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Proposed Mortgage Modifications in Bankruptcy Code.

WRITTEN TESTIMONY

Submission of
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January 22, 2009

Hearing of the Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
United States House of Representatives

It is my pleasure to provide this submission on the topic of mortgage modification in bankruptcy. The nation faces a foreclosure crisis of historic proportions and many homeowners are in deep financial trouble. And there is an understandable desire to "do something" to try confront the problem. Amending the Bankruptcy Code to permit modification of home mortgages must appear especially tempting as a political matter because it doesn't appear to require further expenditure of public funds, thus it appears to be "free" to Washington. Allowing mortgage modification will provide a windfall for some troubled homeowners, but its costs will be borne by aspiring future homeowners and any American who uses credit of any kind, from car loans to credit cards. The ripple effects could deepen the troubles the currently roiling America's consumer credit markets. Finally, because of the federal takeover of Fannie Mae and Freddie Mac, the losses incurred in bankruptcy may eventually come back to the taxpayers anyway.

Called "cramdown" in bankruptcy lingo—because it permits the borrower to "cram the new deal down the throat of the lender"—the ability to modify mortgages in bankruptcy has been allowed for the past thirty years for commercial property, investment properties and vacation homes, and until a few years ago, cars. But it has never been allowed for homeowners' primary residences. Now is not the time to start.

Allowing Cramdown will Increase the Risk of Home Mortgage Lending

Allowing borrowers to rewrite their mortgages in bankruptcy will increase the risk of mortgage lending at the time loans are made. Increasing the risk will increase the overall cost of lending, which in turn will require future borrowers to pay higher interest rates and especially higher upfront costs, such as higher downpayments and points. Empirical studies of residential real estate markets overwhelmingly demonstrate that there is no free lunch—increasing borrower protections from creditors on the back-end of a loan invariably increases the risk and thereby the cost of borrowing on the front end. And riskier borrowers who are the most likely to file bankruptcy will find themselves particularly adversely affected or even excluded from the market completely (or pushed back into high-cost subprime loans). Those who do get loans will have higher monthly payments than they would otherwise—which could, ironically, make them more prone to being pushed into bankruptcy.

A recent study of the impact of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") confirms this finding in the context of cramdown specifically.[1] Among its provisions, BAPCPA eliminated the power of debtors to cramdown most automobile loans. By reducing the risk of automobile lending, BAPCPA resulted in lower interest rates on car loans for consumers, with the specific effects varying among states.

[1] Donald P. Morgan, Benjamin Iverson, & Matthew Botsch, *Seismic Effects of the Bankruptcy Reform*, FEDERAL RESERVE BANK OF NEW YORK STAFF REPORTS, Staff Report No. 358 (Nov. 2008).

Allowing Cramdown of Mortgages Could Dramatically Increase Bankruptcy Filings and Have Spillover Effects on Other Consumer Credit

Allowing mortgage modification in bankruptcy could unleash an unprecedented torrent of bankruptcies. To gain a sense of the potential size of the problem, about 800,000 American families filed bankruptcy last year; this year, the weakening economy and rising unemployment has already pushed the number near one million. By recent count, some 5 million homeowners are currently delinquent on their mortgages and some 12-15 million homeowners are "underwater" on their mortgages. If even a fraction of those homeowners file bankruptcy in order to reduce their interest rates or strip down their principle amounts to the value of their homes, we could see an unprecedented surge in bankruptcy filings.

Finally, once bankruptcy is filed, it won't just affect the mortgage but will sweep in all of the bankrupt's other debts, including credit cards, car loans, medical debt, and any other debt. Thus, what started as a mortgage problem could have the ripple effect of destabilizing the market for all other types of consumer credit. When combined with the high likelihood that a surge of bankruptcy filings would follow, there could be a serious negative effect on already-precarious credit markets.

Cramdown Will Likely Increase the Possibility of Bankruptcy Abuse

Because of record-low interest rates and the foreseeable prospect that home prices eventually will begin to rise at some point in the future, borrowers have strong incentives to file bankruptcy to strip-down their mortgage principle and reduce their monthly payments with the knowledge that if they sell their house sometime in the future they will be able to capture any appreciation during that period. Traditionally, the ability to modify consumer debt was limited to depreciating assets like cars and boats, thus this temptation for strategic behavior was mitigated because borrowers had little prospect of profiting because the property was unlikely to increase in value in the future. Nonetheless, even modification of car loans was made substantially more difficult by the 2005 bankruptcy law amendments—precisely because it was thought that too many consumers were rewriting car loans in bankruptcy and thereby imposing excessive losses on the automotive lending industry.

