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Bankruptcy Reform in 2005 Exacerbated the Mortgage Crisis

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Bankruptcy reform in 2005 exacerbated the recent mortgage crisis by making it more difficult and expensive to discharge debt, according to researchers **Wenli Li**, **Michelle White**, and **Ning Zhu**.

In **Did Bankruptcy Reform Cause Mortgage Default to Rise?** (NBER Working Paper No. 15968), they estimate that the 2005 reform caused mortgage default rates to rise 14 percent for prime borrowers and 16 percent for subprime borrowers. They find that this increase in default rates, which began before the current mortgage crisis, has generated roughly 200,000 additional defaults each year, and exacerbated the recent crisis.

Historically, bankruptcy has helped distressed mortgage-holders keep their homes. Whether through Chapters 7 or 13 of the bankruptcy code, bankruptcy filings allowed homeowners to unload credit card and other unsecured debt, leaving more money to keep up mortgage payments. The process even was used by households with high incomes and large assets.

But in 2005, reforms made bankruptcy less appealing: they raised the cost of filing by more than 50 percent and reduced the amount of debt that filers could discharge. An "income-only means test" closed off the possibility of some high-income homeowners filing under Chapter 7. Filing under Chapter 13 further required them to repay some of their credit-card and other unsecured debt from their future earnings.

Another reform made Chapter 13 even less palatable to homeowners with both high income and non-exempt home equity -- prior to reform, these borrowers had to use only their non-exempt home equity to pay off unsecured debt; after reform, some of them were required to use their non-exempt income as well, if it exceeded their non-exempt home equity.

A final reform capped the homestead exemption at $125,000 for people who had owned their homes for less than 3-1/3 years. This made it tougher for recent home buyers to hold onto their homes if they had substantial equity and lived in states with a high or unlimited homestead exemption.

-- Laurent Belsie

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National Bureau of Economic Research, 1050 Massachusetts Ave., Cambridge, MA 02138; 617-868-3900; email: info@nber.org