

Joint Center for Housing Studies

Harvard University

**Cost Benefit Analysis of Debtor Protection Rules
in Sub-prime Market Default Situations**

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BABC 04-22

June 2004

This paper was produced for *Building Assets, Building Credit: A Symposium on Improving Financial Services in Low-Income Communities*, held at Harvard University on November 18-19, 2003.

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The author would like to thank Bill Apgar, Eric Belsky, Jeanne Charn, Elizabeth Warren, and particularly Tara Twomey for helpful comments.

Introduction

Debtor protection rules ought to influence debtor/creditor interaction at three points: post-default pre-foreclosure negotiations, the rate of default, and the cost of credit. Their cumulative impact should be different for “high road” than for “low road” sub-prime creditors. “High road” creditors make money through loan performance, invest in minimizing default, and lose money when they have to foreclose. “Low road” creditors also make money through loan performance, but invest in quick, low cost foreclosure, and anticipate sometimes being able to appropriate some or all of the debtor’s equity. Enforced non-waivable debtor protection would likely significantly increase low road but not high road costs, and shift market share from low to high roaders, possibly putting the low road out of business. This might well be desirable from an efficiency point of view, given the tendency of borrowers to under-insure against default, and from the point of view of distributive equity, as well as avoiding adverse neighborhood effects of current low road practices.

The Post-default Negotiation

Residential mortgages generally provide that if the debtor is in even minor default, the creditor has the option of “accelerating” the debt. The debtor then has a short time to “cure” by paying arrears and penalties, after which point the debtor must pay the full amount outstanding (plus penalties) within a short grace period or be subject to foreclosure. In practice, after default the parties are likely to engage in some kind of negotiation. I will outline the stakes in the negotiation, the bargaining tools of the parties, the range of outcomes, the “high road” vs. “low road” distinction, and the likely effects of different regimes of debtor protection.

Before beginning this exercise, there are two aspects of the sub-prime market that we will need to keep in mind throughout. The first is that the sub-prime industry is highly segmented: mortgage brokers, loan initiators, syndicators, the secondary lenders, loan servicers, and, finally, actors who specialize in handling loans in default, are likely to be distinct entities, although related through the prices they pay one another for their pieces of the business. I assume initially, counter-factually, that we can treat the “creditor” as a single entity that controls every stage from mortgage brokering through foreclosure. I switch to more realistic assumptions when analyzing the impact of debtor protection on high road and low road market shares.

The second point is that while the market is segmented as above, a single economic entity can engage, through distinct subsidiary entities, in many different parts of the business and can own subsidiary entities that pursue different strategies. Thus a bank can engage in “high road” sub-prime lending while owning or financing other entities that take the “low road.” I will speculate at the end of this paper on the significance of this possibility.

Stakes and Tools in the Post-Default Negotiation

The Stakes as between Debtor and Creditor after Default

The debtor may want to (I) retain possession (quantifiable as the “asking price” of the premises, which is the “home value” as opposed to the market price), (ii) retain whatever equity he may have in the property, (iii) avoid a deficiency judgment (meaning liability for the difference between the loan and what the creditor recovers in the foreclosure sale), and (iv) minimize future payments. It is also possible that the debtor knows that his income has fallen so far that he has no chance of avoiding foreclosure, so that the stakes are limited to retaining equity, protracting possession and avoiding a deficiency judgment.

The creditor wants to maximize profit through some combination of (I) cash payment of arrears, (ii) extraction of credible promises of future payments, (iii) loan recovery by foreclosure, and, possibly, (iv) appropriation of all or part of the debtor’s equity in the foreclosure process. But the creditor must take into account the impact of the way it handles foreclosures on the rate of default, and on market share through the impact of foreclosure policies on the rate the creditor can charge for loans.

Bargaining Tools Available to the Parties

The debtor refuses to pay arrears, threatens to refuse future payments, to cease all maintenance, to retain possession until evicted, to challenge the foreclosure in court (e.g., asserting technical defects, raising innovative defenses), and to join local anti-foreclosure activism. The creditor threatens to accelerate the debt, to unilaterally “preserve the property” at the debtor’s expense, to foreclose immediately forcing resale at a depressed price, to evict as quickly as possible, to pursue a deficiency judgment if the sale price is less than the debt, and to damage the debtor’s credit rating.

