Bankruptcy, Mortgage Default, and the Financial Crisis

Michelle J. White
UC San Diego,
Cheung Kong Graduate School of Business,
and NBER

What is personal bankruptcy?

- A legal procedure for resolving all of an individual’s debts at once.
- It specifies the size and division of the repayment pie
  - What income and assets the debtor must use to repay and for how long.
  - What the debtor can keep.
  - How the payments are divided among creditors.
- When are debts discharged—immediately, after some time period, or never.
- Punishment for debtors – less severe over time.

US and European countries have personal bankruptcy procedures

- The US procedure is the most pro-debtor:
  - no obligation to repay from future earnings for most debtors and immediate discharge of debt,
- European bankruptcy procedures are more pro-creditor:
  - debtors must repay from income for 3-6 years before the remaining debt is discharged.

Why have bankruptcy?

- Consumers gain from borrowing to smooth consumption or make investments.
- But borrowing is risky since debtors may lose their jobs or become ill.
- Bankruptcy reduces the downside risk of borrowing by discharging debt when ability-to-pay is low, i.e., it provides partial consumption insurance.
- It also encourages individuals to become entrepreneurs.

Drawbacks of bankruptcy

- Debtors don’t work as hard, because the cost of job loss is lower.
- Debtors borrow more.
- Debtors may file for bankruptcy even if no adverse event has occurred.
- The rise in default causes lenders to reduce credit supply and raise interest rates.

US bankruptcy law pre-2005

- No requirement for debtors to repay from future earnings.
- Unsecured debts are discharged immediately (mortgage debts not changed).
- Only an obligation to repay from assets > exemption level. Exemption levels vary across US states.
  - Homeowners in high-exemption states can file and keep their homes.
- Only punishment is that debtors' credit scores fall.

Research on effects of bankruptcy:

- Interest rates are higher and supply of credit is lower in US states with higher exemptions for assets.
  - In states with higher exemptions, rich people get more credit and poor people get less.
- More people own businesses in states with higher exemptions.
- But the supply of small business credit is lower.
- Divorce rates are higher in these states.
- Fewer people buy health insurance in these states.

More research on bankruptcy:

