing of financial
products to so-called subprime borrowers. These loans were then repackaged into tradable mortgage-backed securities or collateralized debt obligations and sold to investors.

Although the securitization of mortgages was not in itself a new development, the kinds of high-risk mortgage-backed securities (MBSs) developed by private lenders during the 90s represented a dramatic move away from the low-risk securitization strategies pursued by government-sponsored entities such as Fannie Mae and Freddie Mac. The mortgages that were pooled into traditional low-risk or ‘vanilla’ securities were expected to ‘conform’ to the rigorous underwriting standards that restricted credit to borrowers with good credit scores and secure incomes. The average default rate on a traditional MBS was lower than 0.5, and these default risks were strictly confined to one pool of MBSs. As Herman M. Schwartz points out, government-sponsored mortgage lenders have continued to operate with the highly prudential, actuarial model of risk established in the New Deal era. ‘[V]anilla MBSs in many ways are a classic product of the Bretton Woods or Fordist era welfare state. They socialized the risks attendant on providing housing finance, implicitly homogenized the returns to investors, favored debtors,...and homogenized borrowers to a middle-class-family model buying single-family homes’.

The new generation of private-label mortgage-backed securities and CDOs, by contrast, replaced these traditional, actuarial models of risk standardization with a much more speculative strategy of risk-optimization through diversification into some of the more high-risk segments of the consumer credit market. Having saturated the market for safe borrowers, mortgage brokers began to aggressively market credit to both subprime (low income) and Alt-A (credit blemished) borrowers - precisely those borrowers who would have been automatically excluded from the federally guaranteed loans issued by Fannie Mae and Freddie Mac. Martha Poon notes that the proliferation of subprime lending practices during the 90s saw ‘a gradual shift away from traditional, exclusionary practices of credit control-by-screening and towards gradated practices of credit control-by risk’. Under control-by-risk, ‘managerial decision making was no longer confined to approving or withholding loans, but was extended to the exploitation of stabilized grades of credit quality accessed through scores to create multiple borrowing options tailored to accommodate varying levels of risk’. The standardization of credit scores (through FICO) thus created the conditions for a destandardization of credit options, allowing even the most ‘non-conforming’ of borrowers to be assigned a credit risk and priced accordingly. The subprime market allowed unprecedented numbers of previously marginal borrowers (women, African-Americans, Latinos) and non-normative households (single-mothers and those living in other non-normative arrangements) to aspire to home ownership—but often at an exorbitant price. It was expected that a sizeable number of these borrowers would default, perhaps after rescheduling their loans several times. And yet as long as house prices continued to appreciate, these higher than average default rates would be more than compensated for by the higher-than-average returns to be gleaned from rescheduling fees and the punitive conditions of subprime loans.
Structural Guilt and Strategic Default

In early 2007, the credibility of mortgage-backed securities and collateral debt obligations was thrown into question when rising interest rates provoked an unexpected spike in subprime mortgage defaults. The continuing depreciation of house prices throughout the year forced the credit ratings agencies - Standard and Poor’s, Moody’s and Fitch - to downgrade a sizeable portion of their CDOs from AAA to junk status. In retrospect, many critics remarked that the calculation of default risk amongst subprime borrowers had been based upon insufficient and unrepresentative historical data collected from the preceding decade of continuously rising house prices.

In the long aftermath of the credit crisis, another, potentially more far-reaching problem has surfaced with respect to the calculation of defaults. What if mortgage-holders stopped honoring their obligations not out of strict necessity but as the result of a speculative calculation of profits and losses? What if personal debtors began to default strategically?

The economist Brent T. White calculates that as of June 2009, almost one third of all mortgage-holders in the US were ‘underwater,’ meaning that their outstanding mortgage debt far exceeded the current valuation of their house. The percentage of ‘underwater borrowers’ was expected to increase to almost 50% by the first quarter of 2011. Under these circumstances, it would not be surprising if debtors chose to walk away from their contractual obligations, even if they could strictly speaking still ‘afford’ to service their mortgages. Why would one continue to service a loan on a depreciating asset, especially when rent on a similar home would cost much less than mortgage payments? Instead economists have long marveled at the fact that so few mortgage-holders have opted to default when it was manifestly in their interest to do so. Numbers have until recently remained low, including in states such as Nevada (where two-thirds of all homeowners are underwater), as well as Arizona, Florida, Michigan, and California (where the rate of negative equity hovers around 50%). The unwillingness of personal debtors to opt for ‘strategic default’ has until recently seemed so axiomatic that consumer default risk models routinely factor this in as a key difference between personal and professional investors.