The Range of Post-Default Outcomes

Some of these threats on each side involve imposing losses that exceed the threatening party's gain. If the creditor evicts, the debtor will lose the "asking price" (or "home value") of possession, while the creditor acquires only the auction price. Foreclosure will destroy a part of the debtor's equity through the legal and intangible costs of the legal proceeding. The lost credit rating benefits neither party. On the other side, stopping maintenance threatens permanent damage to the collateral, the expense of foreclosure diminishes the value of the creditor's asset, and debtor activism threatens the creditor's reputation. "Strategic behavior" in using these threats to increase shares will in some number of cases lead to a failure to reach agreement and the inefficient carrying out of threats (of eviction, destruction of collateral, etc.) that are "pure waste." The fear of outcomes of this kind is a spur to settlement and complicates the possible outcomes of bargaining. (Leff 1970)

Ruthless Pursuit of Creditor Remedies

In many cases, however, the result is less dramatic. The debtor pays arrears and a penalty that compensates the creditor for the cost of administering the default, and the mortgage is reinstated (if it has been accelerated). In other cases, the creditor accelerates the debt and proceeds to foreclose, sell at auction, and the buyer (often the creditor) evicts, all in the shortest time that is legally possible. Creditor representatives sometimes assert that when this happens, it is inevitably bad for the creditor as well as for the debtor. But this is highly implausible. It is more plausible that in cases of rapid and ruthless pursuit of creditor remedies there are at the least the following possible outcomes.

Variable Outcomes of Ruthless Pursuit. The creditor's remedy may yield a recovery equivalent to the loss of the loan, because the resale value of the property exceeds the debt by enough to cover the creditor's costs, and the recovery is reinvested at least as profitably (even after transaction costs) as was the initial loan amount. The creditor may end up with a remedy worth less than the lost loan, because the resale value does not cover the outstanding balance plus transaction costs, and the debtor cannot be made to pay a deficiency judgment (no assets, or deficiency judgments legally prohibited).

There is a particularly important third possibility, to wit, that the creditor ends up, in this case of ruthless pursuit of remedies, with a recovery greater than the lost loan. This will occur when the creditor can appropriate all or part of the debtor's equity. This possibility, well canvassed in the legal literature (e.g., Mattingly 1996), tends to be ignored or downplayed in economist's and banker's discussions of foreclosure (personal observation).

Creditor Appropriation of Debtor Equity in the Foreclosure Process. In order for this to happen, the mortgaged property must be worth significantly more than the outstanding balance. The two cases in which this is likely to be true are where the debtor has paid off most of the mortgage with stable property values, and where there has been significant appreciation in the value of the property (either because of debtor improvements or because of a general upward trend in values in the neighborhood). In these cases, it may be the case that, after a default and acceleration of the debt by the creditor, the debtor is able to mobilize his equity in the property to pay off the balance (which may have been significantly increased by interest, penalties and fees).

But it may also be the case that the debtor is unable to do this. First, the debtor may not have cash resources, or resources available from friends or relatives. Second, the state may permit foreclosure in such a short time that the debtor is unable to arrange a commercial loan. Third, the debtor, particularly if elderly, may not be competent to pursue his interests. Fourth, the debtor's credit rating may have deteriorated since the initial loan to such an extent that he cannot obtain commercial credit.

When, for whatever reason, the debtor is unable to pay the accelerated balance, the creditor will have the property sold at auction. The creditor (or another buyer specializing in equity appropriation) will almost always acquire the property at the auction for a price below the market value. First, the market for foreclosed properties is highly restricted. Debtor protections, particularly a debtor right to pay off the balance and redeem the property for some period after sale, are a factor in some states. More significantly, the foreclosing creditor has a vast information advantage over competitors over the short time period between the announcement and the auction ("market for lemons" effect). Second, the creditor can usually bid the amount of the unpaid balance at the auction, without putting up any cash.

A creditor who purchases at auction below market price must pay the debtor whatever difference there may be between the amount of the debt and the auction price. But the creditor

will then hold the property until title is cleared, resell at market, and thereby appropriate the difference between market price and auction price (less expenses), which may be all or merely some of the debtor's equity. In this case, the outcome of the post-default non-negotiation is that the creditor ends up in a better position than it would have been in had the loan been performed.