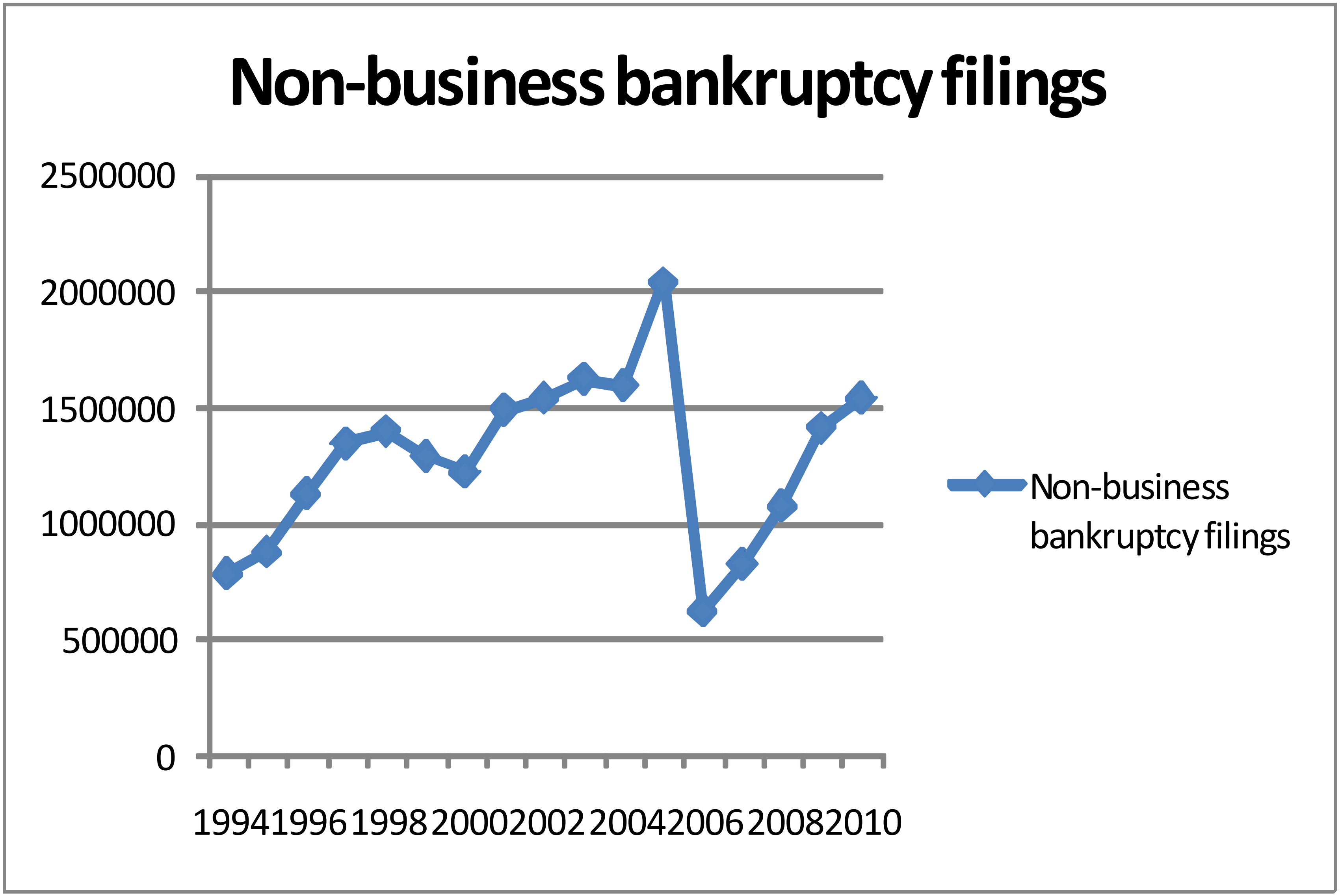
- Across European countries, credit supply is lower/interest rates are higher in countries with more pro-creditor bankruptcy laws.

