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Foreclosure and Bankruptcy — Policy Conclusions From the Current Crisis

By Theresa Kuchler and Johannes Stroebel

The recent turmoil in the U.S. economy has been accompanied by an unprecedented joint increase in bankruptcy and foreclosure rates. In 2008, U.S. consumer bankruptcy filings increased by nearly 33 percent over the previous year, to a total of more than 1 million. During the same period, more than 2.3 million properties faced foreclosure, which represents an 81 percent increase over 2007 and a 225 percent increase over 2006. Alongside the increasing unemployment rate, this twin-crisis of rising foreclosure and bankruptcy rates has been the most visible effect of the recent economic downturn on American households.

Unsurprisingly then, there has been a lively debate among policymakers and economists regarding the causes of and potential solutions to the crisis, and a number of changes to the regulatory framework have been proposed. Foreclosure, like bankruptcy, provides a crude form of insurance to households that receive shocks to their income and the value of their assets. The degree of the insurance provided depends crucially on a number of policy parameters that vary among states and are described in the next paragraph. Changes to these policy parameters are at the center of many current policy proposals: In particular, Martin

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Feldstein (2008) suggested, "The key to preventing further defaults and foreclosures among the current negative equity homeowners is to shift those mortgages into loans with full recourse, allowing the creditor to take other assets or a fraction of wages if the homeowner defaults." In this policy brief we argue that any proposal aimed at reducing foreclosures also needs to consider prevailing bankruptcy laws. We show that a move to recourse mortgages may do little to reduce foreclosure rates and could instead lead to a significant increase in bankruptcy rates.

Policy Environment

In the United States, individuals filing for consumer bankruptcy usually do so under either Chapter 7, the most common form of bankruptcy in the United States ("liquidation bankruptcy"), or Chapter 13 ("consumer reorganization"). Under Chapter 7 bankruptcy, a debtor surrenders his or her non-exempt property to a bankruptcy trustee who then liquidates the property and distributes the proceeds to the debtor's unsecured creditors. In exchange, the debtor is entitled to a discharge of his or her unsecured debt. Asset exemption levels (both for homestead and other property) determine how costly bankruptcy is for individual households and vary widely. For example, in Oklahoma and Texas the homestead exemption is unlimited, while New Jersey has no homestead exemption at all. Other property exemptions also vary significantly. In Texas, couples filing jointly can keep assets up to $60,000, while New Jersey limits property exempt in Chapter 7 bankruptcy to $2,000.

Another important policy parameter to be considered is whether the mortgage is recourse or non-recourse. A non-recourse mortgage is secured by a pledge of collateral, typically the real property, without personal liability of the borrower. If the borrower defaults, the lender can seize the collateral, but the lender's recovery is limited to the collateral. Recourse mortgages, on the other hand, allow a lender to seek a deficiency judgment if in the sale of a foreclosed house the mortgage cannot be repaid in full; the borrower will remain liable for the difference. While 29 states allow deficiency judgments in theory, some of the states most heavily hit by the foreclosure crisis do not, and many have stringent requirements that need to be fulfilled before a deficiency judgment can be obtained. In Arizona, a deficiency judgment is not available if the property is located on 2.5 acres or less and is a single family residence or duplex. Other states, like California, require expensive and time-consuming judicial foreclosures to obtain a deficiency judgment, which makes California a *de facto* non-recourse state (states with similar rules include, among others, Oregon and Washington). Any policy that involves "shifting mortgages into recourse" would thus also involve making it less costly to obtain deficiency judgments in the states that allow them *de jure* but that make them prohibitively expensive.

Policy Analysis

In recent months, reducing the high foreclosure rates has become one of the primary goals of policy. Beyond the individual tragedies that stand behind a family having to give up its home, foreclosures have shown to further depress local house prices, lowering expectations of future house prices and setting off a downward spiral of further foreclosures. The idea behind proposals to shift mortgages into recourse is that by making it more difficult and more costly for households to "walk away" from their mortgages, foreclosures can be reduced. In this policy brief and in more detail in Kuchler and Stroebel (2009), we argue that contrary to many recent proposals, switching loans from non-recourse to recourse does not necessarily provide a solution to the foreclosure problem and may actually lead to an increase in bankruptcy rates.