Preservation of the Loan Post-Default

Ruthless pursuit of creditor remedies is only one possible outcome of default. It may happen that the creditor negotiates with the debtor in an attempt to secure payment of arrears and credible promises of future performance. The creditor may also renegotiate the loan on more favorable terms, in the hope that this will make it possible for the debtor to perform, saving the expense of foreclosure. Here again, it is important to note that the creditor may end up with the equivalent of the loan pre-default, with a less valuable asset post-default, or with a more valuable asset. The creditor will agree to an outcome that is worse than the original when the alternative of foreclosure is even worse (for example, where the amount of the balance is greater than the market value of the property). The creditor will end up better off than if there had been no default where the debtor, to avoid foreclosure, agrees to terms for reinstatement of the loan that are worse for him/her than the original terms.

Determinants of Outcomes of Post-Default Negotiation

If we ask the likely general determinants of post-default negotiations, general market conditions seem likely to have a large influence. Where residential property values in a region or neighborhood are in decline, defaulting debtors are in a good position to obtain concessions, because they may well be in a negative equity position, making foreclosure less desirable for the creditor than accepting credible promises of future payment. Where local real estate values have been increasing, creditors have the possibility of appropriating equity and so ending up better off post- than pre-default. Where the mortgage is fixed rate (or otherwise not refinancable) and rates have declined, the creditor has a motive to preserve the loan rather than collecting through foreclosure.

It is also plausible that specific strengths and vulnerabilities of debtors will affect their success in the negotiation. Age and incompetence, bad credit rating, unemployment, and so forth, make the debtor more likely to lose out. Likewise the extent to which the debtor has made

improvements that increase the “home value” (asking price) without concomitant increase in market value. But there are less obvious determinants, in the nature of modifiable background conditions, that are likely to be ignored. I will focus first on the tendency of creditors to choose either ruthless pursuit of remedies or a loan preservation strategy. I will then turn to the impact of the legal rules governing creditor remedies on the choice of strategy.

The High Road and the Low Road in the Sub-prime Market

What I will call a “High Road” strategy in the sub-prime market is one of making money through loan performance. A “Low Road” strategy in the sub-prime market involves making money either through loan performance or through rapid and cheap foreclosure and resale of properties in default.

The High Road. On the high road, the creditor eschews predatory lending in part because it increases the likelihood of default. It uses point scoring systems or non-point screens that attempt to eliminate borrowers likely to default. It sets up “early warning” and other intervention systems to identify loans that are in trouble before default. And after default the creditor invests money in procedures designed to permit loan “salvage,” including renegotiation and counseling. The high road creditor uses the sticks of threatened foreclosure, eviction and adverse credit rating, but with the goal of inducing the debtor to take steps to improve ability to pay, and to make credible (enforceable) promises of future payment. It employs staff, particularly legal staff, that is relatively high priced and oriented to “ethical” performance of job duties, and never deliberately appropriates a debtor’s equity.

In line with all of these practices, the high road creditor prices its product on the assumption that foreclosure will be relatively rare, and that when it happens it will be expensive. It will be expensive because it will involve wasted salvage attempts and high priced and slow legal procedures, without hope of equity appropriation.

The Low Road. Like the high road, the low road is based on making money in part through performance. The difference is that the low road strategy is much more willing to make loans that are likely to default. It makes money off such a portfolio by pricing on the assumption that foreclosure will be common, but rapid and cheap rather than rare and expensive. It will be

rapid and cheap because the low roader enforces creditor remedies ruthlessly, using cheap legal services, and spends nothing on the various loan preserving tactics of the high roader. Rapid and cheap exercise of remedies has three effects: where the loan is not salvageable, it reduces the cost of terminating it and maximizes the proceeds; the threat of ruthless enforcement may induce the debtor to settle on terms favorable to the creditor; where the property is worth more than the loan, ruthless enforcement will sometimes permit appropriation of the debtor's equity.

The Low Road in the Sub-Prime Market. There are at least two reasons why it seems plausible that the low road strategy might be more common in the sub-prime than in the prime market. First, borrowers who do not have equity substantially greater than their outstanding balance, are less likely, in the sub-prime than in the prime market, to be good candidates for loan salvage. They will have trouble making promises of future performance credible because they are more likely to be unemployed, disabled, incompetent or employed in the low wage secondary labor market without benefits or job security. They are more likely to have no other assets than the property in question, and so to be judgment proof in the case of a deficiency judgment (where deficiency judgments are allowed).

Second, sub prime debtors who have substantial equity in their properties are less likely to be able to defend it, against a low road strategy of appropriating it, than are prime market debtors. After the creditor accelerates the debt, the sub prime debtor is likely less able to mobilize his own or family network assets to pay off the balance, likely less competent at handling the situation, and likely less able, because of unemployment and/or credit history, to borrow commercially.

