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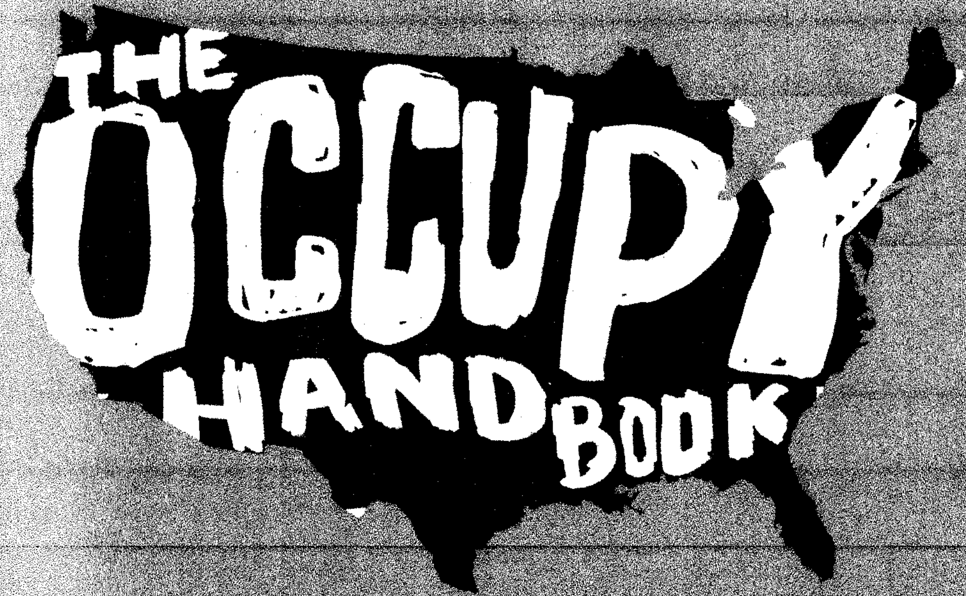

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How Bankruptcy Contributed to the Mortgage Crisis and How It Could Help the Economy Recover

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Occupy Wall Street protesters held an Occupy Our Homes campaign on December 6, 2011, in several U.S. cities to disrupt foreclosures and evictions. In line with the focus on preventing foreclosures, this essay offers some modest proposals to change bankruptcy law in ways that would help to reduce foreclosures.

A bit of background is useful. First, the mortgage crisis that led to the 2008 financial crisis, the recession, and our economic malaise is far from over. Several million foreclosures have occurred, and most predictions are that foreclosures will double or triple by the time housing markets recover. Among mortgages that originated during the housing bubble, 6.4 percent have ended in foreclosure, and an additional 8.3 percent are in serious default and likely to go into foreclosure, according to November 2011 figures from the Center for Responsible Lending. The large number of foreclosures increases the supply of homes for sale, pushing down home prices—which are

Occupy Our Homes, January 6, 2012: In Oakland, California, activists stand on the steps of a foreclosed home that they reoccupied, on a day that brought such actions nationwide. *(Justin Sullivan, Getty Images)*

still falling in fifteen of twenty metropolitan areas for which data are available. The falling prices will put even more mortgages underwater in the future, resulting in a continuing drag on the economy.

Second, economists agree that when homeowners default on their mortgages, lenders have an inefficiently strong incentive to sell homes in foreclosure rather than allow homeowners to keep their homes by renegotiating the terms of the mortgages. When lenders foreclose on a house and sell it for less than the amount owed on the mortgage, they lose the difference between the amount owed on the mortgage and the proceeds of selling the house, and in addition they must pay foreclosure costs. However, lenders do not bear the unquantifiable social costs of foreclosure, stemming from and including the health problems former homeowners experience due to stress; the sagging performance of their children, who are forced to move and transfer to new schools; the decline in value

of nearby houses; neighborhood blight as houses are vacated and not maintained; and cuts in public service by local governments due to plummeting property tax revenues. Even the start rate of new businesses drops, since traditionally homeowners tap their home equity for the capital to open a business. Because mortgage lenders do not bear any of these costs, they have an incentive to foreclose too often.

Third, the various government programs to stop foreclosures, including HAMP (Home Affordable Modification Program), the Federal Housing Administration's FHASecure program, HOPE for Homeowners (a joint project of the FHA and HUD, or Housing and Urban Development), the Home Affordable Refinance Program (a program of the Treasury and Department of Housing and Urban Development), and Fannie Mae's HomeSaver Loan program, have helped very few homeowners. This is because these programs generally require that lenders consent to mortgage modifications, and lenders rarely do so.

