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U.S. Mortgage Meltdown Linked to 2005 Bankruptcy Law

By Dan Margolies

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There's no shortage of blame for the mortgage crisis that drove the economy into the ditch.

But here's a fresh culprit: the 2005 bankruptcy reform act, which was strongly pushed by the credit card industry.

So say three researchers at the Federal Reserve Bank of New York, who argue that the legislation shifted risk from credit card lenders to mortgage lenders, helping trigger the surge in home foreclosures.

Before Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, households could erase their unsecured debts by filing for Chapter 7 liquidation. That freed up income that distressed homeowners could use to make mortgage payments.

The new law, however, forced better-off households seeking bankruptcy protection to file under Chapter 13. That chapter requires homeowners to continue paying their unsecured lenders.

In other words, say the Fed researchers, cash-strapped homeowners who might have saved their homes by filing Chapter 7 are now much more likely to face foreclosure.

"Is it just coincidence that the surge in subprime foreclosures that has rocked financial markets came right after the bankruptcy reform in 2005?" they asked. "Is that surge just about falling home prices, bad mortgage decisions and weak economic conditions?

"No and no."

The paper's lead author, Donald P. Morgan, a research officer at the New York Fed, said last week in a phone interview that he was "99 percent confident" that the bankruptcy reform law was a major reason for the foreclosure crisis and the falling housing prices that have affected virtually every homeowner in the country.

The National Association of Realtors recently reported that the average sale price of an existing home fell 12.3 percent, to $224,200, over the 12 months ending in November.

"Before the reform, overindebted households might file bankruptcy and get rid of their credit card debt, and that would free up income to pay the mortgage," Morgan said. "The new law blocks that escape route and forces better-off households to continue paying credit card debt, which makes it harder than before to continue paying the mortgage."

The conclusions of Morgan and his colleagues echo earlier findings that the new law's tougher requirements appear to have increased the number of people defaulting on their mortgages or walking away from their homes rather than seeking bankruptcy protection.

"One of the great lessons and ironies" of the new law, Treasury Department economist David P. Bernstein wrote in a recent paper, was that, by increasing the dollar value of assets susceptible to default, it has weakened many of the financial institutions that sought the new law in the first place.

Aimed at making debtors take more "personal responsibility" for their debts, the new law did succeed in driving down bankruptcy filings at first. But if the idea of bankruptcy reform was to prevent "can-pay" and high-income debtors from abusing the bankruptcy system, many experts say the law has been a bust.

Drawing on 2007 bankruptcy data, a group of academic experts recently suggested that those purged from the bankruptcy rolls, far from being high-income deadbeats, "appear to have been ordinary American families in serious financial distress."

To be sure, bankruptcy reform was by no means the primary cause of the subprime mortgage debacle, the causes of which are many and varied: loose monetary policy, lax lending standards, poor regulatory oversight and the unsustainable expectations of homeowners and Wall Street investors.

Dan Margolies, dmargolies@kcstar.com.