The profitability of the low road depends on general economic conditions. We might speculate that it will be most profitable during a period combining sustained increases in residential real estate prices, sustained increases in the availability of sub prime credit, increasing unemployment and a restricted social safety net for low income sub prime borrowers. Under these conditions, there should be a high rate of default, weak bargaining power for defaulters, and large amounts of debtor equity to appropriate in the foreclosure process.

Debtor Protection and Low Road Sub Prime Profitability. The profitability of low road strategies in the sub prime market is a function not only of the characteristics of sub prime

debtors and of general economic conditions but also of the legal rules governing what the parties can do to one another in the post default negotiation. This point is central to the remainder of this paper and so requires some elaboration.

Legal Rules Governing Post Default Interactions

The most striking thing about the legal regulation of post default interactions is that different states today, and individual states over time, have adopted strikingly different regimes. Setting up such regimes requires the policy maker to make numerous small choices about apparent details. These, and regimes as a whole, may be more or less favorable to the defaulting debtor, with considerable consequences. Some of the most important policy choices embedded in the post default legal regime are the following.

What safeguards of the debtor's interests in the auction process?

A first question is whether the creditor can declare the loan in default, accelerate it, and then organize and carry out the sale of the property (often to himself) on his own initiative, all without ever going to court for a judgment that he is acting within his rights. Other questions have to do with how much time between default and sale, notice and place of sale, and so forth. Then there is the question whether the creditor should be permitted to bid the amount of the outstanding balance without putting up some cash, as opposed to a sale by a public officer with all potential buyers having to put up cash.

How to define the debtor's equity on foreclosure?

Most states define the debtor's equity as the difference between the auction price and the balance of the debt, minus the creditor's expenses. But some states have sometimes defined it as the difference between the "fair market value" of the property and the balance, on the ground that the procedural measures described above do not work to guarantee a realistic sale price and so further creditor appropriation of debtor equity. (Mattingly 1996)

Whether or not to permit deficiency judgments?

Some states prohibit deficiency judgments so that the creditor has to be satisfied with whatever the property brings at auction. The prohibition eliminates the possibility of going

beyond mere appropriation of equity: where the creditor buys the property at the auction for less than the outstanding balance, even though the market value is larger than the balance, and then collects a deficiency judgment, the debtor ends up worse off than if her had never bought the property in the first place.

Non-waivable equity of redemption or not?

A non-waivable equity of redemption means that the debtor whose debt has been accelerated can, for some period of time, up to or after foreclosure, pay the balance due and reclaim the property. All states allow some type of redemption but the provisions vary widely. (Schill 1991)

Can the debtor assert flaws in the origination of the mortgage at the time of the foreclosure procedure?

In the area of consumer credit, a major 1960's reform was to eliminate the "holder in due course" defense when a holder of consumer paper (usually a bank) was confronted with a claim by the consumer that he had been cheated in the transaction with the seller of the consumer good. Contrary to predictions, the consumer credit market did not collapse. A similar proposal here would allow the debtor to assert in the foreclosure action that the underlying loan was predatory or otherwise questionable.

Predicting the Impact of Debtor Protection: Low Road and High Road

Whether it is the prohibition of deficiency judgments, allowing a strong equity of redemption, or whatever, protective rules reduce the bargaining power of the creditor by reducing its ability to make credible threats to injure the debtor. This effect will have little significance during periods when foreclosure is rare. It is likely, when foreclosure rates are high, to be more important in the sub-prime than in the prime market. A higher proportion of sub-prime loans are likely to be in default. Low road sub prime creditors are likely to be sensitive to the legal rules and motivated to evade or game them, because their practices of ruthless enforcement depend on the vulnerability of sub prime debtors in a way that is not true for creditors oriented to performance.

Debtor Protections and Default Rates: Low Road and High Road

Precisely because they favor the debtor in the post-default negotiation, debtor protections ought, other things being equal, to increase the default rate. By reducing creditor bargaining power, they reduce the expected cost of default to debtors, which should make them more willing to default. Of course, the size of the effect depends on the extent to which default is typically “chosen” on the basis of a rational calculation, rather than imposed by necessity (unemployment, uninsured illness, family emergency). It also depends on the extent to which debtors are aware of the regime, and on their susceptibility to “moral hazard” in relation to their obligation to the creditor. (Schwartz & Wilde 1983)

The impact of debtor protection on the default rate ought to be greater for low road than for high road sub prime creditors. On the low road, the main deterrent to default is the likelihood that the creditor will foreclose and evict as quickly as possible, with maximum damage to the debtor. Increased debtor protections reduce low road creditor power where loan salvage is unfeasible by slowing the process and giving the debtor more opportunity to obstruct it. More important, they should reduce the debtor’s fear of equity appropriation, because many of the protections are specifically aimed at that danger (banning deficiency judgments, equity of redemption). It is at least possible that vigorous enforcement of a strong debtor protection regime would not only increase low road default rates, but also significantly reduce overall profitability (longer to foreclose bad loans and less equity appropriation).