Moreover, the primary effect of cramdown will be to increase this potential for abuse. In theory, cramdown permits a bankruptcy judge to modify both the interest and principal on a homeowner's mortgage. But the Supreme Court has noted that to fully compensate the lender, the interest rate on a cramdown loan must be set at the market rate of interest, considering the risk of the borrower and the loan itself. *See Till v. SCS Credit Corp.*, 541 U.S. 565 (2004). A market-based cramdown interest rate would have to consider the unusual nature of the mortgage—including the fact that the borrower himself often was a highly risky borrower to begin with (especially in the subprime market), that the already-risky borrower has become recognized as even more risky by having filed bankruptcy, and finally that the cramdown loan itself has a 100% loan-to-value ratio, the exact sort of high-risk loan that brought the current crisis about in the first place. Given the risk of the borrower and the loan, few borrowers would seem to be actually entitled to an interest-rate reduction if the interest rate is actually set at the "market" rate of interest. This

suggests that bankruptcy judges who do reduce interest rates often will be setting the interest rate below the actual realistic market rate. Or, alternatively, that the debtor is seeking mortgage modification for the purpose of writing down the principal on the loan, rather than for an interest rate reduction.

Advocates of mortgage modification believe that concern about an adverse credit mark will deter consumers from gaming the incentives created by the opportunity to rewrite their mortgages. Experience and common sense suggests that this blind faith unfortunately is misplaced. Delinquency and foreclosure also damages one's credit report, yet news reports indicate a growing number of homeowners who are voluntarily walking away from underwater mortgages and allowing foreclosure. And the opportunity to strip-off tens or hundreds of thousands of dollars of debt and to even write-down one's interest rate to boot is one that many homeowners will find difficult to resist.

An Appendix to this submission contains a detailed discussion of the causes of default and foreclosure on home mortgages. Not all foreclosures are triggered by financial distress and a proper remedy for foreclosures must rest on a proper understanding of the causes of foreclosure.

Cramdown of Vacation Homes and Investment Properties are Distinguishable

It is true that current law permits modification of mortgages on vacation homes and other investment properties, but few bankruptcy filers own beach homes and even fewer still are likely to file bankruptcy just to avoid foreclosure on a vacation home (unlike their primary residence). Second homes also are essentially considered business property under the bankruptcy laws, thus while the comparison has emotional appeal it is misplaced as a logical matter. The relative paucity of vacation homes in personal bankruptcy cases also means that any increased cost from allowing modification in bankruptcy is likely to be relatively small and impacting only those wealthy enough to be in the market for investment vacation property. Moreover, lenders knew that they were lending for business purposes when those loans were made and priced them accordingly. This is not the case for residential mortgages.

Conclusion

It is understandable why amending the bankruptcy code to allow modification of mortgages is political attractive, but it is a poor solution for today's mortgage problem. Consumer bankruptcy is a relatively blunt instrument that is designed to give a fresh start to households that have a general debt problem, either because of general indebtedness or some unexpected financial shock (such as unemployment or divorce) that has left them unable to pay their bills. It is not well-designed to deal with the type of surgical intervention implied by the mortgage crisis. Solutions focused on resolving the mortgage problem may be more costly than allowing mortgage modification in bankruptcy, but they are much more likely to be effective and will have many fewer unintended consequences than allowing mortgage modification.

To the extent that it is felt appropriate to nonetheless permit cramdown of home mortgages, it would be prudent to consider the following limitations, among others:

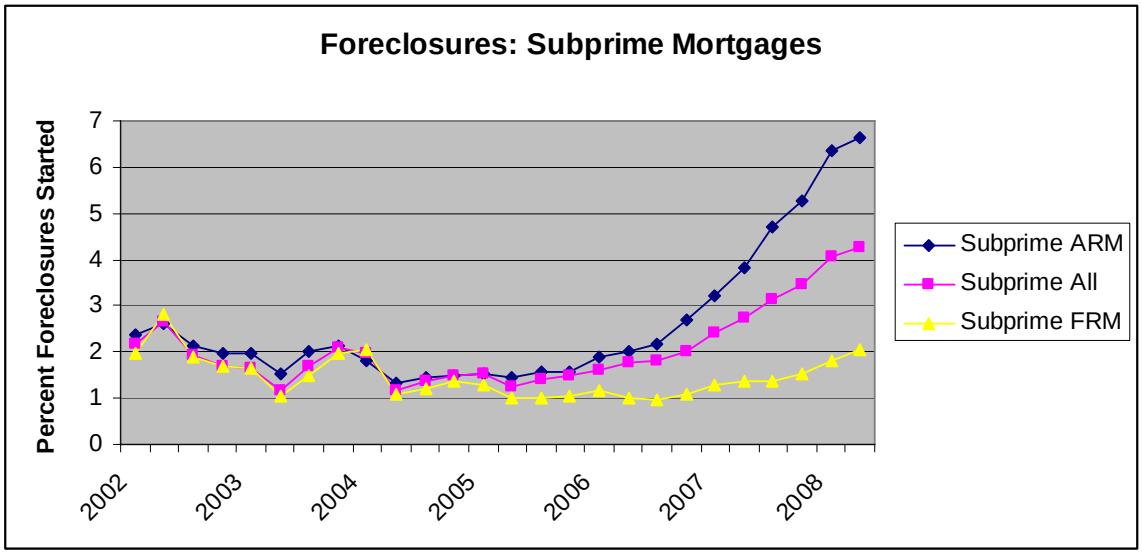
- Limiting cramdown to high-interest loans for which market-based interest rates may actually result in a reduction in interest rates;
- Severely limiting repeat-filings to prevent borrowers from using bankruptcy as a device to stave off legitimate foreclosures;
- Providing for some amount of equity recapture for lenders if the borrower sells the house for a profit after an equity stripdown;
- Making cramdown retrospective only for loans issued before a certain date.