In most cases, deficiency judgments in recourse states are dischargeable in bankruptcy proceedings. After defaulting on a mortgage and entering into foreclosure, a household may also declare bankruptcy in order to discharge a potential deficiency judgment. This may be particularly appealing if the costs associated with bankruptcy (both in terms of lost assets but also in terms of legal costs, damage to credit score, and stigma effects) are small. Thus, one of the essential differences between recourse and non-recourse states is that in recourse states it is not possible to just walk away from an underwater mortgage. To do so, the household would also need to declare bankruptcy to discharge the deficiency judgment.

Therefore, in recourse states the household's decision to enter into foreclosure partially depends on the state's bankruptcy laws, especially the generosity of the property exemption limits. In some states exemption limits are very high, so that many debtors would not have to give up significant assets in the case of bankruptcy. Moreover, foreclosure allows households to get rid of a property with significant negative equity. First American Core Logic's Negative Equity Report of March 4, 2009, shows that in California, there are more than 1.9 million borrowers that are "underwater" (United States: 8.3 million), of which 723,000 have a loan-to-value ratio of more than 125 percent. For households with such a mortgage, even in recourse states, the additional costs of filing for bankruptcy will likely be dwarfed by the benefits of being able to walk away from their massive negative home equity. Therefore, we believe that there is a danger in assuming that a switch from non-recourse mortgages to recourse mortgages will necessarily reduce foreclosures. In many states, the effect on foreclosures will be limited, while bankruptcies can be expected to rise.

An important question is how substantial this effect is empirically. In Kuchler and Stroebel (2009) we show that a 10 percent fall in house prices over the previous year (as measured by the OFHEO index) is associated with an increase of 16.9 bankruptcies per 100,000 individuals per quarter in non-recourse states and an increase of 21.8 bankruptcies per 100,000 individuals per quarter in recourse states. When compared with a rate of 50 bankruptcies per 100,000 households per quarter in 2006, the effects of the recourse laws are economically significant. This analysis would suggest, for example, that in a non-recourse state like Arizona, which experienced a 15 percent decline in house prices in 2008, the introduction of recourse mortgages would have increased the number of observed bankruptcies by 10 percent. This corresponds to an additional 500 bankruptcies in the fourth quarter alone. The following diagrams show the development of bankruptcies in California and Arizona during the past two

Figure 1 – Arizona

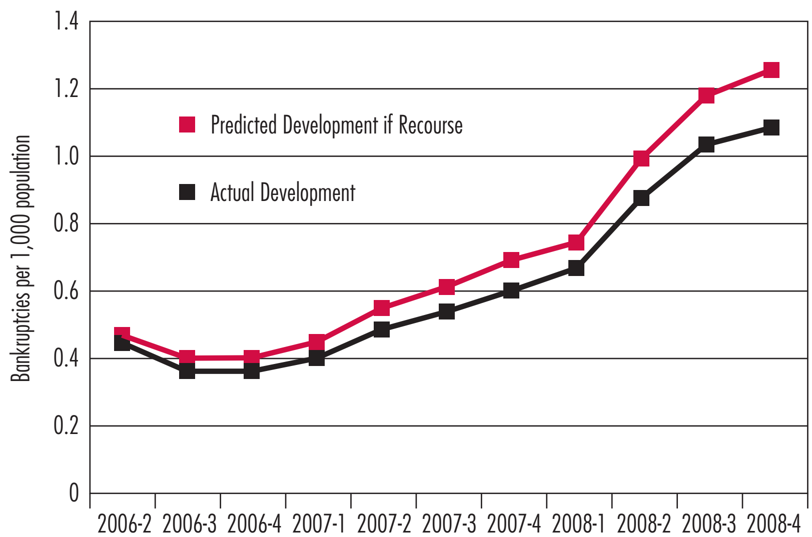
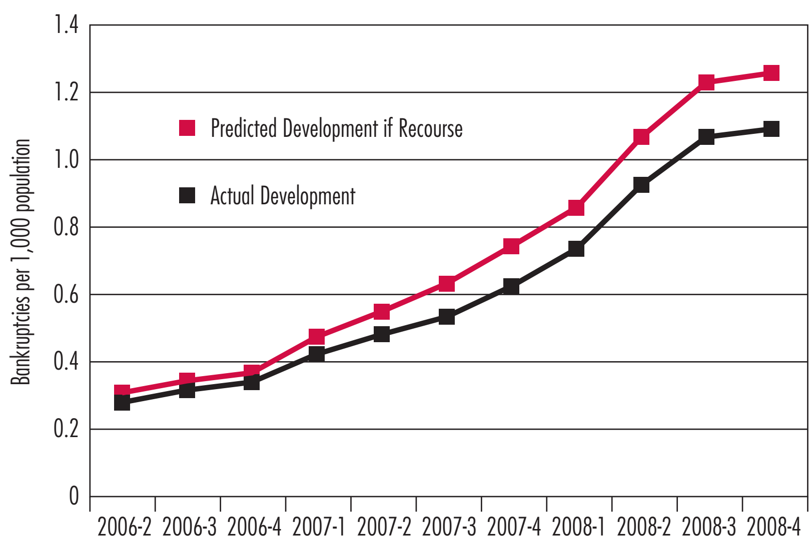