On the high road, creditors invest in early warning, pre-default intervention, post-default counseling, and renegotiation. They have lower default and foreclosure rates than low roaders. Increased debtor protection reduces high roader bargaining power in all these situations, and so should increase the default rate for them, as well as for the low roaders. But the impact on high road profitability should be small by comparison. The legal rules will come into play less often if default rates are low. High roaders can reduce the impact of rules by investing more in their current anti-default practices. And, most important, high roaders are not making money by appropriating equity.

Debtor Protections and Price Effects: Low Road and High Road

Debtor protections ought, other things being equal, to increase the cost of sub prime mortgages. Standard analysis says that terms unfavorable to creditors are costly, and the cost must be distributed between buyers (debtors) and sellers (creditors) through higher prices, reduced margins and reduced volume. Some debtors, in the standard analysis, are priced out of the market. Some of these would have performed and gained equity. Others would have defaulted and been foreclosed, perhaps losing equity but also perhaps having lived at sub-market “rents” while they were performing. (Schwartz & Wilde 1983)

Low Road Price Effects

It seems plausible that these price effects will be quite different for the low road and the high road. Low road creditors would likely lose significant revenues from debtor protection and have to raise their prices significantly in response. This will reduce the welfare of their performing debtors. It will also increase the default rate with attendant increase in the appropriation of the equity of low road debtors. But it will also deter some potential borrowers from taking a low road mortgage, saving them from the danger of equity appropriation in the event of default, while denying them the chance to build equity through ownership.

High Road Price Effects

On the high road, debtor protections should not significantly reduce post default revenues, because high roaders already minimize default. The protections should therefore induce only a small increase in the price of high road credit, with minimal effects on low road debtors.

Debtor Protection Should Expand the High Road at the Expense of the Low Road

At first blush, it might appear that legal measures increasing the costs of low roaders, without significantly impacting high roaders, ought to force price increases on low roaders, that would then cause an increase of the market share of the high road at low road expense. This initial impression may be quite wrong, given the peculiar conditions of the sub prime market. In that market, it seems to be the consensus (amply supported by the papers in this volume) that borrower behavior is strikingly unresponsive to the price and terms of mortgage credit.

Information Asymmetry in the Sub Prime Market. A substantial segment of sub prime borrowers do only the most minimal shopping, and are unable to understand the real terms of the transactions they are entering into. This applies both to price terms and to the virtually incomprehensible “boiler plate” that lays out the legal position of the parties in case of default. This segment of the market is also ignorant of the distinction between low road and high road post default practices. The upper limit on creditor pricing has to do either with legal restrictions or with debtor substitution of other commodities for credit, when the apparent monthly cash cost of credit becomes too high.

To the extent low roaders specialize in the least informed segment of this market, forcing higher costs on them, with accompanying price increases, may have little or no impact on their volume. Its effect would be to increase the total payments of performing debtors, increase the default rate, and improve the bargaining position of defaulting debtors (conserving some equity from low roader appropriation). (Schwartz & Wilde 1979)

Syndication and Specialization in the Sub Prime Market. There is, however, another characteristic of the sub prime market which suggests that debtor protection could indeed reduce low roader market share. The vast majority of sub prime loans are syndicated, securitized, and sold into the secondary market. The servicing of these loans is performed by banks or other entities that typically have no connection with the origination of the loan prior to securitization. The servicers in turn may sell their defaulting loans to specialists who make their money through collections.

If the analysis above is accurate, debtor protection should have a significant impact on servicers and collection specialists who take the low road, but not on those who take the high road. The market in which specialists purchase rights to collect from defaulters, unlike the market in which home owners purchase mortgages, is relatively competitive and transparent. If low road collection specialists lose revenue because of debtor protection, they will have to bid less for collectibles, and should lose market share to high road specialists. It is worth noting that increasing the market share of high road collection specialists might reduce their unit costs, and multiply their advantage over the low road—as well as reducing the default rate and saving debtor equity.