How do economists explain the relatively low numbers of strategic defaults? In a recent media debate on the subject, economists of various persuasions have evoked a structural sense of ‘guilt’ amongst personal debtors, which in an optimistic light can be seen as a sense of honor, and in a more cynical light as a deliberately cultivated state of fear. Economist Brent T. White, for example, maintains that mortgage servicers and government agencies actively maintain a sense of ‘structural guilt’ amongst personal debtors, through the threat of damage to personal credit-scores.

What would happen if this structural sense of guilt were to wane? The economist Luigi Zingales warns that the resulting increase in strategic defaults would undermine the whole edifice of liquid promises upon which structured finance is built,
leading to a systemic breakdown of financial relations much more dangerous than the first phase of the credit crisis. ‘If the underwater homeowners who currently refuse to default changed their minds and decided to abandon their mortgage commitments,’ he warns, ‘the results could be catastrophic’22. After all, the habitual non-ruthlessness of personal debtors has until recently represented one last constant in an increasingly fragile mortgage market. Any increase in strategic defaults could set off a contagion effect leading not only to the familiar evils of depreciating home prices and its knock-on effects (restrictions on credit, the high price of debt, devaluation of neighborhoods) but also to the destigmatization of default itself. In short, it is feared that personal investors might start behaving with the same ruthlessness as professional investors, voiding one of the fundamental premises of default risk models.

In the face of recent surveys which suggest that the US is now (as feared) witnessing an unprecedented rise in ‘strategic defaults,’ many economists, legal scholars and politicians are calling for the urgent remoralization of debt amongst personal defaulters. In a televised speech, Secretary of the Treasury Henry Paulson intoned that ‘any homeowner who can afford his mortgage payment but chooses to walk away from an underwater property is simply a speculator - and one who is not honoring his obligations’23. In June 2010, FannieMae announced that it would refuse to underwrite the mortgages of strategic defaulters for a period of seven years following the date of foreclosure and, where possible, would also sue to recoup the outstanding mortgage debt24. The condemnation reserved for strategic defaulters is instructive for what it reveals about the differential norms applied to personal and professional debtors, even when financialization claims to fully induct consumers into the realm of professional investment. In the moment of crisis, and even as professional investors proceed to liquidate all their long-term commitments, what is demanded of the personal debtor is a non-strategic and in the last instance sentimental attachment to an illiquid asset of depreciating value (the home). While professional investors continue to assert a decided ‘liquidity preference,’ the personal debtor alone is enjoined to treat the contractual investment as ‘permanent and indissoluble, like marriage, except by reason of death,’ an option that Keynes briefly and facetiously entertained as a solution to the liquidity crises of modern financial markets25.

The condemnation of those who ‘walk away from their debts’ is all the more remarkable when we consider that default, strategic or otherwise, is in fact a perfectly legal option, whose conditions are set out within the terms of the mortgage contract. As noted by the pragmatist legal scholar, Oliver Wendell Holmes, in the late nineteenth century, common law sets the conditions under which contract can be breached but does not prohibit the breach per se. Thus, the ‘only universal consequence of a legally binding promise is, that the law makes the promisor pay damages if the promised event does not come to pass’26. To assert otherwise would be to blur the lines between free and absolute obligation, contract and bondage. The invocation of moral law with respect to personal debtors (and personal debtors only) thus represents a truly exceptional departure from the conventions of commercial transaction.

And yet short of imposing an absolute obligation on personal borrowers to continue to service their debts, it is becoming increasingly difficult to draw a sharp divid-
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ing line between a strategic and a necessary default, a legitimate and an illegitimate breach of contract. (Even the ratings agency Moody's has raised this question with respect to Fannie Mae's plans to penalize so-called 'strategic defaulters')\textsuperscript{27}. At what point, after all, does a decision to not work longer hours become necessary, and not merely strategic? The distinction between what one 'can' afford, in an absolute sense, and what one is 'willing' to pay was translated by Marx as that between the 'free' (because finite) wage labor of the worker and the unfree (because infinite) labor of the slave - that is, between finite and infinite debt. The truly dramatic depreciation of home values brought on by the financial crisis means that many borrowers are faced with the prospect of a life of indebtedness— and an obligation without foreseeable limit to redeem their state of insolvency. Under these conditions, almost any decision to absolve oneself of debt must be seen as 'strategic'—indeed, in the words of Paulson, as a form of speculation.

