Our view on the housing crisis: Give strapped homeowners a break in bankruptcy court

You can get a workout plan for cars and yachts; why not mortgages?

USA Today - Editorial

March 4, 2008

With the nation's housing crisis getting worse and some 2 million American homeowners facing the loss of their homes, Congress and the Bush administration are scrambling for ways to slow the tide of foreclosures. Some proposals involve spending billions of taxpayer dollars to buy foreclosed homes or otherwise help hard-pressed homeowners.

Here's a better idea that could cost taxpayers next to nothing: Change the bankruptcy law.

As the law stands, a bankruptcy judge can work out payment plans for credit card accounts, cars, yachts and loans for vacation homes and family farms. In fact, the only debt the judge can't modify is the mortgage on a debtor's primary home. If that means the debtor loses the house, too bad.

Removing the special status for mortgages could save about 600,000 homeowners from losing their homes, say the idea's supporters, who fell short in a Senate vote last week but plan to try again. If the change worked, the broader economy would benefit from fewer foreclosures, which drive down home values, batter communities and spread collateral damage to people who never made or received a subprime mortgage loan.

This is no free ride.

Bankruptcy is a tough process carrying a stigma that lasts for years and requires debtors to keep paying down what they owe. Only certain existing mortgages would be eligible, and a bankruptcy judge would have to certify that a homeowner had no alternative except foreclosure. One provision would allow a lender to recapture some or all the increase in value if the home were sold.

Even so, mortgage lenders strongly oppose the change. They argue that exposing lenders to the uncertainties of bankruptcy court would cause everyone's rates to go up by perhaps 1.5 percentage points.

That's what they say. But there's little hard evidence it would happen.

In fact, a recent study, by a law professor at Georgetown and an economics doctoral candidate at Columbia, found virtually no difference between the rates lenders charged for mortgages that could be modified by bankruptcy courts and those that could not. (The study looked at the differences between current mortgage rates for first and second homes, and rates during a period in the 1980s and 1990s when some states allowed primary mortgages to be modified by bankruptcy courts, a practice ended by the U.S. Supreme Court in 1993.)

In all likelihood, if the bankruptcy law were changed, lenders would tighten standards and employ more risk-based pricing, rather than raise interest rates for all borrowers.

It's no small matter to change a contract after the fact. But that's what bankruptcy courts do every day, and stripping away primary mortgages' special status would merely make them equal to other debt.

It would be better for everyone if troubled mortgages never ended up in bankruptcy court at all. Lenders could forestall that in many cases by voluntarily working out new terms with hard-pressed borrowers. That's happening, but slowly.

Adding the hammer of bankruptcy court would create an incentive for more lenders to do that more urgently — and would provide a reasonable last chance for qualified homeowners when lenders don't act.