There should be price effects, because what the servicer can sell collectibles for will affect what servicers charge syndicators, and what syndicators offer to originators, and thus indirectly the cost of credit. But to the extent that high roaders displace low roaders, the price increase should be small, since the impact of debtor protection on high road costs should be, according to the analysis above, quite small. In the extreme case, enforced high levels of debtor protection might shut down low road post default operators altogether, with only a very small increase in the cost of credit.

An Unanswered Question: The Organizational Structure of the Low Road. In speculating about the impact of strong, enforced debtor protections on the post default low road, there is major uncertainty as to who owns the collection industry, and as to its internal cost structure. Here are three dramatically different hypotheses, not meant to exhaust the possibilities.

First, perhaps the low road collection industry is the extension of a low road origination industry that is sharply distinct from the “legitimate” high road, with manipulative mortgage brokers, predatory mortgage companies, “tin men,” secondary mortgage “scammers,” and ruthless foreclosers linked in a chain, and linked culturally as unethical, low cost, “chiselers.” In this hypothesis, the bad loans of the predatory lenders go to debtors with high default rates, get syndicated with an element of fraud into the secondary market, and then foreclosed by low road servicers or collection specialists. These acquire them well understanding their suspect (predatory) origins, and that their debtors will either be bad candidates for loan preservation or particularly vulnerable to equity appropriation. On this basis they rationally (though unethically) engage in ruthless pursuit of creditor remedies.

Second, perhaps the low road collection industry is largely owned by mainstream institutions which pursue the low and high roads simultaneously, practicing price discrimination as originators and market segmentation post default, in each case through intermediaries whose function is precisely to allow the mainstream institutions to deny their involvement. Of course, the degree of mainstream institutional involvement can vary across a spectrum from the pure case of outright, but disguised ownership, to providing lines of credit to low road originators and low road collectors, preserving deniability about how much they know of the practices they are financing.

Third, perhaps collection is done by specialized firms connected neither to predatory low road originators nor to mainstream institutions, pursuing profit maximizing strategies based on triage, going for fast foreclosure, to cut losses or appropriate equity, or high road loan-preservation, according to which they think will be most profitable in the class of cases to which the debtor belongs. Such companies might be arrayed on a low road to high road spectrum, each with a different internal culture.

Standard analysis suggests that under conditions of perfect competition, perfect information and zero transaction costs, whichever of these arrangements is most transactionally efficient should eliminate the others. But under conditions of imperfect competition, uncertainty, information asymmetry and path dependence, it is of course perfectly possible that all three patterns, and others as well, could coexist and compete indefinitely. (Schwartz & Wilde 1979)

Public choice theory might, at first, seem to suggest that mainstream ownership, or at least involvement, is the most likely pattern. Were the mainstream uninvolved, we would expect it to lobby for closing down the low road. But this intuition is counteracted by the thought that a mainstream committed only to the high road still has a powerful interest in forestalling regulation across the range of issues in finance. The mainstream industry might be willing to tolerate low road survival as a cost of maintaining an across the board stance in favor of freedom of contract.

Uncertainty about the organization of the low road would be troublesome if its resolution made a big difference to the expected effect of debtor protection. But as far as I can see, enforced high level debtor protection should induce a shift from low road to high road in each of these organizational patterns. This is, nonetheless, an obvious domain for further empirical research, which might unsettle the analysis above.

Efficiency Effects of Favoring the High Road

The efficiency effects of regulations favoring the high road would be numerous. I will organize my speculations according to the scheme of post default, rate of default, and price effects.

At the Post Default Stage

In the post default negotiation, the great danger is that the parties will end up executing their threats to impose losses on their bargaining partners that exceed their own gains. Debtor

protection functions to reduce this danger on one side: it reduces the chances that the creditor will accelerate, foreclose and evict where the “asking price” or “home value” of possession is far greater than what the creditor collects in the process. (Note that appropriation of equity is not in itself inefficient, since it is simply a transfer.) Reducing the share of the low roaders would lead to higher expenditures on early warning, counseling and “work out.” (Leff 1970) It seems plausible to me that these costs would be less than the benefits to debtors through higher rates of loan preservation and reduced equity appropriation.

