



HOUSING CRISIS September 11, 2008, 5:00PM EST

Tougher Bankruptcy Laws Bite the Lenders

How tough new laws on resolving personal debts are burning lenders—not just cash-strapped Americans

by [Jessica Silver-Greenberg](#)

The latest lesson for lenders from the housing crisis: Be careful what you wish for. Banks and other financial outfits spent eight years and \$40 million lobbying for sweeping new bankruptcy rules that would limit their losses from deadbeat debtors. But it turns out those changes, enacted in 2005, are forcing more troubled borrowers to walk away from their homes—even those who didn't take on risky mortgages in the first place. And that's bad news for lenders, which suffer financially every time they have to take a troubled property on their books.

Before the new rules kicked in, many consumers could find debt relief—and keep their homes—by filing for bankruptcy protection. Now the process is much more onerous and expensive and the benefits more limited, making foreclosure seem appealing by comparison. A July paper by David Bernstein, a researcher at the U.S. Treasury, found that 800,000 fewer homeowners have filed for bankruptcy since the rules kicked in. A quarter of those people, says the report, have likely had to give up their homes as a result—boosting foreclosures nationwide at least 4%. "[The rules] are directly responsible for the rising foreclosure rate," notes another report by investment bank Credit Suisse ([CSR](#)). Counters Philip Corwin, counsel at the trade group American Bankers Assn.: "These studies don't stand up to scrutiny."

Banks and other lenders probably never imagined such an outcome when they pushed for changes to bankruptcy rules. The courts were clogged, the industry argued, with consumers looking for any easy out from bills they could pay. As a deterrent, companies wanted to raise the bankruptcy bar.

They got what they wanted. Previously, anybody could file for Chapter 7, the quick and cheap proceedings that liquidate financial assets but not the home to cover debts and dismiss unpaid bills. Now only low-income borrowers qualify, and Chapter 7 doesn't stave off foreclosure.

ONLY TEMPORARY RESPITE

As a result, many struggling borrowers have no other option but Chapter 13, which requires that people follow a court-mandated repayment plan for all their debts, including medical, credit-card, and other bills typically discharged under Chapter 7. Going the Chapter 13 route can halt a foreclosure already in process. But that's often only a temporary salve, since other debts aren't eliminated, and banks can resume foreclosure proceedings as soon as the payments begin to slip anew. Says Chicago bankruptcy lawyer David P. Leibowitz: "In some cases, bankruptcy has become so onerous that it's not worth it to save the house."

The pain of foreclosures, of course, isn't limited to the people losing their homes. A single foreclosure cuts the value of nearby homes by an average of \$1,508 nationwide, according to a report by the Joint Economic Committee of Congress (JECC). Lenders, too, are feeling the bite. Financial firms, the JECC found, take a \$50,000 hit on each property they inherit via foreclosure. That weighs on earnings and limits their ability to make fresh loans.

Cases such as Yvonne Reina's will mean more pain for everyone on the housing food chain. Reina hoped to keep her duplex in suburban Chicago by filing for bankruptcy. The 54-year-old claims processor fell behind on her mortgage payments after a knee injury left her unable to work. She consulted a lawyer about declaring Chapter 13. But he advised against it, saying the payment plan would be too burdensome, given her limited income. In March the bank foreclosed, and Reina moved into an apartment. Says Reina: "I just couldn't make it work anymore."

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