Appendix: Analyzing Foreclosures

Home foreclosures may result from two conceptually distinct, although practically overlapping, reasons. *See* Todd J. Zywicki and Joseph Adamson, *The Law and Economics of Subprime Lending*, 80 U. COLO. L. REV. __ (Forthcoming 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1106907 . First, foreclosure may result from economic distress, resulting in a borrower who wants to keep his home but is unable to do so. This may be an unexpected income shock, such as unexpected job loss, or an unexpected increase in expenses, such as an increase in the interest rate on an adjustable-rate mortgage. But second, foreclosure may result from a debtor's decision to walkaway from a home that has fallen in value and is now "underwater." *Both* theories appear to have some explanation in the current environment. Treating the foreclosure crisis as one of primarily economic distress, however, may open the door to abuse by those who opportunistically avail themselves of bankruptcy in order to game the system.[2]

Interest rate resets connected to adjustable-rate mortgages helps to explain the rapid rise in foreclosure rates. Moreover, it helps to explain the spread of the foreclosure contagion beyond the subprime market into the prime market in many areas. First, consider the trends on foreclosures on subprime mortgages. Figure 4-12 shows the trends for foreclosures starts for subprime mortgages since 2002.

Figure 4-12



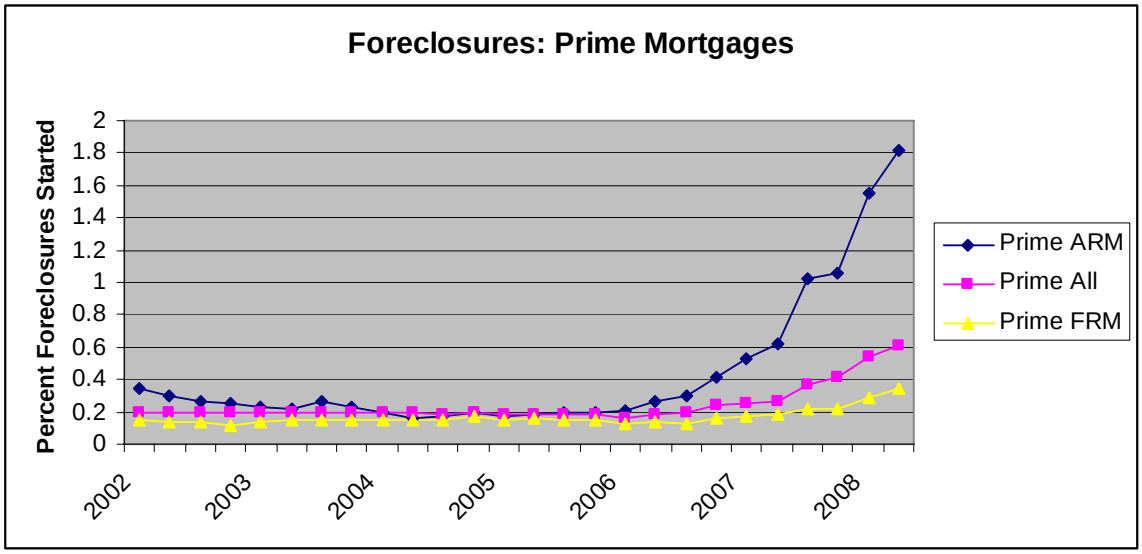
As can be readily seen, from 2002 into 2006 the foreclosure rate on subprime ARMs was comparable to the foreclosure rate on subprime FRMs. Beginning in 2006, however, the trends diverge, leading to a dramatic rise in subprime ARMs. In fact, although the foreclosure rate on subprime FRMs has risen it actually remains *lower* than at periods in the past. In part this distinction in default rates reflects differential sorting by lenders among subprime borrowers for fixed and adjustable-rate mortgages as subprime ARM borrowers have substantially lower FICO credit scores and higher combined LTV ratios

[2] The following discussion is adapted from Todd J. Zywicki, *Bankruptcy Law and Policy in the 21st Century* (Forthcoming 2009, Yale University Press).

than subprime FRM borrowers.[3] The difference, however, is not huge and it is difficult to imagine that the characteristics of the borrowers alone rather than the characteristics of the loans themselves explain the dramatically different performance of these loans.

