The Effect of Principal Reduction on Household Distress

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Debt relief and foreclosure

Measure the effect of debt relief under bankruptcy on household foreclosure

Relevant policy question, during Great Recession different policies were used to limit defaults

- Reduce Monthly payments (HAMP)

- Mortgage Refinancing (Home Affordable Refinancing Program)

Mortgage Cramdown not implemented, as part of Chapter 13

Principal Reduction, Cramdown and Chapter 13

1. Mortgage Cramdown (partially forgive mortgage debt) under Ch. 13, implies a potential big principal reduction

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2. Ch 7. asset liquidation vs Ch. 13 debt restructuring

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3. Chapter 13 acts as a retention of assets, safe house mechanism.

- White and Zhu (2010) :

— 96% of Ch. 13 filer are homeowners, 79% repay mortgage, only 9% unsecured debt. 77% file voluntarily instead of Ch.7

- Porter (2011) 70% Ch. 13 filers wants to avoid foreclosure

Existing Literature

Chapter 13 and Foreclosure

— Dobbie et al (2011) show that discharge leads to a decrease in foreclosure of 1.6% (dismiss filler average of 7%) reduction of ~30%

Principal reduction or maturity extensions

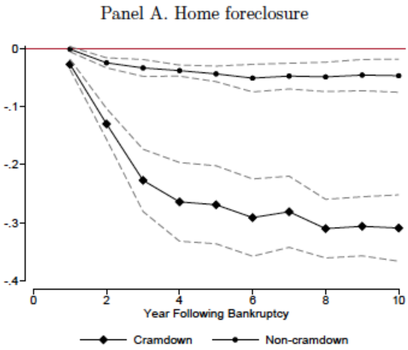
– Ganon and Noel (2018) show that (small) principal reduction no effect reducing defaults, but maturity extensions leads (higher liquidity) increase relief

– Dobbie and Song (2020) unsecured write down positive effect, where payment reduction do not.

Paper Contribution

What happens when you offer significant write downs?

This paper documents a 26% reduction on foreclosure rates for discharges in cramdown states in comparison to a 4-5% on no-cramdown states



It argues that reduction of debt overhang due to cramdown is the driving mechanism.

Comments: Empirical Strategy and Identification

[Judge assignment is random, cramdown decision is not!]

Identification of the discharge effect is well identify.

- Judgement assignment is random

The key contribution is on the comparison between cramdown and no-cramdown

Endogeneity concerns on cramdown state status:

- Role of other bankruptcy rules on the sample selection into chapter 13

Comments: Empirical Strategy and Identification

White and Zhu(2010) documents:

- Average home equity of filers 56k in 2006, exemption in Delaware 50k under chapter 7

Thus more than 2/3 choose chapter 13, to avoid house liquidation

Low equity protection Ch.7 –> higher gains from Ch 13

If correlated with cramdown state choice, potential sample bias

Comments: Empirical Strategy and Identification, Ch7 Exemptions

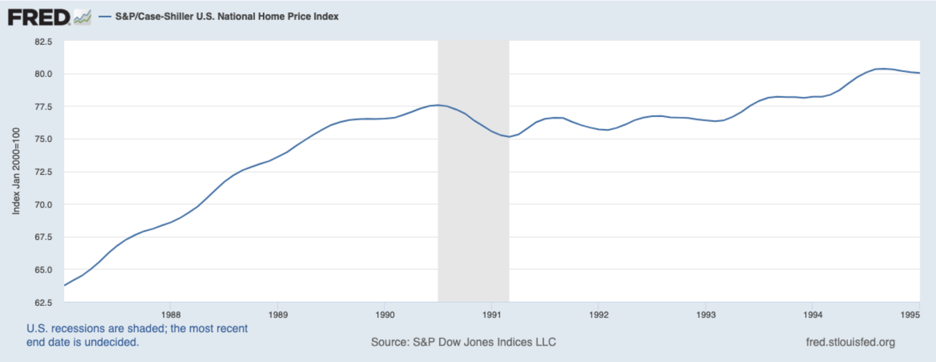
Level of Ch.7 bankruptcy protection in 1994

	home protection	personal protection
cramdown state	85,370	12,942
no cramdown state	164,748	11,129

