Study: Chapter 13 bankruptcy little help in saving homes

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Current chapter 13 bankruptcy laws do little to help filers save their homes from foreclosure, according to a study published in the Journal of Legal Studies.

The research, conducted by Michelle White of the University of California, San Diego, and Ning Zhu of UC Davis, finds that only about 1 percent of filers who would have otherwise defaulted are actually able to save their homes under chapter 13. This is despite the fact that 96 percent of chapter 13 filers are homeowners—an indication that it is seen as a "save your home" procedure, the authors say.

Chapter 13 bankruptcy is designed to help homeowners save their homes in three ways. First, it delays foreclosure proceedings and gives homeowners a chance to catch up on overdue payments. Second, it allows judges to eliminate burdensome lender fees. Third, it enables judges to partially or completely discharge credit card and other unsecured debts. This so-called credit card subsidy is designed to free up money that filers can then put toward their mortgages.

Using bankruptcy data from Delaware, White and Zhu constructed a model to determine whether the credit card subsidy actually helps filers avoid foreclosure. They found that for one-third of filers, the money freed up by the subsidy is not enough to save their homes, and many other filers have enough income to save their homes even without the subsidy. White and Zhu estimate that 85 percent of the credit card subsidy dollars go to people who could have saved their homes anyway.

The proportion of filers who would have lost their homes but were able to save them thanks to the subsidy turns out to be around 1 percent.

"Overall, the credit card subsidy is not an effective program for reducing foreclosures," the researchers conclude.

The Cramdown Effect

Under current law, bankruptcy judges cannot change the terms of mortgage loans. But in recent months, lawmakers have introduced several bills that would give judges the power to restructure or "cram down" mortgage debts in chapter 13. White and Zhu were able to tweak their model to estimate the impact of cram-down authority if it were to become law.

Cram-down authority would allow mortgage debt to be split into two parts: a secured portion equal to the market value of the home, and an unsecured portion equal to the remaining principle after the home value is subtracted. Judges would have the option of discharging the unsecured portion of the mortgage.

According to the model, the proportion of filers who save their homes when they otherwise would have defaulted goes from 1 percent to 10 percent under cram down. "For these debtors, cram down reduces future mortgage payments by an average of $134,000," White and Zhou write.

The price tag for banks would be substantial. White and Zhu estimate that cram-down authority would cost lenders around $30 billion.

The most recent cram-down legislation was defeated in the House of Representatives last December.

More information: Michelle J. White and Ning Zhu, "Saving Your

Home in Chapter 13 Bankruptcy." Journal of Legal Studies. 2010 39:1, 33-61.

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