How could bankruptcy law help in reducing foreclosures? In the past, homeowners in financial distress often filed for bankruptcy in order to save their houses. Bankruptcy helps them in several ways. The automatic stay on legal actions against debtors stops foreclosure at least temporarily and gives financially distressed homeowners breathing space to sort out their finances. It also ends garnishment of debtors' wages. Unsecured debts such as credit card loans, installment loans, and medical debts are discharged in bankruptcy, although the terms of homeowners' mortgage contracts cannot be changed. Along with ending wage garnishment, the discharge of unsecured debt in bankruptcy increases debtors' ability to pay. In the past, homeowners in bankruptcy often used the extra money to repay their mortgage arrears and keep their homes. Also, homeowners in bankruptcy could file a plan to spread the cost of repaying their mortgage arrears over three to five years.

If they made all the repayments required under the plan, then the original mortgage contract was reinstated.

Bankruptcy law was reformed in 2005 to make it less debtor-friendly. Some types of debt that previously could be discharged in bankruptcy became nondischargeable. Homeowners with income above the median level in their state were required to use some of their future income to repay unsecured debt. The most important change, however, was that filing became much more costly and difficult. Lawyers' fees and filing fees rose from less than $1,000 before the reform to around $2,000 afterward (for debtors who do not file repayment plans) and $3,500 (for debtors who file repayment plans). Other hurdles were also put in place by the reform, including requirements that bankruptcy filers undergo credit counseling before filing, take a financial management course before receiving a debt discharge, and file copies of their pay stubs and income tax returns with the bankruptcy court even if they had never filed tax returns in the past. These and other requirements fall heavily on the most financially distressed debtors, who often can no longer afford to file for bankruptcy.

By making bankruptcy more difficult and costly, the reform caused the number of filings to plummet, from around 1.5 million per year in 2004 to only 600,000 in 2006. In 2011 research, I argued that an unintended effect of bankruptcy reform was to sharply increase the number of mortgage defaults, since homeowners who could no longer have their unsecured debts discharged in bankruptcy were more likely to default on their mortgages. I estimated that even before the mortgage crisis began, bankruptcy reform caused the default rate to rise by 23 percent on prime mortgages and 14 percent on subprime mortgages. The number of additional mortgage defaults was 225,000 per year.

How could bankruptcy law be changed to help solve the foreclosure crisis?

My first proposal is to reduce debtors' costs of filing for bankruptcy, thus making it easier for financially distressed homeowners to use bankruptcy to save their homes. This could be done by eliminating some of the hurdles to filing that were adopted as part of the 2005 bankruptcy reform.

My second proposal is to allow bankruptcy judges to change the terms of homeowners' mortgage contracts in bankruptcy. A version of this change was part of proposed legislation to deal with the mortgage crisis: the Helping Families Save Their Homes in Bankruptcy Act of 2009. Although the act was adopted, the bankruptcy provision was dropped. Under the proposal, bankruptcy judges would have the power to reduce the principal amount of homeowners' mortgages to the current market value of the home if the mortgage was underwater and to reduce the interest rate on mortgages to the current market level. Unlike HAMP and HOPE or the other government programs designed to aid homeowners, this legislation would allow bankruptcy judges to change the terms of mortgage contracts without lenders' consent.

The main criticism that has been made of this proposal is that it would reduce the availability of mortgage loans and cause interest rates on mortgages to rise. Yet bankruptcy judges have the power, under existing legislation, to change the terms of mortgage loans on investor-owned and vacation properties. (They do not have this power for owner-occupied primary residences.) Research has shown that there is little difference between the availability and terms of mortgage loans for (a) vacation homes or investor properties (with mortgages that can be modified in bankruptcy) and (b) owner-occupied primary residences (with mortgages that cannot be modified). Both types of mortgages are offered on the same terms because

lenders' losses are in fact smaller when mortgages in default are modified in bankruptcy—their losses when mortgages are modified are approximately 20–25 percent of the mortgage principal, compared to 50 percent or more when foreclosure occurs. These results suggest that allowing mortgage modification on owner-occupied primary homes would not change the supply of mortgage credit.

Another criticism of the proposal is that many homeowners would use bankruptcy to modify the terms of their mortgages even if they have the ability to pay according to the original mortgage terms. However, homeowners who wished to use bankruptcy to change their mortgages would have to file a repayment plan in bankruptcy, live on a bankruptcy trustee–supervised budget for five years, and have the bankruptcy filing on their credit records for up to ten years. These costs dissuade homeowners from using bankruptcy except when they would otherwise default on their mortgages and lose their homes.