At the Default Stage: Neighborhood Effects

The “optimal” rate of default is an empirical matter of hopeless complexity. Law and economics provides no categorical solution as to what legal rules are best in the abstract, let alone in practice. It does suggest that debtor protection has countervailing impacts. It should increase default rates by reducing the costs of default. But in so much as it shifts market share from low roaders to high roaders, it should reduce the rate of default because high roaders invest in preventing it. It seems plausible that the default reducing effects would be far larger than the default increasing effects, especially if the increase in enforced debtor protection were accompanied by effective measure against predatory lending.

Neighborhood Effects of Debtor Decisions to Default

If it is the case that debtor protection would reduce default rates, there might be significant external beneficial neighborhood effects. First, debtors deciding whether or not to default, or to passively accept foreclosure, do not take into account the effects of their decisions on their neighborhoods. But sub prime defaults are likely to be geographically concentrated, because of the class and race segregation of American home ownership, and because the economic downturns that generate high default rates are often regionally specific. High default rates that are geographically concentrated threaten downward spirals, as the literature since the 70's has amply demonstrated. (e.g., Kennedy 1987, Kennedy 2002b)

Neighborhood Effects of Ruthless Pursuit of Creditor Remedies

Sub prime lenders are nationally organized, and may well spread their loans across many markets, thereby reducing their vulnerability to local fluctuations in loan viability. It is quite

possible that low road collections by different entities in a single neighborhood will cumulate beyond the threshold at which neighborhood effects emerge. In this case, a collective action problem leads to a reduction of the value of creditor collateral by reducing neighborhood property values across the board—with negative consequences for non-defaulting neighbors—because low road creditors do not calculate the interaction of their ruthless pursuit of their remedies with similar strategies of other low roaders in the vicinity. Debtor protections that squeezed out the low road, thereby reducing the default and foreclosure rates, might significantly reduce this risk.

At the Ex Ante Stage: Price Effects

The two main efficiency issues in the pricing of sub prime credit are whether debtors under-insure against default and whether weak debtor protection creates an incentive for predatory lending.

Debtors Under-insure Against Default

From the point of view of the borrower, debtor protection rules function as insurance against the adverse consequences of default. In other words, because there is an equity of redemption, the debtor is less likely to suffer equity appropriation than if the creditor could take the property finally in response to a minor default. (Schill 1991) Debtor protection has to be non-waivable to work, not only because of information asymmetry, but also because sellers (lenders) have an interest in concealing the costs of default associated with their products (both in order to maintain market share vis a vis one another, and in order to maintain the competitiveness of credit vis a vis other products). (Kennedy 1983) Because the protections are not waivable, this is an example of compulsory insurance paid for through the price and administered by the seller (the creditor).

The standard efficiency analysis of this kind of compulsory insurance applies. (Abraham 1986) First, the insurance may correct a market failure if debtors as a class tend to underestimate the value of this kind of insurance to them. Second, the risks may be uninsurable in the free market for insurance because of transaction costs (particularly “market for lemons” information problems). Because the insurance is compulsory, and the rational expectations and

risk preferences of debtors are highly variable, some debtors who would not have bought as perfectly informed buyers in a competitive market will have to buy as part of the price of credit.

Overall, there will be efficiency gains if the benefits to those consumers who would have bought, had third party insurance been available and had they been well-informed, outweigh the losses to those forced to buy insurance they neither want nor need. Michael Schill's path-breaking statistical study (Schill 1991), done prior to the rise of the sub-prime market, suggested that debtor protection costs debtors overall far less than they receive in benefits. In the sub-prime market today, we can identify characteristics of debtors that point toward greater efficiency gains and others that point the other way.

Sub-prime debtors are likely even less informed than Schill's prime market debtors, and they will often have even more to lose from foreclosure. On the other hand, they are likely poorer, and possibly have higher risk preference, and so might be more likely to forego insurance if fully informed. It seems implausible to me that debtor protection enhances efficiency in the prime market but not in the sub prime market.

Debtor Protection and Predatory Lending

One form of debtor protection at the default stage would directly impede predatory lending--the abolition of the holder in due course defense for the entity doing collection. Defects at the origination stage could then be raised at foreclosure even though the debt had been sold numerous times since origination. But increasing and enforcing other non-waivable protections at the default stage could also reduce the incentives for predation.

