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

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Occupy Wall Street protestors held an Occupy Our Homes campaign on December 6, 2011 in several cities to disrupt foreclosures and evictions.[1] In line with the focus on preventing foreclosures, this article offers some modest proposals to change bankruptcy law in ways that would help in reducing foreclosures.

A bit of background is useful. First, the mortgage crisis that led to the 2008 financial crisis, the recession, and the current economic malaise is far from over. Several million foreclosures have occurred already, and most predictions are foreclosures will double or triple by the time housing markets recover. Among mortgages that originated during the housing bubble, 6.4% have already ended in foreclosure, but an additional 8.3% are in serious default and likely to go into foreclosure, according to recent figures from the Center for Responsible Lending.[2] The large number of foreclosures means that many houses are sold for low prices, causing housing prices in many markets to continue falling.[3] The result is that more mortgages will be 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 foreclose rather than renegotiate 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, plus the costs of foreclosing. But lenders do not bear other costs of foreclosure, including former homeowners having health problems due to stress, their children's school performance falling because they are forced to move and transfer to new schools, nearby homes falling in value, neighborhoods becoming blighted because many homes are vacant and

[1] See "Occupy Homes," in Wikipedia.
[2] See Debbie Bocian, Wei Li, Carolina Reid, and Roberto G. Quercia, "Lost Ground, 2011: Disparities in Mortgage Lending and Foreclosures," Center for Responsible Lending, November 2011.
[3] As of the end of September 2011, data from the S&P/Case-Shiller index of home values showed that housing prices were falling in 15 of the 20 metropolitan areas for which data are available.

unmaintained, and local governments being forced to cut public services because property tax revenues fall. Even the start rate of new businesses falls, since homeowners often tap their home equity for the capital to start 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, the FHASecure program, HOPE for Homeowners, and Fannie Mae's HomeSaver Loan program, have helped very few homeowners. This is mainly because these programs require that lenders consent to mortgage modifications, and lenders rarely do so. (check this?)

How could bankruptcy law help in reducing foreclosures? In the past, homeowners in financial distress often filed for bankruptcy in order to save their homes. 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, but 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 and, 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 3 to 5 years. If they made all the repayments required under the plan, then the original mortgage contract was reinstated.

However bankruptcy law was reformed in 2005 to make it less debtor-friendly. Some types of debt that previously could be discharged in bankruptcy became non-dischargeable. Homeowners with income above the median level in their state were required to use some of their future income to repay unsecured debt. But the most important change was that filing for bankruptcy 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 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. [4]

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 recent 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% on prime mortgages and by 14% on subprime mortgages. The number of additional mortgage defaults was 225,000 per year.[5]

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." [6] But the bankruptcy provision was dropped before the Act became law. 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, bankruptcy judges could change the terms of mortgage contracts without lenders' consent.

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[4] See Stephen R. Elias, *The New Bankruptcy: Will It Work for You?* Nolo Press, 2011.
[5] See Wenli Li, Michelle J. White, and Ning Zhu, "Did Bankruptcy Reform Cause Mortgage Defaults to Rise?" *American Economic Journal: Economic Policy*, vol 3:4, 123-147 (2011). www.econ.ucsd.edu/~miwhite/Li-White_Zhu-final-AEJ-Pol.pdf.
[6] H.R. 200, 111th, Congress, 1st Session [2009].

The main criticism that has been made of this proposal is that it would reduce the availability of mortgage loans and cause mortgage interest rates to rise. But bankruptcy judges currently have the power to change the terms of mortgage loans on investor-owned and vacation properties, although they do not have this power for owner-occupied primary residences. Researchers have shown that there is little difference between the availability and terms of mortgage loans for vacation homes, investor properties, and owner-occupied multi-family homes with mortgages that can be modified in bankruptcy versus for primary residences with mortgages that cannot be modified. [7] The reason is that lenders' losses when mortgage loans are modified in bankruptcy are generally 20-25% of the mortgage principle, far less than the 50% or more that they lose when they sell homes in foreclosure.[8]

Another criticism of the proposal is that many homeowners would use bankruptcy to change the terms of their mortgages, even if they have the ability to pay the original mortgage terms. But homeowners who wished to use bankruptcy to change their mortgages would have to file a repayment plan in bankruptcy, would have to live on a bankruptcy trustee-supervised budget for five years, and would have the bankruptcy filing on their credit records for up to 10 years. These costs imply that homeowners are likely to use bankruptcy only if they would otherwise default on their mortgages and lose their homes.

These proposals, if adopted, would substantially reduce the number of foreclosures and speed the recovery of U.S. housing markets. Because many homeowners would have lower mortgage payments, they would spend more and help the economy recover.

[7] See Adam J. Levitin, "Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy," Wisconsin Law Review, 2009, pp. 565-655. Available to papers.ssrn.com/sol3/papers.cfm?abstract_id=1071931.

[8] *Ibid.*