

Oral Testimony

of

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United States Senate

The Looming Foreclosure Crisis: How to Help Families Save Their Homes

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

6 I am Joseph Mason, an Associate Professor of Finance
7 at Drexel University and Senior Fellow, the Wharton
8 School, and these are my personal views. Before joining
9 Drexel University, I studied consumer credit, personal
10 bankruptcy, structured finance, and financial crises at the
11 Office of the Comptroller of the Currency and have since
12 advised bank and securities market regulators as well as
13 many firms, industry groups, and the press on the recent
14 market and economic difficulties.

15 People only file for bankruptcy if they are first
16 vulnerable, i.e., have debt greater than their assets, and
17 second, only if some financial shock occurs that prevents
18 them from keeping debt service payments current.
19 Economic theory suggests that the population vulnerable
20 to personal bankruptcy should be in their thirties, because
21 debt load typically peaks as individuals approach age
22 thirty-five or so. The typical shocks that cause bankruptcy
23 – divorce, illness, accident, and addiction – have all
24 increased over the last several decades and are
25 particularly prevalent among individuals in their thirties.
26 With the advent of subprime mortgages, we must now add

27 adjustable-rate mortgage payment shocks to the list of
28 classic influences.

29 The question today, therefore, is to what extent
30 legislative intervention can and should insulate individuals
31 from the payment shocks in their mortgage contracts? To
32 that end, I have been asked to evaluate the economics of
33 addressing those shocks through judicial intervention into
34 mortgages in personal bankruptcy proceedings. I reach
35 three main conclusions.

36 **First**, mortgages and other real assets are poor
37 candidates for bifurcation in bankruptcy because they can
38 be fully expected to regain value later on in the life of the
39 contract. Hence, bifurcation of a debt secured by real
40 estate may be considered a “taking” in a sense not
41 applicable to fully depreciable assets.

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

48 For real estate, even in today’s market conditions, the
49 value of the collateral can be expected to grow in the
50 future, so that bifurcating the claim is akin to taking away

51 real value from the lender and giving that value to the
52 borrower.

53 The concept is especially egregious in real estate
54 markets that are highly sensitive to economic or market
55 conditions. High-flying real estate markets of the 1980s
56 returned handsome profits for investors after the
57 relatively brief market disruptions of the late 1980s and
58 the recession of 1991.

59 The Case-Shiller mortgage price index, which begins in
60 January 1987, shows that Boston home prices hit a high of
61 75.53 in July 1988 and retreated thereafter, only to reach
62 and exceed that level in May 1997. Boston now stands at
63 170.73, providing a 127% total return, or 4.2% annually,
64 since 1987.

65 Los Angeles peaked at 100.00 in June 1990 and, after a
66 similar hiatus, breached that level again in January 2000.
67 Los Angeles now stands at 254.79, providing a 155% total
68 return, or 5.7% annually since 1990.

69 These are *worst case* returns, obtained from buying at
70 the top of the market and holding, and the cases do not
71 account for the fact that the investment made by a home
72 buyer is leveraged, so that an investment of 20% down,
73 along with periodic payments, is enough to obtain the full
74 gain on the property value.

75 **Second**, legislative changes to enable bifurcation of
76 mortgage contracts will increase the cost of credit to
77 mortgage borrowers to cover the expected aggregate
78 value of judiciary settlements. The cost of mortgage credit
79 can be expected to rise to levels on par with other secured
80 non-mortgage credit (like automobile loans) and
81 unsecured credit (like credit cards).

82 The problem, however, will also extend to secondary
83 markets for securitized loans that have been devastated
84 by uncertainty over the past year. Since the ability to
85 bifurcate mortgages will extend to contracts already
86 written and sold in securitized pools, existing loans will
87 decline in value by the risk difference implied in the spread
88 between non-real estate and real estate secured credit.
89 That means that the value of residential mortgage-backed
90 securities will decline further, as well.

91 In the event that markets will not be able to
92 adequately ascertain the impact of judicial intervention,
93 they will impose an additional “lemons discount,” above
94 and beyond that already imposed on the market for
95 fundamental opacity and ratings agency malfeasance, to
96 account for the maximum possible effect a priori. Knock-
97 on effects will reverberate through resecuritization
98 markets like those for CDOs and SIVs.

99 The point is that judicial adjustment will add further
100 information difficulties to an *already uncertain* market

101 environment. The market today is struggling to sort out
102 information. Investors will not join back in until
103 information about values and holdings is improved. Hence,
104 moving the valuation target by changing the legal nature
105 of the contract will not help end the current credit market
106 difficulties.

107 Additionally, changing the nature of mortgage priority
108 in bankruptcy further incentivizes the shift away from
109 building equity in one's home by paying down the
110 mortgage: if mortgage debt is tax-exempt and can be
111 discharged in bankruptcy it becomes more advantageous
112 for consumers to maximize their mortgage *debt* relative to
113 the value of the home.

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

122 **Last**, the act of bifurcating mortgage credit will
123 increase the cost of bankruptcy to cover appraisal and
124 other transactions costs needed to establish the “fair
125 market value” of the underlying real estate, imposing yet
126 another cost on filers above and beyond those imposed in

127 the Bankruptcy Abuse Prevention and Consumer
128 Protection Act that went into effect in October of 2005.

129 In the case of bifurcating the automobile loan
130 mentioned above, the judge need only look at Kelley Blue
131 Book to establish a reasonable market value for the
132 collateral asset.

133 In the case of the mortgage, however, getting the fair
134 market value is not so simple. To begin with, a judge will
135 have to order an appraisal of the property to assess a fair
136 market value. Appraisals can cost \$300 to \$500 and the
137 cost would be expected to be paid by the debtor.

138 In addition to the cost, however, the accuracy of
139 appraisals must also be considered. The fact is, appraisals
140 have not been very accurate in the recent past. Appraisals
141 skewed to the high end fueled recent overborrowing and
142 home price inflation, causing much of the present-day
143 mortgage market difficulties.

144 An industry experiencing such difficulties, which has
145 contributed so much to the recent mortgage crisis, is
146 hardly a reliable basis for a substantial component of
147 bankruptcy law.

148 **In conclusion**, the US economy continues to
149 experience very real problems stemming from the
150 mortgage crisis. The problems originate in a variety of

151 unsafe and unsound practices in the mortgage industry,
152 ranging from predation to speculation.

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

160 Giving the judiciary the power to fully bifurcate
161 mortgage contracts, however, sets the stage for a
162 potential abuse of the bankruptcy system to further
163 speculative purposes and further incentivizes cashing out
164 home equity rather than sustainable home ownership.