Personal Bankruptcy and the Mortgage Crisis

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What I’ll talk about:

• Why have a personal bankruptcy law?
• US bankruptcy law and changes under the 2005 bankruptcy reform.
• Can bankruptcy help solve the mortgage crisis?
Bankruptcy provides consumption insurance to debtors

- Individuals benefit from borrowing, but face risk.
- Bankruptcy reduces downside risk by discharging some debt when ability-to-repay falls.
- This makes risk-averse debtors better off.
- States with higher exemptions provide more complete consumption insurance.
Bankruptcy encourages entrepreneurship

• Risk-averse individuals are more willing to start businesses if the cost of failure is lower.

• Evidence shows that states with more generous bankruptcy exemptions have more entrepreneurs.
But a generous bankruptcy law:

• reduces credit availability/raises interest rates
  This applies to:
  – Consumer credit
  – Small business credit
  – Credit to small corporations

• encourages opportunistic behavior
US Personal Bankruptcy Law

• Two procedures—Chapters 7 and 13
Chapter 7

- Unsecured debt is discharged.
- Debtors must use assets above an exemption to repay.
- All future income is exempt.
- Some states have high homestead exemptions—in these states debtors can keep high income and high assets.
- Prior to 2005, 70% of filings were Ch 7.
Chapter 13

• Unsecured debt is discharged.
• Debtors must use some future income to repay debt for 3-5 years.
• All assets are exempt.
• Ch 13 mainly used by debtors to save their houses or cars (mortgages and car loans aren’t discharged in bankruptcy).
Sounds pretty favorable to debtors…
Bankruptcy filings rose 5-fold from 1980-2005
But pro-debtor bankruptcy law doesn’t explain the rise in filings.

What does?
Consumer and mortgage debt
/median income, 1980-2005
# Rising Debt Relative to Income

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<thead>
<tr>
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<th>1980</th>
<th>2005</th>
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<tbody>
<tr>
<td>Consumer debt/median Income</td>
<td>3%</td>
<td>13%</td>
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<tr>
<td>Mortgage debt/median income</td>
<td>56%</td>
<td>150%</td>
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Lenders lobbied heavily for bankruptcy reform—What did they get?

• New “means test” forces high-income debtors to file under Chapter 13 and repay some unsecured debt (not very strict).
• Higher bankruptcy costs discourage all debtors from filing.
Effects of the 2005 reforms

• Filings fell from 2 million in 2005 to 600,000 in 2006, but rose to 800,000 in 2007.

• Higher debt: Consumer debt/HH rose 13% and mortgage debt/HH rose 16% from 2005-07.

• Lower charge-off rate on credit card loans.

• More Ch 13 bankruptcies.
How does bankruptcy help debtors save their homes?
Homeowners and Ch 7

Ch 7 helps homeowners because credit card debt is discharged, so paying the mortgage is easier.

• But Ch 7 doesn’t stop foreclosure.
• Since 2005, some debtors can’t pass the means test for Ch 7.
• Homestead exemption is capped at $125,000 if debtors moved in the past 3.5 years.
Homeowners and Ch 13

Stops foreclosure and allows debtors to repay mortgage arrears over 5 years under a repayment plan.

• Most unsecured debt is discharged b/c mortgage is paid first.
• But no mortgage forgiveness in bankruptcy.
• Not changed in 2005.
How are debtors using Chapter 13?

Rепay unsecured debt or save their homes?
Debtors are using Chapter 13 to save their homes/cars

• In a 2006 sample, 96% of Ch 13 filers were homeowners.

• 78% passed the means test, so they could have filed under Ch 7.

• What debtors repaid in Ch 13 plans:
  -- 78% repaid mortgages.
  -- 45% repaid car loans.
  -- only 9% repaid just unsecured debt.

• But Ch 13 doesn’t help the mortgage crisis.
Bankruptcy and The Mortgage Crisis

• 2.7 million foreclosures occurred in 2007 and 2008; 2 million more to come.

• Foreclosures have very high costs:
  – Owners lose since they must move;
  – Some become homeless;
  – Lenders lose 1/2 of loan value;
  – Neighborhoods harmed because vacancies cause blight/disease;
  – Cities lose property tax revenue.

• Foreclosures lead to yet more foreclosures…
Solutions 1: renegotiate mortgage contracts

• Avoiding foreclosure is in both sides’ interest.
• But little renegotiation has occurred—why?
  – Most mortgages are in securities that limit or prohibit changes in financial terms.
  – Mortgage servicers fear liability if they renegotiate.
  – Servicers are paid for foreclosing, not renegotiating.
  – Second mortgage-holders can block refinancing of first mortgages.
  – Private mortgage holders prefer foreclosure.
Solutions 2: Government programs

• “Hope Now” – program to encourage voluntary renegotiation. It did little.

• “Hope for Homeowners” passed July 2008.
  – Government will issue new mortgages.
  – Program requires old lenders to consent.
  – This means adverse selection (large losses for government) and tough bargaining by lenders (some worthwhile refinancing won’t occur).
Solutions 3: Bankruptcy approach

• Allow bankruptcy judges to “strip-down” mortgages in bankruptcy.
• Divide mortgage into:
  – secured part = current market value and
  – unsecured part = the remainder.

The unsecured part could be discharged or partially repaid, like other unsecured debt.
Solutions 3: cont.

• Judges could also:
  – Reduce the principle or interest rate.
  – Discharge excessive fees.

• Lenders’ consent not required, so no renegotiation problem and no adverse selection.

• Bankruptcy trustees could spot opportunism since bankruptcy requires extensive documentation.
Solutions 3: cont.

Possible drawbacks:

- Mortgage interest rates might rise?
- Reduced supply of credit card loans because more would be discharged.
Bankruptcy approach provides an alternate route for debtors if:

• lenders refuse their consent or
• government programs run out of money.