Figure 2 – California



years. The lower line depicts the actual development of bankruptcies, while the upper line shows the predicted development of bankruptcies that would have occurred, if the states had been recourse states (or, in the case of California, if obtaining deficiency judgments had not been prohibitively costly and time-consuming).

Inducing Households to Switch

An additional difficulty with a proposal such as Feldstein's is that a switch from non-recourse to recourse mortgages would most likely require an ex-post change in contract terms, to which the households would have to agree. In the November 18, 2008, hearing of the House Financial Services Committee, Chairman Barney Frank commented how Congress would "have a hard time legally forcing it [the change from recourse to non-recourse] on others." Feldstein's solution to this is to offer a substantial write-down in the outstanding loan balance in order to induce households to accept such a switch; the government would cover the balance between the maximum write-down that the creditor would accept and the minimum write-down that the

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homeowner requires to give up his current right to walk away from his debt.

However, in an environment where house prices are expected to continue falling, households would require a very large reduction in their outstanding mortgage balances to be enticed to accept a switch. For households expecting house prices to fall further, the option to "walk away" from a mortgage is very valuable; even if all negative equity was wiped out by the write-down, future falling house price can quickly push the household underwater again, then requiring bankruptcy on top of mortgage default to walk away. In addition, determining the exact amount by which the face value of mortgages would have to be reduced to induce households to accept the change in their contract terms is very difficult — both sides would have an incentive to misrepresent their true demands.

Conclusions

In this policy brief and in Kuchler and Stroebel (2009) in more detail, we have assessed whether a switch from non-recourse to recourse mortgages, as has been proposed by a number of policy commentators, will be sufficient to significantly reduce foreclosures. We arrive at the following conclusions:

- The effect on foreclosure rates of turning mortgages from non-recourse into recourse loans crucially depends on (i) the existing bankruptcy exemption limits and (ii) the net non-housing asset position of those households defaulting on their mortgage. Under generous bankruptcy exemption limits, or for households with few non-housing assets, such a switch will have only small effects on reducing foreclosure rates, while driving more households with underwater mortgages into bankruptcy.
- In recourse states, a lowering of the exemption limits in bankruptcy can be a powerful tool to reduce foreclosures. This could be achieved without having to change existing contracts and could thus potentially be implemented in a timely manner.
- In states such as California where it is legally possible to obtain a deficiency judgment, but where the process of doing so is expensive and time-consuming, a good step in the right direction would be to make the pursuit of deficiency judgments easier, while simultaneously lowering property exemption levels in bankruptcy.
- In non-recourse states, a simultaneous introduction of recourse mortgages with a lowering of bankruptcy exemption limits promises to be successful at reducing foreclosure and bankruptcy rates.
- In an environment when households expect a further decline in house prices, the reduction in the face value of the mortgage that is required to induce households to accept changes in their mortgage contracts that make them recourse is substantial.

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