The argument in favor of strategic default has only become more compelling in light of the increasingly contested status of property rights in the mortgage securitization process, a point I will discuss in the following section.

Trespass and Uncertainty of Title

The subprime crisis has created a new wave of homelessness in the United States, not only amongst former mortgage-holders but also and especially amongst renters who have been evicted without notice from foreclosed homes (National Coalition for the Homeless 2009; Johnson 2010)\textsuperscript{28}. Yet the same events have also permitted an extraordinary flowering of legal and semi-legal forms of trespass. As the foreclosure process slows down beneath the weight and costs of repossession, more and more people are living mortgage-free in foreclosed homes they once 'owned,' rent free in foreclosed homes they once rented or squatting in foreclosed homes that have been vacated by their former residents (Leland 2009; Peñalver 2009)\textsuperscript{29}. The foreclosure crisis has thrown the legal conventions of contract, property and ownership into a state of uncertainty for which there is no imminent solution. More recently, this uncertainty has been compounded by the revelation that in many if not most cases, the transfer of legal title attendant upon mortgage securitization was conducted in a manner that was at best incompetent and at worst fraudulent.

Traditionally, the transfer of property title is a painstaking procedure requiring that an actual physical recording of each change of title be filed at the country registry of deeds. These records are designed to ensure that the history of a title is complete, that ownership is secure and that the priority of multiple liens placed on property (a mortgage and a home equity loan, for example) is clearly defined. But when loan volumes intensified as a result of the housing boom, mortgage originators replaced this system of arduous paperwork with a cheaper, faster electronic registration system (the Mortgage Electronic Registration System or MERS) capable of processing high volumes of origination and securitization\textsuperscript{30}. Although MERS did not own the mortgages it registered, it was frequently listed in public records either as a nominee for the actual owner of the note or as the original mortgage holder. It is the note holder who is entitled to receive principle and interest payments, who has a lien against the
property, and who has the right to foreclose and take the property in the event of default. Thus, during the foreclosure crisis, it was often MERS that filed foreclosures against delinquent borrowers.

In the normal course of things, the note should have been deposited into the legal entity, known as a Trust, that bundles together mortgages into structured securities. But in most cases, the structuring process seems to have occurred without the proper transfer of title—not only was the title not deposited in a Trust in the first place, but the process of properly filing the mortgage note every time the structured product changed hands was also neglected.

The problem could be safely ignored as long as house prices continued to rise. During the housing boom, few borrowers foreclosed on their mortgages since rising house prices meant that they could sell the home to pay off their outstanding debts rather than default. The problem came to light when the numbers of defaults began to rise and record numbers of foreclosures had to be signed off on. When it became apparent that MERS (not the Trust) was filing the greatest number of foreclosures, lawyers began questioning how an electronic database that owned neither note nor mortgage could move against a borrower. It appears, moreover, that many of these foreclosures were performed en masse without proper verification of legal title, often deploying the exceptional procedures that can be invoked when documents are lost in a fire or other accident.

Investigation into the legality of these foreclosures revealed a structural flaw that could not easily be ignored. Because the proper rules of title transfer had not been followed, it was no longer clear which lender, if any, had legal title to a given home. In some cases, creditors have claimed title to the same collateral. In other cases, foreclosures have been filed against homeowners who weren’t in default or who didn’t have a mortgage. Somehow, the basic legal conventions of real property title and transfer were forgotten in the process of creating and selling structured securities.