But this difference in performance is not limited to subprime loans. Prime loans show a similar pattern of foreclosures (although at much lower base rates), as seen in Figure 4-13:

Figure 4-13



As with subprime loans, prime loans also show a dramatic divergence in performance between fixed and adjustable rate mortgages. Although the foreclosure rate on fixed FRMs is at its highest point during this period, the increase is modest compared to the dramatic rise in foreclosures on ARMs.

In short, the "payment shock" theory may have some validity in the current climate although the mechanism of transmission is difficult to understand. The artificial lowering of interest rates from 2001-2004 pushed down short-term interest rates, allowing borrowers to qualify for larger mortgages than they otherwise could. But this was a phenomenon that was not limited to the subprime market. As during prior times when the spread between short and long-term interest rates expanded, home purchasers gravitated toward adjustable-rate mortgages—both prime and subprime borrowers. As a result, when interest rates began to increase in the 2005-2006 period this may have made payment obligations unaffordable for many homeowners.[4]

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[3] Mayer, Pence, & Sherlund, *The Rise in Mortgage Defaults* at 8.

[4] This leaves aside the phenomenon of "teaser" or below-market introductory rates. Where teaser rates were present, the impact of payment shock was heightened when the interest rate reset. For instance, among subprime loans with initial below-market "teaser" rates, one study predicts that 32% of loans with initial teaser rates eventually will default as a result of interest rate reset, but only 7% of market-rate adjustable loans will default due to reset. CHRISTOPHER L. CAGAN, MORTGAGE PAYMENT RESET: THE ISSUE AND THE IMPACT 44 (2007).

On the other hand, ARM-related payment shock does not provide a comprehensive explanation of all foreclosures. One factor that has been often-cited as a cause of rising foreclosures are so-called "hybrid" mortgages, that have an initial fixed period of two or three years (usually at below-market interest rates) followed by adjustable rates for the duration of the loan. It is contended that these hybrid mortgages are "exploding" mortgages that start with extremely low rates during the fixed-rate period of the loan but then "explode" to extremely high rates after the interest rate reset. But it is doubtful that this phenomenon can explain the rise in foreclosures, at least the early wave. One estimate of subprime loans facing foreclosure in the early wave of foreclosures found that 36% were for hybrid loans, fixed-rate loans account for 31%, and adjustable-rate loans for 26%.[5] Of those loans in foreclosure, the overwhelming majority entered foreclosure *before* there was an upward reset of the interest rate.[6] Most defaults on subprime loans occur within the first 12 months of the loan, well before any interest adjustment.[7] For those borrowers who actually undergo an interest-rate reset, the new rate is higher, but not dramatically so when compared to the original rate.[8] On average, the rate for subprime borrowers from the period 2003-2007 adjusted from an initial rate of about 8 percent to about 11 percent. Economists Anthony Pennington-Cross and Giang Ho find that the transition in a hybrid loan from an initial fixed period to the adjustable rate period results in heightened rates of prepayment, not default.[9] They also find that the termination rate for subprime hybrid loans (whether by prepayment or default) is comparable to that of prime hybrid loans. Other studies have also documented a dramatic rise in early payment defaults, an absence of rising defaults at the time of interest-rate adjustments, a tendency toward prepayment rather than default around the time of reset, and an absence of evidence of "exploding" rates. In light of these facts, economists have almost universally concluded that hybrid mortgages (at least alone) cannot explain the rise in foreclosures. After examining the evidence, several economists from the Boston Federal Reserve flatly state, "Interest-rate resets are not the main problem in the subprime market."[10]

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[5] James R. Barth et al., *Mortgage Market Turmoil: The Role of Interest-Rate Resets, in* SUBPRIME MORTGAGE DATA SERIES (Milken Inst.) (2007); C.L. Foote, K. Gerardi, L. Goette, & P.S. Willen, *Subprime Facts: What (We Think) We Know about the Subprime Crisis and What we Don't*, FED. RES. BANK BOSTON PUBLICLY POLICY DISCUSSION PAPER 08-02 (2007); C. Mayer, K. Pence, & S.M. Sherlund, *The Rise in Mortgage Defaults: Facts and Myths*, J. ECON. PERSPECTIVES (Forthcoming 2008).

[6] Barth, *supra* note. Of those subprime loans in foreclosure, 57 percent of 2/28 hybrids and 83 percent of 3/27 hybrids "had not yet undergone any upward reset of the interest rate."

[7] Mayer, Pence, & Sherlund, *The Rise in Mortgage Defaults* at 11; Shane Sherlund, *The Past, Present, and Future of Subprime Mortgages*, Federal Reserve Board (Sept. 2008); Kristopher Gerardi, Adam Hale Shapiro, & Paul S. Willen, *Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures*, Federal Reserve Bank of Boston Working Paper No. 07-15. Mayer, Pence, and Sherlund find a dramatic rise in "early payment defaults" well before any interest rate adjustment takes place.

