Negative effects of bankruptcy for home owners: reduced access to credit and lost option value

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Main results

1. Bankruptcy filing leads to a 30% higher probability of losing a home and a significant reduction in access to mortgage loans;
2. Bankruptcy filing has a substantial option value;
3. A typical home owner’s benefit from filing for personal bankruptcy is substantially smaller than previously believed.
4. Estimates for some useful parameter values: price elasticity for mortgage loans, value of access to credit, and value of waiting in bankruptcy filing
Relevant concepts

- Interest rate
- Demand for mortgage loans
- Consumer surplus (Lower bound)
- Bias in estimation
- Option value (waiting is valuable)
- Changes over time
- Mortgage reduction due to bankruptcy filing
- Amount of mortgage loans
Estimating negative effects of bankruptcy filing for home owners

- **Mortgage reduction due to bankruptcy filing:**
  1989-1995 PSID data
  - A bankruptcy record increases a home owner’s probability of losing home ownership by: **30%**
  - Expected loss of mortgage loans for a typical home owner: **$7,800**

- **Demand for mortgage loans & utility loss due to mortgage reduction:**
  1989-2001 SCF data
  - Price elasticity for mortgage loans: *(0.62, 0.84)*
  - Utility gain per dollar of mortgage holding: *(0.07, 0.10)*
  - Utility loss due to reduced mortgage: *(3,200, 4,300)*

- **Option value of bankruptcy filing:**
  SCF 1989 panel
  - Option value of bankruptcy filing for home owner: *(290, 380)*
Summary and implications

- Bankruptcy filing substantially reduces the access to mortgage loans for home owners, which leads to two deterrence effects: reduction in access to credit and loss in option value of bankruptcy filing;
- Access to credit is valuable and thus the reduction in mortgage loans leads to important utility loss to home owners;
- Uncertainty in demand for mortgage loans and irreversibility of bankruptcy filing make waiting valuable and the option value of bankruptcy filing non-negligible;
- Due to these two deterrence effects, the number of households that benefit from personal bankruptcy is smaller than previously believed;
- Factors that reduce the deterrence effects above will lead to higher benefit from bankruptcy filing;
- One such factor is the more readily available credit made to consumers with tarnished credit record;
- Further studies are needed to understand how credit availability has affected bankruptcy filing in the past two decades.