How could this have happened? While allegations of fraud should certainly not be discounted, I would like to suggest a slightly different line of interpretation here, namely that the tendency to ‘forget’ private property is already implied within the very process of abstraction that is referred to as securitization. To securitize an asset, it is already necessary to abstract from the ownership of solid, physical assets, installing in its place a more complex geometry of appropriation - where what one lays claim to is not a solid, indivisible res (the house as real estate or the single mortgage) but rather a share in the future appreciation of its value (the home as leveraged investment). In the words of Dick Bryan, Randy Martin and Michael Rafferty, “[s]ecuritization involves framing an asset or collection of assets in terms of their expected income streams, and selling rights to the income stream, but with no necessary transfer of the ownership of the underlying asset itself. Hence, in the now infamous US subprime crisis of 2007—a process that has given securitization such a public prominence—mortgage originators retained ownership of mortgage contracts but on-sold exposure to the performance of bundles of mortgages, so that as mortgage defaults grew, the income stream based on exposures to mortgages declined, and the value of the mortgage-backed securities fell”. A similar abstrac-
tion and an early form of securitization was already at work in the creation of the mid-nineteenth century joint-stock company, which enabled stockholders to own shares in the performance of a company. Marx suggestively referred to this process of abstraction as "the abolition of capital as private property within the confines of the capitalist mode of production itself". Securitization today goes even further in that it sells shares to the income streams of any kind asset, abstracted from the institutional form of the company, and can also bundle together these assets in any number of combinations. Tracing a similar move toward abstraction in the history of common law notions of property, the legal scholar Morton J. Horwitz notes that in the last decades of the nineteenth century, the American legal tradition began to articulate an essentially modern notion of property right - one that displaced value from the physical object to the expectation of a future flow of income. Prior to this, the prevailing theory of law equated property with a Lockean natural right—the right of possession being confirmed by the mere fact of transforming land through labor. In this conception, trespass to land represented the paradigmatic case of interference to property. This exclusively physicalist conception of property was progressively qualified in the jurisprudence of the late nineteenth century, which increasingly came to recognize that the individual's right to indivisible property needed to be offset by collective claims to future value or shares. The evolution of both common law and commerce thus seems to replace one more abstract, fungible or liquid form of property with another, progressively abolishing, within the confines of capital, the foundational role of private property itself.

But perhaps rather than a chronological evolution of property forms, from the feudal to the industrial to the post-industrial, we should think of tangible property as included within and presupposed by structured financial instruments such as mortgage-backed securities or collateral debt obligations. Newer, more abstract claims to ownership may have displaced landed property as the focal point of accumulation, yet the legal title to real estate and other tangible assets remains integral to the more complex claims of structured finance, especially when real estate serves the role of collateral. In the moment of expansion, the question of title is neglected since the focal point of accumulation lies elsewhere, in the proliferation of leveraged claims to future income. It is in moments of crisis, when debts are called in and claims to collateral filed, that the importance of proper legal title reasserts itself. Hence the seriousness of the recent confusion around private property rights.

In November of 2011, the Congressional Oversight Panel charged with investigating the foreclosure scandal released a damning report, concluding that 'irregularities' in property title had reintroduced an element of unknowable, systemic risk into the US financial system and seriously undermined confidence in the entire real estate sector. For investors in MBSs, the uncertainty of legal title raised a host of incalculable risks which could well make continued investment too unsafe—the possibility, for example, 'that MBS trusts may not actually own the underlying loans they claim to own, that servicers may not be able to foreclose upon delinquent borrowers and thus recover invested capital, that borrowers who have already been foreclosed upon may sue, or that other currently unknown liability issues exist'. For potential home-
buyers, the risk of unknown title and legal problems could well serve as a long-term deterrent against entering the housing market. More seriously, the report concluded, systemic neglect of the legal rules of contract had undermined faith in private property law itself. ‘Clear and uncontested property rights are the foundation of the housing market. If these rights fall into question, that foundation could collapse’.

It appears that public confidence in the enforceability of contract has indeed faltered in the face of seemingly undecidable disputes about the priority of legal claims. When it is no longer clear who, amongst investors, mortgage servicers and banks, has legal title to a home, it is the very distinction between ownership and trespass that is voided. Many potentially homeless people have availed themselves of this legal ambiguity to squat vacant properties or remain in foreclosed residences for free. However impermanent it may turn out to be, what this phenomenon signals is a move beyond the limited abstraction of securitization—‘the abolition of private property within the confines of the capitalist mode of production itself’—toward a more general contestation of private property, beyond the confines of “democratized finance”.