[8] *See* C.L. Foote, K. Gerardi, L. Goette, & P.S. Willen, *Subprime Facts: What (We Think) We Know about the Subprime Crisis and What we Don't*, FED. RES. BANK BOSTON PUBLICLY POLICY DISCUSSION PAPER 08-02 (2007).

[9] *See* Anthony Pennington-Cross & Giang Ho, *The Termination of Subprime Hybrid and Fixed Rate Mortgages* 18 (Fed. Reserve Bank of St. Louis, Working Paper No. 2006-042A, 2006).

[10] Christopher L. Foote, Kristopher Gerardi, Lorenz Goette, and Paul S. Willen, *Subprime Facts: What (We Think) We Know about the Subprime Crisis and What We Don't*, FED. RES. BANK OF BOSTON PUBLIC POLICY DISCUSSION PAPERS 2 (May 30, 2008).

Economists generally conclude that of more importance to foreclosures is falling house prices—the interest rate on a mortgage, whether "exploding" or not, is largely irrelevant if the borrower can refinance or sell out of the mortgage. It is only when the borrower is unable to sell or refinance that the interest rate matters, thus hybrid mortgages (or adjustable rates generally) matter for foreclosures only in a falling real estate market. Mortgages with positive equity tend to terminate in a prepayment of the mortgage (either as the result of a sale or refinance) whereas those with negative equity tend to terminate in foreclosure.[11] As one report concludes, "Without home price increases, hybrid loans will surely exacerbate the foreclosure problem if interest rates reset upward, but they are not the basic cause of it."[12] Finally, to the extent that hybrid or adjustable-rate loans are associated with higher levels of default and foreclosure, this may be a result of a selection effect bias rather than a reflection of the products themselves—borrowers with the most fragile finances are those most likely to choose (or accept) an ARM or a hybrid loan with a teaser rate, and thus their propensity to default may reflect their underlying riskiness rather than the riskiness of the products that they choose.[13]

The relationship between ARMs and foreclosures appears to have been a manifestation of the unique circumstances of the past several years rather than an inherent problem of ARMs. The percentage of ARMs in the market have been much higher at times in the past yet they did not previously result in the surge of foreclosures that have resulted in the most recent environment. In fact, adjustable-rate mortgages are the norm in most of Europe and the rest of the world without the catastrophic events that have transpired in the United States in recent years.[14] The primary difference, it appears, was that in the United States in the past where the yield-spread between ARMs and FRMs became larger, this reflected a general downward trend in interest rates, with ARMs falling ahead of FRMs and FRMs eventually declining as well. In the most recent iteration, however, the interest-rate on ARMs was pushed artificially and unsustainably low, thus the eventual interest rate reset resulted in the interest rate on ARMs *rising* back to the level of FRMs, rather than FRMs falling to the level of ARMs (as was generally the case in the past). It is difficult to argue that ARMs *per se* are therefore unreasonably risky; it is only when ARMs are combined with a monetary policy that pushed short-term interest rates to unsustainably low rates (as was the case from 2001-04 in the United States) that ARMs became a problem.

The decision to maintain homeownership or default and allow foreclosure can be modeled as a financial option. In the option model, the decision to permit foreclosure is driven primarily by a change in the underlying value of the asset. Where the option is "in the money" (i.e., the home is worth more than the amount owed) the homeowner can treat

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[11] Anthony Pennington-Cross, *The Duration of Foreclosures in the Subprime Mortgage Market: A Competing Risks Model with Mixing* 4-5 (Fed. Reserve Bank of St. Louis, Working Paper No. 2006-027A, 2006).

[12] Barth et al., *supra* note 5, at 2.

[13] *See Ending Mortgage Abuse: Safeguarding Homebuyers: Hearing Before the Sen. Subcomm. on Hous., Transp. and Cmty. Dev. of the Sen. Comm. on Banking, Hous., and Urban Affairs*, 109th Cong. 5 (2007) (statement of Anthony M. Yezer, Professor of Econ., George Washington University).

[14] Richard K. Green & Susan M. Wachter, *The American Mortgage in Historical and International Context*, 19 J. ECON. PERSP., Fall 2005, at 93, 107–08 (2005). Most other countries also have shorter mortgage maturity payments combined with a final balloon payment in contrast to the 30-year fixed-rate self-amortizing mortgage that is standard in the United States.

the house as a "call" option—if the homeowner is unable or unwilling to make her monthly payments (perhaps because she is moving) then she can either sell the home or refinance it and pay off the underlying mortgage. Thus, the option to allow foreclosure is of low value to the homeowner in a rising market because the homeowner can instead sell or refinance the house and pocket the equity. But where the house has negative equity (often referred to as "under water" or "upside down"), then the consumer has a put option—either she can continue to pay the mortgage and retain ownership or exercise the "option" to default and allow the lender to foreclose. If this option increases in value or becomes less expensive to exercise, homeowners will become more likely to exercise it.

