

Testimony
United States Senate Committee on the Judiciary
The Looming Foreclosure Crisis: How To Help Families Save Their Homes
December 5, 2007

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Mr. Chairman, Ranking Member Specter and members of the Committee, thank you for the opportunity to be here today. I am pleased to appear before you to discuss the foreclosure crisis and possible legislative options for addressing the economic and social concerns arising from that crisis.

I am Joseph Mason, an Associate Professor of Finance at Drexel University and Senior Fellow, the Wharton School, and these are my personal views. Before joining Drexel University, I spent three years at the Office of the Comptroller of the Currency studying consumer credit, bankruptcy, and structured finance, and have since advised bank and securities market regulators as well as many industry groups on the press on the recent market and economic difficulties.

Personal bankruptcy relieves debtors and creditors of their duties and claims arising from credit mistakes, wither originating in over-borrowing or over-lending. Without such a relief valve, debts are carried throughout lifetimes and even passed through generations resulting in the debt peonage problems characteristic of America's early colonial period and the post-bellum South. Well-balanced and clearly articulated bankruptcy laws are therefore crucial to our social and economic well-being.

People only file for bankruptcy if they are first vulnerable, i.e., have debt greater than their assets, and second, only if some financial shock occurs that prevents them from keeping debt service payments current. Economic theory suggests that the population vulnerable to personal bankruptcy should be in their thirties, because debt load typically peaks as individuals approach age thirty-five or so. Growth in the number of individuals in that demographic has not, however, adequately explained personal bankruptcy growth in most academic and industry studies.

The reason is that debt is a necessary, but not sufficient, condition for personal bankruptcy. Rather, it takes some shock to income in the presence of a heavy debt load to cause a person to file for bankruptcy. The typical shocks – divorce, illness, accident, and addiction – have all increased over the last several decades and are particularly prevalent among individuals in their thirties, just when they have the highest debt burdens of their lifetimes.

With the advent of subprime mortgages, we must now add adjustable-rate mortgage payment shocks to the list of classic influences. Clearly, adjustable-rate payment shocks are having an indelible effect on housing markets. The question, however, is to what extent legislative intervention can and should insulate individuals from the payment shocks in their mortgage contracts?

To that extent, I have been asked to evaluate the economics of addressing those shocks through judicial intervention into mortgages in personal bankruptcy proceedings. I reach three main conclusions. First, mortgages and other real assets are poor candidates for bifurcation in bankruptcy because they can be fully expected to regain value later on in the life of the contract. Hence, bifurcation of a debt secured by real estate may be considered a “taking” in a sense not applicable to fully depreciable assets. Second, legislative changes to enable bifurcation of mortgage contracts will increase the cost of credit to mortgage borrowers to cover the expected aggregate value of judiciary settlements. The cost of mortgage credit can be expected to rise to levels on par with other secured non-mortgage credit (like automobile loans) and unsecured credit (like credit cards). Last, the act of bifurcating mortgage credit will increase the cost of bankruptcy to cover appraisal and other transactions costs needed to establish the “fair market value” of the underlying real estate, imposing yet another cost on filers above and beyond those imposed in the Bankruptcy Abuse Prevention and Consumer Protection Act that went into effect in October of 2005.

I. BIFURCATION OF DEBTS SECURED BY REAL ASSETS CAN BE EXPLOITED IN WAYS THAT BIFURCATION OF DEBTS SECURED BY OTHER ASSETS CANNOT

Bifurcation, commonly referred to as “cramdown,” has long been applicable to non-real estate collateral. But, while the concept is sensible for non-real fully-depreciable collateral like automobiles, the idea is fundamentally flawed for assets like real estate.

The reason a bifurcation makes sense for fully-depreciable collateral is that the value of the collateral is decreasing throughout the life of the loan. If a court bifurcates a claim on an automobile loan, the automobile is not expected to ever be worth more than the current market value established by the courts.

For real estate, even in today’s market conditions, the value of the collateral can be expected to grow in the future, so that bifurcating the claim is akin to taking away real value from the lender now that will accrue to the borrower in the future. Whether that value growth is two years ahead or twenty is irrelevant. The concept is fundamentally different from bifurcating a fully-depreciating asset in that it is a taking of real property.

The concept is especially egregious in real estate markets that are highly sensitive to economic or market conditions. High-flying Houston and New England real estate markets of the early 1980s returned handsome profits for investors after the relatively brief market disruptions of the late 1980s and the recession of 1991. The Case-Shiller mortgage price index, which begins in January 1987, shows that Boston home prices hit a high of 75.53 in July 1988 and retreated

thereafter, only to reach and exceed that level in May 1997. Boston now stands at 170.73. Los Angeles peaked at 100.00 in June 1990 and, after a similar hiatus, breached that level again in January 2000. Los Angeles now stands at 254.79. True homeowners obtained those gains. Speculators did not.

Furthermore, today, while California and Florida markets are expected to decline in value the most in the short-term, they are also expected to rebound sharply in the expansion that follows. In fact, it is not those markets that should be the source of concern, but markets like those of Ohio and Michigan, whose economic growth will not support timely rebounds from even mild home price depreciation, although they will rebound, nonetheless.