**Unforgivable Debt and No Escape Clauses**

To suggest that the unfolding of the financial crisis is limited solely to the issue of home ownership and housing would be to gravely underestimate the structural position that mortgage finance has assumed within the expansion of all kinds of consumer credit, not least that of student loans. The reverberations of the subprime crisis have been felt with particular intensity in the higher education sector and the market for student-loan backed securities, where some are predicting a repeat of the subprime debacle. In 2010, the Wall Street Journal reported that outstanding student loan debt - both federal and private - had for the first time surpassed the total consumer debt owed on credit cards. In the meantime, independent studies reported that up to $50 billion worth of federal loans were in default, while over one third of borrowers were either late on payments or had requested that their payments be postponed. The crisis of student indebtedness is particularly salient not only because of the dramatic rise of tertiary education as a prerequisite to employment within the post-industrial US economy, but also because of the exceptional nature of legal regulations governing student debt.

In US law, student loan debt stands apart from all other kinds of non-criminal, consumer debt in the sense that it cannot be discharged in bankruptcy. The history of this exception begins in an almost accidental manner. Limitations on student bankruptcy were first introduced in 1978 when media stories emerged about student debtors moving into high paying professions who filed for bankruptcy immediately after graduation. Although at the time, the actual figures for discharge stood at less than 1%, Congress responded to the perceived problem by introducing the Bankruptcy Reform Act of 1978, which prohibited the discharge of student loans for five years after first payment. More recently, restrictions against student debt relief have been strengthened in what can only be seen as a series of deliberate policy moves. During the same period that saw the incubation of the subprime crisis, successive limitations
were enacted against the ability of students to discharge debt in personal bankruptcy claims. In 1990, the period of non-discharge was extended from five to seven years. In 1998, Congress completely eliminated the ability to discharge student loan debt in bankruptcy, making them the only type of loan covered by a Federal 'no-escape' clause. Finally, in 2005 the Bankruptcy Code extended non-discharge protection on student loans from public to private lenders, making all types of student loans almost impossible to discharge. The truly exceptional nature of these regulations can be appreciated if one considers that the same status applies only to debts from fraud and criminal acts. As non-dischargeable debt that is secured by the future labor power of the borrower, the repayment of student loans can only be avoided if the debtor permanently flees the country—an option that increasing numbers of students are pursuing.

In the meantime, the Federal Government has underwritten the risks borne by private lenders since 1972, when amendments to the HEA (Higher Education Act) created the government-sponsored enterprise known as Sallie Mae (the Student Loan Marketing Association). SallieMae encourages private banks to provide low-interest loans to students by insuring the lenders against the risk of default. As Derek Price explains, 'Sallie Mae’s historical status as a government-sponsored enterprise implicitly guaranteed “the full faith and credit of the United States” as the financial underwriter for its total debt'. In practice this has meant that lenders received 100% insurance against defaulted loans until 1992 (the amount has since been reduced to 98%) while the U.S Treasury assumes the quasi-totality of risks. This public-private alliance is both highly profitable to private lenders and from the point of view of the Federal Government, cheaper than the alternative public loans (or Pell Grants) since it only has to pay for the costs of interest and default.

In many respects, the history of higher education in the US closely follows the trajectory of housing politics. Here too, the 1960s witnessed a spate of policies aiming to ‘democratize’ access to higher education through a selective expansion of the welfare state. But here also, a short-lived expansion of welfare was quickly displaced by a politics of access through structural indebtedness, as the federal loan program was liberalized to encourage private loan providers. In 1960, President Dwight Eisenhower’s Goals for Americans report called for the expansion of higher education to lower income students, a policy that would be implemented in three successive stages during the 1960s. In 1965 President Lyndon Johnson signed the Higher Education Act (HEA) with the aim of permanently opening up higher education to lower-income students through the provision of federally guaranteed loans and grants (Price 2004, 30-34). The combined effects of these policies and the demands of the civil rights and feminist movements led to a historical shift in the demographic profile of the American college student. And yet in a move that anticipates the rise of subprime lending in the housing market, the brief moment of expansion which took place in the 1960s was quickly replaced by a politics of conditional inclusion, as rising levels of indebtedness became the price that had to be paid for ‘equal access’ to higher education.