It seems possible that predatory mortgage brokers and loan originators generate a disproportionate share of loans that have the two characteristics of equity that can be appropriated and a high probability of default. In the anecdotal typical case, an elderly minority home owner has largely paid off a mortgage (often initially a subsidized mortgage), lives in a neighborhood where home values have recently increased, has little income, no assets other than the residence, and needs a loan to pay for maintenance. In this situation, the value of the loan will be greater, and therefore the incentive to make it at any given (predatory) rate will be greater, the easier it is to appropriate the equity on default.

Increased enforced debtor protection should make the pay off from predation smaller by reducing the equity appropriation component of the value of a predatory loan. This will be true

even if predation is initially the work of mortgage brokers and only secondarily the work of initiators and those who provide them working capital. These actors have eventually to price collectibles. That pricing affects what they will accept from brokers and what they will get from the secondary market. Again, further empirical work seems highly desirable, but there is at least a presumption based on abstract modeling that if debtor protection shifts market share from low road to high road creditors at the default stage, there should be a reduction of predation at origination.

In conclusion, with respect to the efficiency consequences of debtor protection, it is important to keep in mind that the overall cost benefit outcome has to include all the stages of the transaction. There are costs and benefits at the post default stage (e.g., reducing dead weight losses from failure to settle and execution of threats of destruction), another set at the default stage (e.g., neighborhood effects), and yet a third set at the ex ante stage (optimal insurance issues and the effects on predation). How to add up all the elements is inevitably speculative. But the case for debtor protection on efficiency grounds seems to fall somewhere between plausible and highly convincing, depending on one's intuitions about the underlying unresolved empirical questions.

Distributive Effects of Favoring the High Road

The preceding efficiency analysis identifies most of the relevant distributive considerations (Kennedy 1983), supposing that debtor protection had the effects I have been modeling. As between debtors and creditors as groups, it seems likely that debtors will be better off and creditors (along with their employees and stockholders) worse off. As between different classes of creditors, high roaders should gain (increased market share outweighs marginal reduction of their post-default bargaining power) at the expense of low roaders.

The more complex distributive question concerns effects as between debtors. The choice of a more or less vigorous debtor protection policy is an aspect of a larger and important policy choice between favoring (a) low cost, low protection credit with high rates of borrowing, high default and foreclosure, or (b) higher cost, better protected credit with lower participation, lower default and lower foreclosure rates. The high risk strategy permits many to enter the lottery, with the chance of becoming homeowners and accumulating equity, but imposes high costs on the losers. If the strategy is generally successful it has the good neighborhood effects of high

home ownership rates, but if it does not work it imposes the bad neighborhood effects of high foreclosure rates.

Debtors in the sub prime market are likely those that incur the highest risks from the high risk strategy. The loss of equity is likely to wipe out their assets. The loss of “home value” through eviction is likely to lead to a sharp fall in standard of living by forcing a move into high cost rental housing. The neighborhood effects of high foreclosure rates are likely to be much greater in poor than in middle class or affluent neighborhoods. The high risk strategy is based on the idea of “triage”—in order for the largest number to enter the middle class, it is acceptable to sacrifice, rather brutally, those who miscalculate their ability to perform.

In practice, debtor protection regimes fall toward the middle of a spectrum. At one extreme, the legal regimes could (but do not) actively encourage equity appropriation in every case of default, no matter how minor, in order to subsidize the cost of sub prime credit and maximize participation. In this case, defaulting debtors would cross subsidize those who perform. At the other extreme, the regimes could (but do not) force substantial cross-subsidies from performing to non-performing loans, making foreclosure rare, sub prime credit expensive, and participation much lower than it is.

Both the existing regimes and the regime of more vigorous debtor protection discussed here fall in between the extremes. It seems plausible that the change under consideration, if it switched market share from low road to high road post-default practices, would reduce the availability of the high risk option without significantly reducing participation. High roaders with increased market share would not have to increase their prices significantly because they already eschew ruthless pursuit of creditor remedies and invest in loan preservation instead. Moreover, cutting back the low road should reduce predation *ex ante*, making high participation rates less risky for low income borrowers than they now are.

Of course, this leaves unresolved the larger question of the extent to which policy should push toward high participation when it inescapably increases the risks for losers in the lottery. But that is a subject for another paper. (See Kennedy 2002a for preliminary considerations.)

Conclusion

The analysis of the costs and benefits of post default debtor protection in the sub prime market suggests that there is a case for measures designed to shift market share from low roaders to high roaders, and even a case for putting the low road out of business altogether. It suggests considerably more strongly that, in the absence of a more elaborate model and a good deal of new empirical information, there is no basis for a policy presumption against non-waivable debtor protections.

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