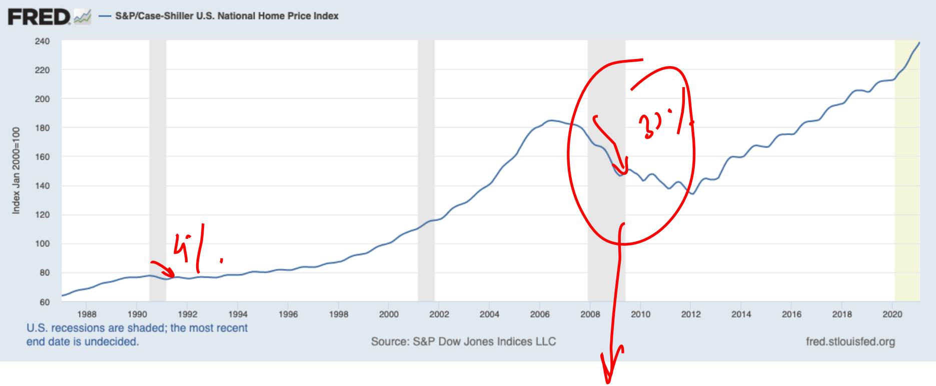
Cramdown states are states where home-equity protection is lower, which affect the sample selection into Ch 13 fillers in those states

Filler across state types may not be same

Comments: Empirical Strategy and Identification, Ch7 Exemptions



Comments: Empirical Strategy and Identification, Ch7 Exemptions



No really a period of negative equity

Negative equity necessary but not sufficient (Gerardi et al, 2018)

Comments: Empirical Strategy and Identification, Judicial Foreclosure

No Judicial states: makes it easy for creditor to initiate foreclosure

—Ch13, larger impact on homeowners than want to keep their home.

	judicial	no judicial
cramdown state	6	10
no cramdown state	2	2

Higher proportion of no judicial states in cramdown states

Suggestion: Empirical Strategy and Identification

1. Look specifically to the composition of fillers

— How does the fraction of Ch7 vs Ch 13 looks like?

— What about homeownership?

2. Explore the heterogeneity on exemption, judicial, etc.

3. Compare states types across other dimension in the time-series and cross-section (aka difference in difference)

– Potentially think of a IV-Difference in Difference Duflo (2001)

4. Describe existing data more extensively, mobility.

Comment: Interpretation of the mechanism

Taking of the results as given, let's think about the mechanism

— **Is this liquidity or debt overhang?**

The authors argue for debt overhang because :

- **Monthly payment no-modified:**

— Ch. 13 cramdown could allow for second lien stripping, and loan modification are possible

- **Alternative unsecured relief is better under Ch.7**

— White and Zhu (2011) show than in Delaware only 9% of borrowers repay unsecured debt (high liquidity provision)

Suggestion: Interpretation of the mechanism

Debt overhang interpretation relies on:

Mortgage discharge amount, which is not observable

- Data hard to obtain

- Be upfront about the caveat, gather anecdotical information

Endogenous selection into the sample

- Previous discussion (and solution) should help

Comments: Empirical Strategy Nuance

1. Random assignment with respect to other data in the pre-period

— New address, moving zip-codes characteristics, homeownership, etc.

2. Heterogeneity: Is the random assignment and first stage valid for both type of states?

– Provide this evidence

3. Female difference no significant

— Only statistical difference comes with looking at young females and weakly significant

— Not sure it merits the inclusion on the abstract

Comments: Interpretation, Magnitudes

Interpretation [IMPORTANT]

— Only focus on ex-post effect, but needs to worry about ex-ante effect on prices.

Magnitude.

— Magnitudes are big in comparison to the literature

- Provide baseline ratios for dismiss cases
- Due a more direct comparison with other debt overhang papers
  - Di Maggio et al (2020) effect of student debt on wages
  - Bernstein (2020) negative equity and labor supply

Conclusion

Interesting paper that aims to document the importance of cramdown to alleviate household mortgage distress

- Strong casual effect of Ch. 13 on foreclosure
- Need to sharpen the empirical strategy to be linked to cramdowns
- This will help to clarify the contribution

Looking forward to read the new version.

Thank you!