When placed within the context of America’s singular history of bankrupt laws,
the exceptional contractual conditions reserved for student loans become even more striking. Even during a period when both the United States and England were moving away from the notion of insolvency as a criminal condition, leading to the gradual phasing out of imprisonment for debtors in the late nineteenth century, North American legislation demonstrated an exceptional generosity toward the commercial debtor. In the early Republic, Federalists believed that clear bankruptcy laws were needed to facilitate the creative/destructive cycles of failure and renewal integral to the speculative expansion of a commercial society (Skeel 2001, 3; Mann 2002). In a world in which non-fraudulent failure was becoming an increasingly common experience, the laws of bankruptcy specified the conditions under which contract could be legitimately voided, allowing the non-fraudulent debtor to begin life anew. The expansion of commerce weakened the moral economy of debt that had been so rigorously upheld by the Methodist Church, turning failure from an exceptional moral state into a predictable, and largely unavoidable, economic one. Moral discourse around insolvency shifted from a tenor of absolute condemnation to one of qualified forbearance - contingent upon the distinction between the legitimate and illegitimate debtor, the fraudulent and honest businessman. Bankruptcy, then, came to be figured as a legitimate (if not precisely honorable) form of default, a way of breaking the conventions of contract and obligation without undermining the authority of contract per se.

It is this non-punitive understanding of commercial failure and renewal, developed with the entrepreneur in mind, that would later shape the consumer bankruptcy laws which emerged in the twentieth century. With the expansion of consumer credit in the 1920s and widespread insolvencies amongst wage earners during the Great Depression, reformers advocated for special provisions to protect the 'honest' (reputedly non-fraudulent) wage-earner from the consequences of financial failure. The passage of the Bankruptcy Reform Act of 1978, which established a generous minimum federal exemption, marked a high point in the evolution of laws for the protection of consumer debtors. While the 1978 Act has since been somewhat modified in favor of creditors (mostly under pressure from credit card companies), student debt alone has been excluded from the relatively generous bankruptcy laws that protect consumer debtors in the United States.

How can this exception be explained? Following Marc Bousquet, who argues that academia has been at the forefront of neoliberal labor reform, I would suggest that student debt is accorded an exceptional (quasi criminal) status because, not in spite of, the integral role of higher education in the production of a post-fordist labor force. The non-dischargeability of student debt performs the function of ‘structural (legally mandated) guilt’—a compulsion to work under whatever conditions one finds in order to avoid the even worse treatment reserved for the defaulter. If this compulsion has become increasingly visible in the wake of the financial crisis, it is not because the structural conditions of debt were not there before, but because work is now less and less available to the recently graduated. The knock-on effects of the financial crisis (including double-digit unemployment levels for those aged 20-25) have thus brought to light a state of structural obligation that was already implied
within the logic of financialization. The expansion of consumer credit may well have opened up higher education to those who were formerly excluded, but on the condition that the indebted student assume the role of ‘shock absorber of last resort’ to the vicissitudes of the labor market.

**Conclusion**

Given the unfolding severity of the financial crisis and the inevitable comparisons with the Great Depression, it should come as no surprise that liberal and progressive reformers are calling for a new social contract modeled more or less faithfully on the New Deal. Such an intervention calls for a new demarcation between legitimate and illegitimate default, trespass and ownership, responsible and irresponsible debtors, making it once again possible to standardize and predict default risk with a reasonable amount of confidence.

We can catch a glimpse of such a politics in the figure of bankruptcy lawyer Elizabeth Warren, former Chair of the Congressional Oversight Panel on bank bailouts and now Head of the newly created Consumer Financial Protection Agency, who wants to restore America’s ‘once-solid foundation’ - its strong middle class - via the rearticulation of a new social contract. It is clear from Warren’s obsessive familialism and almost exclusive focus on the middle class that this social contract will not extend as far as the non-normative borrowers included in the category of subprime. Echoing Keynes, Elizabeth Warren and other liberal reformers oppose the presumed solidity of household consumption—invariably buttressed by a highly normative vision of familial life and marriage—to the excessive liquidity, fligh
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ness and promiscuity of finance, which extends credit to those who can’t be trusted. In this moral economy of debt and redemption, the responsibility of the personal debtor—her fidelity to obligation and long-term commitment—is counterposed to the evasiveness of speculative finance.