The point, therefore, is that real estate gains will resume and even if they are not on par with recent growth, the gains will restore value for true homeowners in the long term even if speculators lose in the short term.

II. BIFURCATING MORTGAGES WILL INCREASE THE PRICE OF CREDIT IN BOTH PRIMARY AND SECONDARY MARKETS

It is straightforward to conclude that the ability to bifurcate mortgages in consumer bankruptcy will increase the cost of mortgage credit. One only needs to look as far as other types of secured credit that is subject to bifurcation to see that the cost of credit in those markets is higher than the cost of credit on mortgages.

Worse yet, the effective price difference has led in recent years to the evolution of home equity loans and home equity lines of credit that allowed consumers to take advantage of the price difference by pledging their home as collateral while borrowing for automobile purchases, vacations, and even typical credit card expenditures.

Changing the nature of mortgage priority in bankruptcy further incentivizes the shift away from building equity in one's home by paying down the mortgage: if mortgage debt is tax-exempt and can be discharged in bankruptcy it becomes more advantageous for consumers to maximize their mortgage relative to the value of the home.

As a result of such long-term shifts, we face a generation that stands to enter their retirement years without the historically largest retirement asset – their home equity – intact. Poorly-funded 401-k's, pension funds that will eventually have to face up to subprime mortgage losses, and Social Security will not make up for that shortcoming, which will therefore create a tremendous drag on economic growth and social well-being.

The problem, however, will also extend to secondary markets for securitized loans that have been devastated by uncertainty over the past year. Since the ability to bifurcate mortgages will extend to contracts already written and sold in securitized pools, existing loans will decline in value by the risk difference implied in the spread between non-real estate and real estate secured credit. That means that the value of residential mortgage-backed securities will decline further. In the event that markets will not be able to adequately ascertain the impact of judicial intervention, they will impose an additional "lemons discount," above and beyond that already

imposed on the market for fundamental opacity and ratings agency malfeasance, to account for the maximum possible effect a priori. Knock-on effects will reverberate through resecuritization markets like those for CDOs and SIVs, making those already difficult-to-value assets even more opaque.

The point is that judicial adjustment will add further information difficulties to an already uncertain market environment. The market today is struggling to sort out information. Investors will not join back in until information about values and holdings is improved. Hence, moving the valuation target by changing the legal nature of the contract will not help end the current credit market difficulties.

III. BIFURCATING MORTGAGES WILL INCREASE THE COSTS OF PERSONAL BANKRUPTCY

In the case of bifurcating the automobile loan mentioned above, the judge need only look at Kelley Blue Book to establish a reasonable market value for the collateral asset. In the case of the mortgage, however, getting the fair market value is not so simple.

To begin with, a judge will have to order an appraisal of the property to assess a fair market value. Appraisals can cost \$300 to \$500 and the cost would be expected to be paid by the debtor.

To get an example of the impact of such an additional cost, filing costs under the Bankruptcy Abuse Prevention and Consumer Protection Act that went into effect in October of 2005 are estimated to have increased some 150%. Some claim that the increased filing costs, alone, have acted as a disincentive for individuals to seek relief under personal bankruptcy (see, for instance, High Foreclosures but Low Bankruptcies: Why the Disconnect? Knowledge@W.P. Carey Blog., Arizona State University).

Additionally, many have also cited the increased legal expenditures as a reason why bankruptcy filings have fallen off so dramatically since the enactment of the previous legislation. If that is the case, additional costs will deter even more filings, making relief for consumers more difficult to obtain.

In addition to the cost, however, the accuracy of appraisals must also be considered if appraisals are to be used in the judicial process. The fact is, appraisals have not been very accurate in the recent past. Furthermore, appraisals skewed to the high end fueled recent overborrowing and home price inflation, causing much of the present-day mortgage market difficulties.

Although proposals have recently been advanced, the appraisal industry is still unregulated and subject to gross errors and irregularities. An industry experiencing such difficulties, which has contributed so much to the recent mortgage crisis, is hardly a reliable basis for a substantial component of bankruptcy law.

CONCLUSION

In conclusion, the US economy continues to experience very real problems stemming from the

mortgage crisis. The problems originate in a variety of unsafe and unsound practices in the mortgage industry, ranging from predation to speculation.

It is easy to see the need to address predation in the mortgage industry. It makes sense to seek judicial remedies that have the power to nullify contractual terms violating terms of the Real Estate Settlement Procedures Act, the Truth in Lending Act, the Home Owner Equity Protection Act, and/or other laws and regulations relating to the mortgage industry.

It is especially important that the judiciary have the power to address violations of relevant laws and regulations because it is so hard to set quantitative or easily verifiable tests to violations of those provisions. Hence, a case-by-case treatment is often necessary to identify and correct the violations that are easy to see when the parties present themselves and the relevant facts, but difficult to identify in raw loan applications and data. It will be a powerful remedy to give the judiciary the chance to correct the terms of such predatory mortgages in bankruptcy in order to avoid unnecessary foreclosures.

Giving the judiciary the power to fully bifurcate mortgage contracts, however, sets the stage for a potential abuse of the bankruptcy system to further speculative purposes and further incentivizes cashing out home equity.