Under the option theory of foreclosure, therefore, the decision to allow default is essentially a voluntary and rational response to the incentives created by the change in value of the asset—the borrower *could* continue to service the loan but chooses not to. Default and foreclosure result because the borrower strategically chooses the option of foreclosure over the option of continued payment of the loan. Disentangling the distress and option hypotheses is difficult, because housing prices are inversely correlated with interest rates—as interest rates rise, housing prices will tend to fall.

Empirical studies traditionally have tended to support the option theory of foreclosure.[15] For instance, even though interest rates generally rise uniformly across the country, the foreclosure rate is lower for residential real estate where price appreciation has been higher.[16] This suggests that in deciding whether to default the primary consideration by homeowners is the amount of equity that they have accrued in their property (which might be lost in the event of a foreclosure) rather than "payment shock" resulting from an unexpected rise in interest rates. Similarly, those who have drawn against accumulated home equity through home equity loans or junior liens exhibit a greater propensity to default than those who have retained their equity.[17]

The relationship between home price appreciation and foreclosures is striking—foreclosure rates show a close inverse relationship to changes in house prices:

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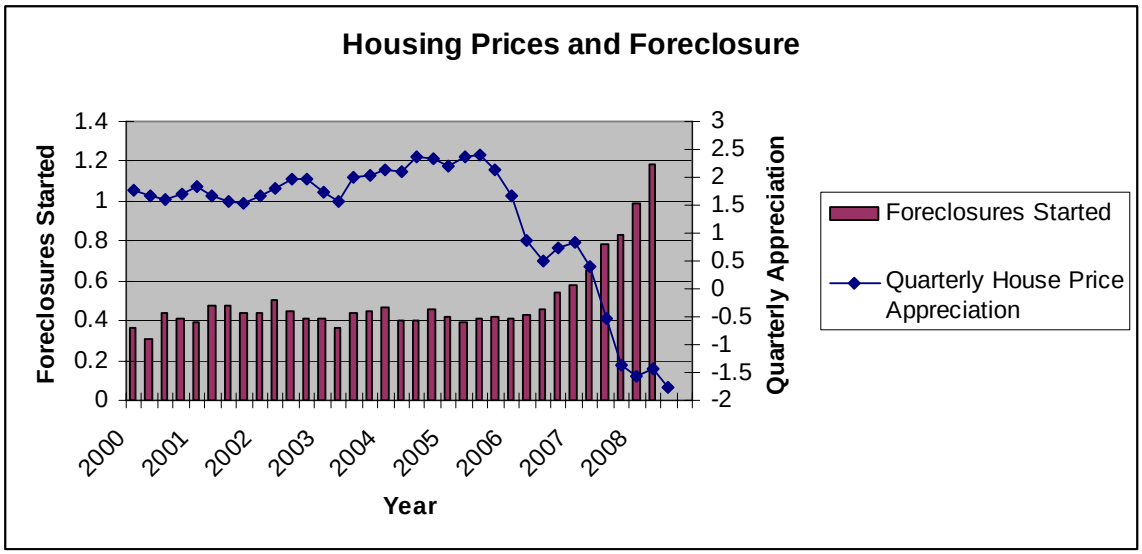
[15] *See* Kerry D. Vandell, *How Ruthless Is Mortgage Default? A Review and Synthesis of the Evidence*, 6 J. HOUSING RES. 245 (1995); James B. Kau & Donald C. Keenan, *An Overview of the Option-Theoretic Pricing of Mortgages*, 6 J. HOUSING RES. 217 (1995); Patric H. Hendershott & Robert Van Order, *Pricing Mortgages: An Interpretation of the Models and Results*, 1 J. FIN. SERVICES RES. 19 (1987).

[16] Mark Doms, Frederick Furlong & John Krainer, *House Prices and Subprime Mortgaged Delinquencies* 1–2 (FRBSF ECON. LETTER NO. 2007-14, 2007); Brent W. Ambrose, Charles A. Capone, Jr. & Yongheng Deng, *Optimal Put Exercise: An Empirical Examination of Conditions for Mortgage Foreclosure*, 23 J. REAL EST. FIN. & ECON. 213, 218 (2001) (higher default rates where home price appreciation slower); Kristopher Gerardi, Adam Hale Shapiro & Paul S. Willen, *Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures* 2–3 (Fed. Res. Bank of Boston, Working Paper No. 07-15, 2008), *available at* http://www.bos.frb.org/economic/wp/wp2007/wp0715.pdf (concluding that dramatic rise in Massachusetts foreclosures in 2006-07 resulted from decline in house prices beginning in summer 2005); Ellen Schloemer, Wei Li, Keith Ernst & Kathleen Keest, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners*, CRL RES. REPORTS, (Ctr. for Responsible Lending, Durham, N.C.), Dec. 2006, at 1, 13.

