

Comments on:

**“Mortgage Default, Foreclosures
and Bankruptcy in the Context of
the Financial Crisis”**

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10th Jacques Polak Annual Research Conference
November 5-6, 2009, Washington, D.C.

Very important topic

US personal bankruptcies rose to their highest level since 2005, when changes in bankruptcy law prompted a rush of filings to comply with the (more lenient) earlier rules. Rising unemployment and falling home prices are taking their toll, and individual filings were 25% higher last month than a year earlier.

➤ News reports, November 3, 2009

Praise and Structure of Comments

- Comprehensive, well-researched, sophisticated investigation of the relationships between default, bankruptcy, foreclosure in the context of a financial crisis
- Important lessons for policy makers
- My Comments
 - Main comment: Could do more on policy lessons
 - Hypotheses and Questions on story: explain clearly what the relationships are to be expected?
 - Data: some scope for improvements
 - Empirical Methodology: some suggestions

Main Results

1. Leads/lags exist among Default, Bankruptcy, Foreclosure (DBF)
 - i. Default on mortgage “leads/predicts” bankruptcy
 - ii. But bankruptcy also “leads/predicts” default
 - iii. Foreclosure “leads/predicts” bankruptcy
2. Decisions largely financial & economic rational
3. Effects are economically large (up to “16 fold”)
4. There are externalities, regional and otherwise
 - i. Lagged DBF rate “causes” more DBF
 - ii. Lower house price (growth) “causes” more DBF

Policy implications: Optimal bankruptcy law more pro-creditor and other policies more pro-debtor

Questions that paper addresses

1. What drives DBF?
 - i. Why do homeowners (+ lenders) default?
 - ii. Why do homeowners file for bankruptcy?
 - iii. Why do lenders foreclose?
2. Are all individual decisions economically rational? Are there efficiency/welfare losses?
 - i. Is there “too little”/”too much” DBF?
 - ii. Do inefficient DBF lead to too much DBF?
 - iii. Are there (regional) spillovers from individual DBFs? Other externalities?
3. Implications for DFB design (bankruptcy)

Analysis done on DBF decisions

1. What drives D or B or F?

- i. Does default trigger bankruptcy or
- ii. The other way around? or
- iii. Are both jointly determined? Inefficiently?

2. Priors

- i. Default need not trigger bankruptcy if default is resolved properly, could be + or -
- ii. Bankruptcy could reduce other debts and be used to save you home, -, or to facilitate D, +
- iii. Foreclosure is most likely to mean bankruptcy

3. But all simultaneity, omitted factors, etc.

Main Policy Question: Optimal DBF?

1. In policy discussion, paper mainly concerned with bankruptcy rules
2. But many other aspects drive DBF, e.g.:
 1. Macroeconomic: unemployment, interest rates
 2. Incentives of lenders: e.g., due to securitization hard to restructuring, worse underwriting
 3. Consequences of government interventions: e.g., bankruptcy changes, housing programs
 4. These impacts can vary by D, B, and F
3. Like to see lessons/implications for these other DFB design aspects as well

Analysis on optimal B design

1. Get less insights from analysis
 - i. We do get policy conclusions, but they do not follow directly from the analysis
2. Analyze if the design is suboptimal
 - i. Chapter 13 versus 7 (?); what is best?
 - ii. Differences across states, due to varying homestead exemptions/features, imply.. (?)
 - iii. Differences over time, due to bankruptcy law of 2005 (some findings, but more): better?
 - iv. Effects of crisis, changed incentives, lower capital/liquidity, etc. Adapt bankruptcy now (?)

Securitization especially interesting

- Findings: if securitized, more likely DBF:
 - B ↑ after D, and D ↑ after B, B ↑ after F (n.s.), F ↑ after B
 - Effects stronger for prime than sub-prime
 - Suggests securitization worsens restructuring
- Additional tests to perform
 - Follow individual over whole DBF (joint Cox)
 - Some more formal causation tests
 - Run matched sample tests; yes/no securitization, prime-sub-prime. Cleaner comparisons
 - Do FICO 620 test (ease of securitization increased)

Role of lenders and crisis

- Explore more the identity/type of lender/services (not just private-public)
 - Are there fixed effects among servicers? Some more inclined to allow D, to do F? Newer servicers?
 - Can you look at lender's capital adequacy, loan-loss provisioning, liquidity positions?
- Use the financial crisis as “experiment”
 - What was impact of crisis? For example, mergers (Countrywide/BoA, Wachovia/Wells Fargo)
 - Effects of Fannie and Freddie restructuring

Data and Robustness

- Sample is huge, need to randomize: yet tempting to ask for some “more draws”.
- Also use all data to create lagged DBFs
- Observations are dropped when transferred to a different servicer: why?
- Robustness on the default definition (not just two months delay)
- Refinancing seems hard to create

Empirical Approach

- Good to a hazard/duration (Cox) model for the (conditional) probability of DBF
- Combine prime/sub-prime in one regression
- Do clustering, probably at state/servicer level
- Year dummies, not clear. Replace with introduction of specific government programs
- Benchmark with earlier periods of recessions
- Show number of observations, pseudo R^2

Conclusion

- Well-researched paper. Good data. Sensible econometric methodology
- Very useful insights and findings on DBF links, “causes”, with economic significance
- Can expand on methodology to address specific policy questions