Bankruptcy and the financial crisis

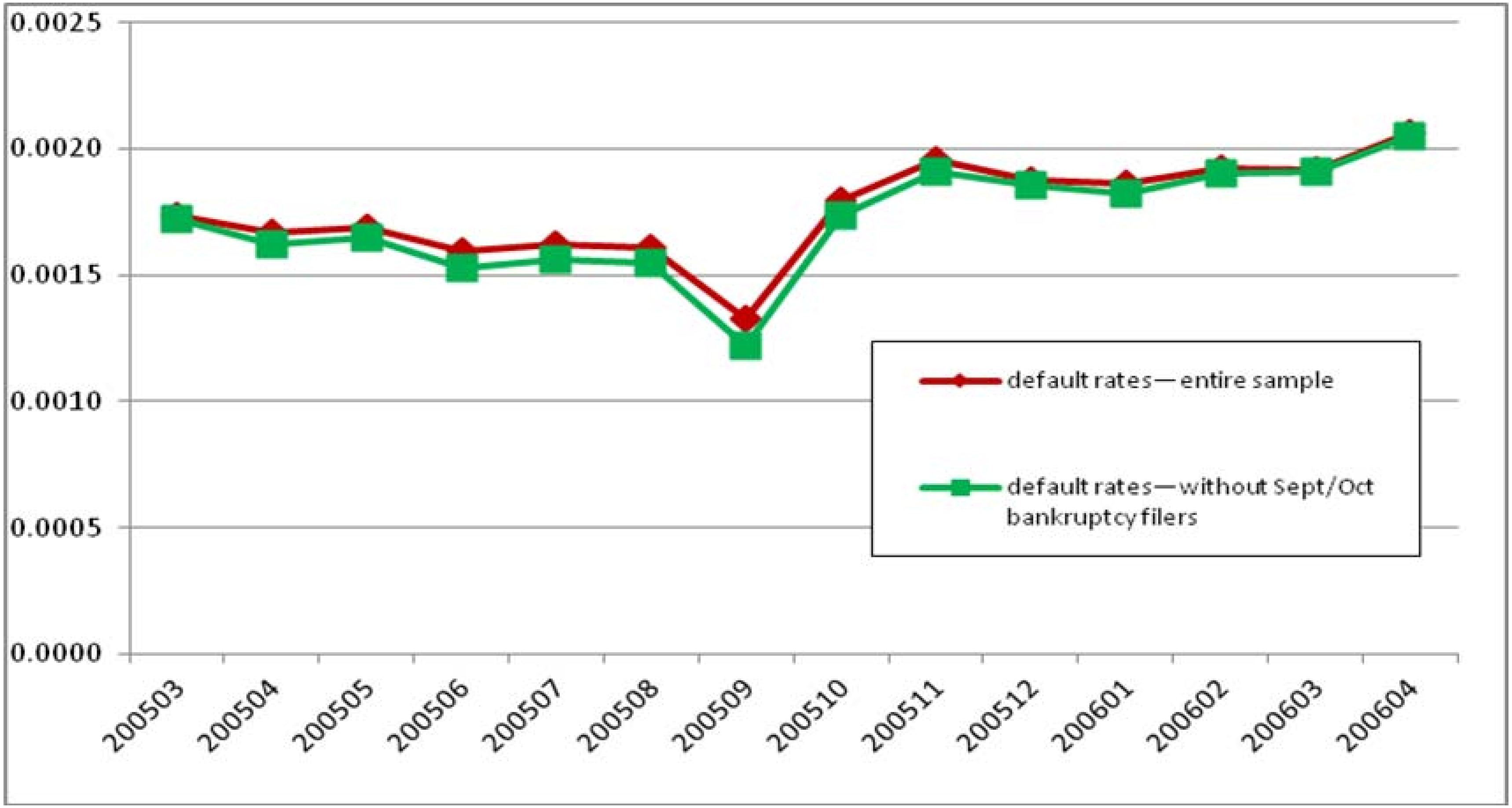
- US bankruptcy law was changed in 2005:
  - Some high-income debtors now must use future earnings to repay unsecured debt.
  - The highest homestead exemptions were reduced, forcing some homeowners with high home equity to sell their homes in bankruptcy.
  - The costs of filing for bankruptcy rose for all debtors.

Effect of Bankruptcy Reform on Mortgage Default (Li, White, Zhu):