[17] *See* Michael LaCour-Little, *Equity Dilution: An Alternative Perspective on Mortgage Default*, 32 REAL ESTATE ECON. 359, 369 (2004).



Leading economists have also concluded that the largest factor driving the recent upward trends in the foreclosure rate has been changes in housing prices, rather than interest rates or "trigger events."[18] In particular, it is argued that the primary cause of the foreclosure crisis is to be the dramatic and unexpected fall in house prices that encouraged borrowers to default, rather than dramatically weakened underwriting criteria—if home prices had not declined to the degree that they did then foreclosures would have been dramatically lower, even with all of the other much-criticized practices in the mortgage market over the past decade.[19]

Another factor that has increased the propensity for default and foreclosure is the increase in low-downpayment and interest-only mortgages that meant that borrowers put down or accumulated little equity in their homes. Moreover, this was exacerbated by home-equity loans or cash-out refinance loans that led to equity depletion by many homeowners. In short, many homeowners had minimal equity in their homes. As a result, they bore little cost from permitting default and foreclosure on these homes—in short, they were functionally the same as renters, not homeowners. Permitting cramdown of home mortgages will be particularly advantageous to these borrowers, giving them a second opportunity for their home to appreciate in value and engage in a subsequent home-flipping.

Loans with little or no down payments (such as those with high LTV or mortgages combined with piggyback loans) offer an unusually powerful incentive to default if property values fall.[20] Lower downpayments are correlated with higher rates of default[21]

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[18] KRISTOPHER GERARDI, ANDREAS LEHNERT, SHANE SHERLUND, & PAUL WILLEN, MAKING SENSE OF THE SUBPRIME CRISIS, BROOKINGS PAPERS ON ECONOMIC ACTIVITY (Douglas W. Elmendorf, N. Gregory Mankiw, and Lawrence Summers eds., Fall 2008);

[19] In fact, Gerardi, et al., find that subprime borrower FICO scores actually rose during the housing boom).

[20] In fact, LaCour-Little, et al., conclude that negative equity for homes in foreclosure are more often the result of post-purchase cash-out refinancing or home equity loans are more responsible for the presence of negative equity than housing price declines. *See* LaCour-Little, Rosenblatt & Yao, at 20.

[21] *See id.*

and lower LTV ratios are reflected in lower risk premiums in interest rates.[22] One study found that conventional mortgages with loan-to-value ratios at origination of 91–95% were twice as likely to default as loans with LTVs of 81-90% and five times more likely to default than those with LTVs of 71-80%.[23]

The incentives to "walk" are especially strong in those states with antideficiency laws that limit creditor's remedies to foreclosure without the right to sue the borrower personally for the deficiency.[24] Empirical evidence indicates that foreclosure default and foreclosure rates are higher where law limits lender recourse through antideficiency laws. In a study of the neighboring provinces of Alberta and British Columbia in Canada, Lawrence Jones found that "in a period of sizable house-price declines, the prohibition of deficiency judgments can increase the incidence of default by two or three times over a period of several years."[25] Similarly-situated borrowers with negative home equity (that is, where they owe more than the value of the house) "will be observed defaulting in antideficiency jurisdictions but not where deficiencies are truly collectible."[26] In fact, in Alberta (which had an antideficiency law) 74% of those who deliberately defaulted had negative equity; in British Columbia (which permitted deficiency suits) only one homeowner defaulted with negative book equity.[27] Other researchers have also found that prohibitions on deficiency judgments tend to produce higher delinquency[28] and default rates.[29] Limits on collection of deficiency judgments in FHA and VA loans may also explain the higher default rates on those loans compared to private market loans.[30] Because the presence of antideficiency laws increases the risk of lending, these laws also are associated with higher interest rates and other costs, such as higher required downpayments, especially among those marginal borrowers who would be expected to be the most likely to default.[31] This increase in interest rates and other costs may also

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[22] *See* Elliehausen, Staten, & Steinbuks, at 43-44.

[23] Robert B. Avery, Raphael W. Bostic, Paul S. Calem, & Glenn B. Canner, *Credit Risk, Credit Scoring, and the Performance of Home Mortgages*, 82 FED. RES. BULL. 621, 624 (1996).