In this article, I have focused instead on those moments in which personal borrowers have liquidated their long-term positions, abandoned commitments, and reneged on promises. These are the critical moments in which everyday investors have failed to confirm the predictions of credit risk models, becoming an unknown, elusive, quantity in the calculation of financial futures. This unknown (and perhaps unknowable) quantity cannot be captured within neoclassical or critical epistemologies of finance, both of which focus almost exclusively on the interests or passions of professional investors and therefore assume an overwhelmingly monological vision of financial markets. What it calls for instead is a ‘dialogic’ understanding of debt and credit which does not treat consensus as a given.

The geopolitics of early 21st century finance has created the extraordinary situation in which the American household (and in particular, the marginal, subprime household) has come to function as the world’s consumer of last resort. It has also placed the US household in the unenviable position of acting as ‘shock absorber of last resort’ to the world’s financial markets, as the IMF so vividly put it. In this article, I have identified ways in which the household debtor has selectively declined this role, finding more or less strategic ways to evade the prospect of crippling indebtedness. In a context of rising homelessness, mass unemployment and restricted credit,
strategic default, trespass and debt evasion are all practical solutions for transferring risk back to the financial sector. This phenomenon should not be over-interpreted as a fully articulated political position or over-romanticized as a necessarily progressive one - the affective disinvestment manifested by strategic defaulters could conceivably be harnessed in both critical and ultra-conservative directions.9 And yet it is a significant phenomenon, especially considering the pivotal role of the American household within global financial markets. In his classic study of political defection and representation, *Exit and Voice*, Albert O. Hirschman made the following remarks about the singularity of exit in the American context:

As a country’s central bank is the lender of last resort, so has the United States long been the ‘country of last resort.’ To most of its citizens—with the important exception of those whose forefathers came as slaves—exit from the country has long been peculiarly unthinkable.90

As Hirschman’s caveat might suggest, for those who have only recently and conditionally been included within the ‘American Dream’ of democratized finance, exit from the social contract of debt and redemption may appear not only eminently thinkable but also unavoidable.


3 Bruce. G. Carruthers, “Knowledge and Liquidity: Institutional and Cognitive Foundations of the Subprime Crisis,” *Markets on Trial: The Economic Sociology of the U.S. Financial Crisis: Part A (Research in the Sociology of Organizations, Volume 30)* Ed. Michael Lounsbury,(London: Emerald Group Publishing Limited, 2010), 157-182. Donald Mackenzie aligns himself with this ‘cognitive’ theory of ‘credible’ knowledge when he writes that '[t]rustworthy public estimates of borrowers’ creditworthiness make debt markets far more liquid than they would be if borrowers’ capacity to meet their obligations had to be investigated from scratch. Believable bank balance sheets encourage banks to lend to each other; it was the suspension of such lending that undid Northern Rock.’

4 André Orléan, *De l’euphorie à la panique: penser la crise financière*, (Paris: Editions de la rue d’Ulm, 2009)


6 See Angela Mitropoulos, “Oikopolitics, and Storms.” *The Global South* 3(1) (2009), 66-82, for a discussion of the intersections between household politics and finance, both in the Fordist and post-Fordist moments.


11 Montgomerie and Young, “Home is Where the Hardship is: Gender and Wealth (Dis) accumulation in the Subprime Boom,” 5.


18 In many states, mortgage contracts are ‘nonrecourse loans,’ meaning that there is no legal basis for a bank to pursue a defaulter’s assets in a so-called ‘deficiency judgement’ beyond foreclosing on the house.


Marx (1894), 567.


Congressional Oversight Panel, 5.


Derek V. Price, *Borrowing Inequality: Race, Class and Student Loans*, (Boulder: Lynne Rienner, 2004), 34.

Price, *Borrowing Inequality: Race, Class and Student Loans*, 30-34.


Significantly, limitations on the dischargeability of student loans were introduced during a period in which higher education was becoming increasingly important to the American economy. The Cold War had called for a scientific education for all. The deindustrialization of the US economy during the seventies meant that a professional education was fast becoming a prerequisite for the most productive sectors of the labor market.


I wrote this article at a time when the Tea Party was on the ascendant. Today what was
once a largely passive and unorganized strategy of default appears to have been actively embraced by such movements as the Right to Default in Europe and the Occupy Wall Street Movement in the United States.