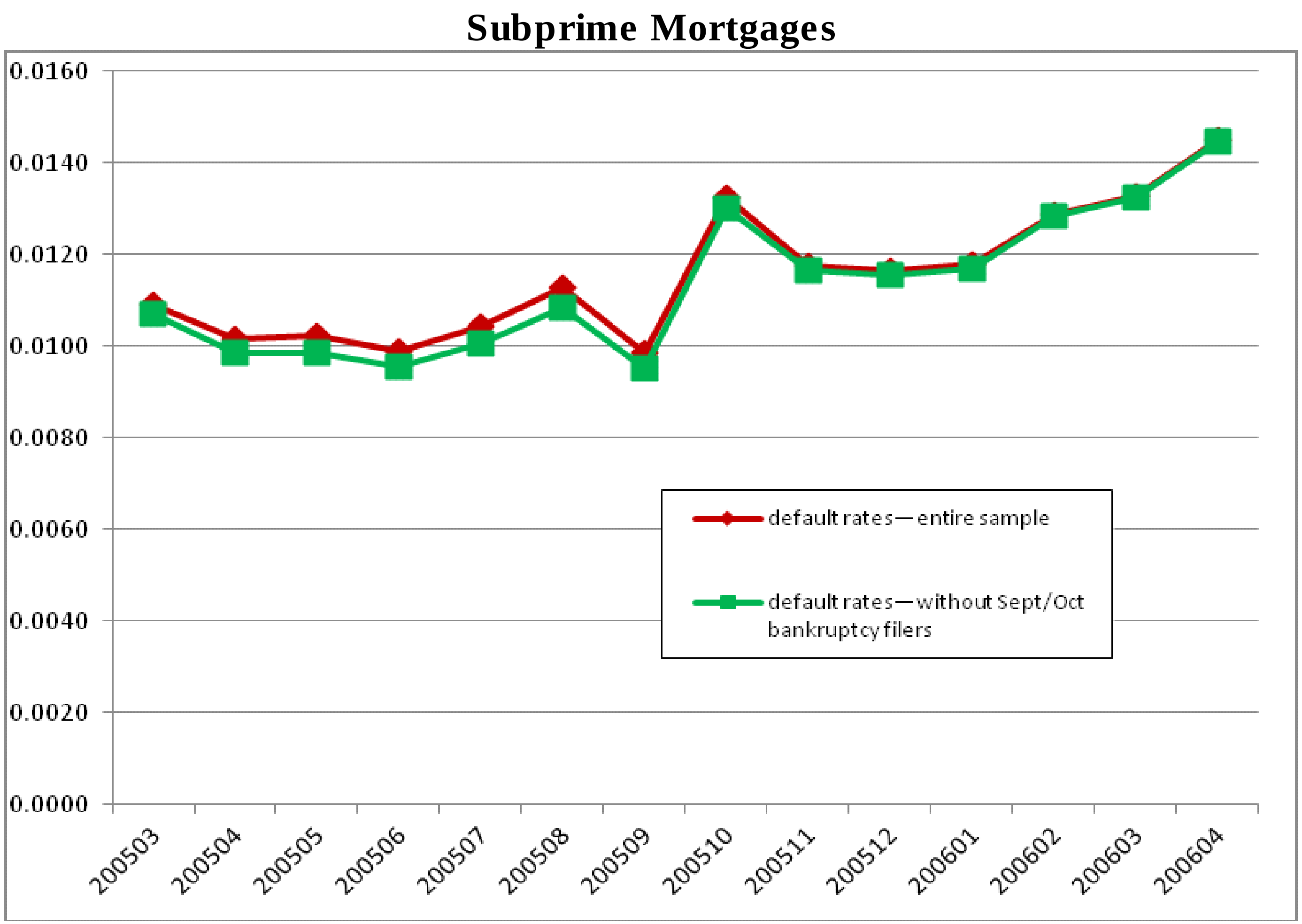
- Prior to 2005, many homeowners used bankruptcy to save their homes.
  - They filed for bankruptcy and had non-mortgage debts discharged—this gave them more money to pay their mortgages.
- After 2005, this route was partially blocked.
- Result was fewer bankruptcy filings and more mortgage defaults.


Non-business bankruptcy filings
2500000
2000000
1500000
1000000
500000
0
1994
1996
1998
2000
2002
2004
2006
2008
2010
Non-business bankruptcy filings