[24] *See* Michael T. Madison, Jeffry R. Dwyer, & Steven W. Bender, 2 THE LAW OF REAL ESTATE FINANCING §12:69 (Dec. 2007), *available in* Westlaw REFINLAW § 12:69. It is difficult to estimate exactly how many states have antideficiency laws as foreclosure rules vary a great deal from state to state, but an approximation may be about 15-20 states including many larger states. *See* United States Foreclosure Law, http://www.foreclosurelaw.com (last visited Sep. 17, 2008) (providing a full list of state laws). In addition, even in states where lenders may seek a deficiency, borrowers may be judgment-proof because of a general lack of other assets, as those with assets presumably would be more likely to provide a downpayment in the first place and would not be as likely to be in a negative equity position in their house.

[25] Lawrence D. Jones, *Deficiency Judgments and the Exercise of the Default Option in Home Mortgage Loans*, 36 J. L. & ECON. 115, 135 (1993).

[26] *Id.*

[27] *Id.* at 128–29. Jones states that the one defaulter in British Columbia reportedly left the country. *Id.* at 129.

[28] Brent W. Ambrose & Richard J. Buttimer, Jr., *Embedded Options in the Mortgage Contract*, 21 J. REAL ESTATE FIN. AND ECON. 95, 105 (2000).

[29] Ambrose, Capone & Deng, *supra* note 16, at 220.

[30] Brett W. Ambrose, Richard J. Buttimer, Jr., & Charles A. Capone, *Pricing Mortgage Default and Foreclosure Delay*, 29 J. MONEY, CREDIT & BANKING 314, 322 (1997).

[31] Ambrose, Buttimer, and Capone note that the higher risk of FHA and VA loans associated with limits on deficiency judgments contributed to a substantial increase in the insurance premiums charged by those lenders. *Id. See also* Pence, at 177 (finding that average loan size is smaller in states with defaulter-friendly foreclosure laws); Jones, *supra* note 25 (higher downpayments; Mark Meador, *The Effects of Mortgage Laws on Home Mortgage Rates*, 34 J. ECON. & BUS. 143, 146 (1982) (estimating 13.87 basis

increase financial distress and thereby contribute to higher foreclosures at the margin. Moreover, if it is the case (as it appears to be) that the propensity for default and foreclosure is a function in part of state laws regarding the collection of deficiency judgments and judicial foreclosure actions, and that lenders have already priced that risk *ex ante* in the loan, this raises questions about the propriety as a matter of equity and efficiency of governmental "bail outs" for distressed borrowers and lenders. Put alternatively, if California's high foreclosure rate is in part a function of California's extremely borrower-friendly laws one can question whether taxpayers and homeowners from the rest of the country should be taxed (directly or indirectly through higher interest rates and tighter credit) to essentially bribe California homeowners not to walk away from their mortgages.

Many of the states with antideficiency laws, such as California and Arizona[32], are also among the states with the highest foreclosure rates. Other high-foreclosure states, such as Nevada and Colorado, have laws that limit the amount that lenders can recover from borrowers, but which do not bar deficiency judgments completely. Antideficiency laws also appear to affect homeowners' incentives to maintain their property—homeowners in states that have antideficiency laws may be less willing to invest in maintenance and improving their homes.[33] Moreover, although there are costs to "walking"—particularly the negative effect on one's credit report—in light of the widespread nature of defaults and foreclosures future lenders may discount the impact of this adverse event in comparison to prior eras.[34] In addition, the pure number of mortgage walkers may underestimate the number of truly voluntary foreclosures because during the period that a home is in foreclosure the owner ceases making mortgage payments, thus essentially living rent-free during the foreclosure period. Thus, even if the owner is willing to permit foreclosure she may nonetheless not simply surrender the property immediately, but instead take advantage of the opportunities presented by foreclosure.

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point increase in interest rates as a result of antideficiency laws); Brent W. Ambrose & Anthony B. Sanders, *Legal Restrictions in Personal Loan Markets*, 30 J. REAL ESTATE FIN. & ECON. 133, 147–48 (2005) (higher interest rate spreads in states that prohibit deficiency judgments and require judicial foreclosure procedures); U.S. DEPT. OF HOUSING AND URBAN DEVELOPMENT, A STUDY OF CLOSING COSTS FOR FHS MORTGAGES at p. 50 (May 2008) (finding that presence of antideficiency laws raises costs of loan). *But see* Michael H. Schill, *An Economic Analysis of Mortgagor Protection Laws*, 77 VA. L. REV. 489, 512 (1991) (finding mixed results for impact of antideficiency laws on foreclosure rates depending on specification of regression).

[32] *See* Madison, *et al.*, *supra* note 24.

[33] John Harding, Thomas J. Micelli, & C.F. Sirmans, *Deficiency Judgments and Borrower Maintenance: Theory and Evidence*, 9 J. HOUSING ECON. 267, 271 (2000); *see also* John Harding, Thomas J. Micelli, & C.F. Sirmans, *Do Owners Take Better Care of Their Housing Than Renters?*, 28 REAL ESTATE ECON. 663, 669–70 (2000).

[34] Harding, Micelli & Sirmans, *Owners Take Better Care*, *supra* note 132.