Prime Mortgage Default Rate



Subprime Mortgage Default Rate



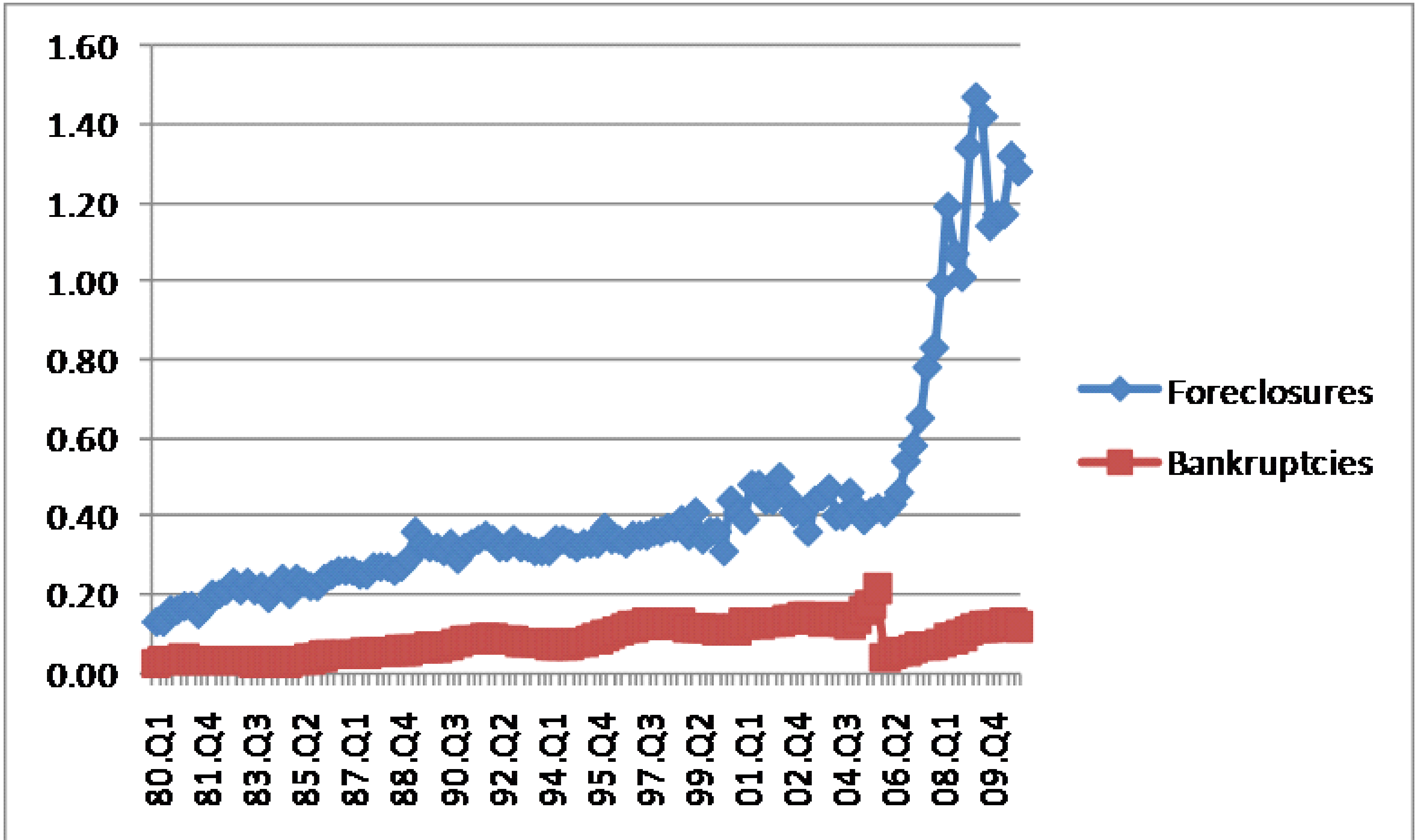
Increase in Mortgage Default Rates After Bankruptcy Reform:

	Prime mortgages	Subprime mortgages
All mortgage-holders	23%	14%
Mortgage-holders with high incomes	26%	5%
Mortgage-holders subject to lower asset exemptions	30%	28%

What can we conclude?

- Direct effect: bankruptcy reform caused 225,000 additional mortgage defaults in 2006—an increase of 1 percentage point in the mortgage default rate. This increased housing supply.
- Indirect effects: the reduction in consumption insurance due to bankruptcy reform reduced housing demand.
  - US housing prices peaked in spring 2006 and began falling quickly in 2007.
  - Lower housing prices caused even more mortgage default, especially by subprime borrowers with little home equity.
- The financial crisis began with subprime mortgages.

Mortgage Foreclosure and Bankruptcy Rates, 1980-2009



Conclusion

The 2005 bankruptcy reform in the US at least partially caused the subprime mortgage crisis, the 2008 financial crisis, and the "Great Recession."