Dēmos

MILLIONS TO THE MIDDLE *SERIES*

FAIRNESS IN BANKRUPTCY ACT

HELPING AMERICANS BUILD ASSETS

Widely shared middle-class prosperity has made the United States the most hopeful and dynamic country on earth and is a foundation of strong democracy. Yet today, America's middle class is in trouble: the traditional routes into the middle class have become more difficult to travel and security has eroded for those already in the middle class. Major economic and policy changes over the past three decades have widened economic inequality and reduced mobility in ways that go far beyond the impact of the recent recession. Too many people who play by the rules and do everything right find that they cannot climb into the middle class—or stay there. To meet this challenge, Millions to the Middle offers dramatic public policy initiatives to rebuild and grow the nation's middle class.

POLICY IN FOCUS

FAIRNESS IN BANKRUPTCY ACT

Make the bankruptcy process work again for Americans overwhelmed by debt they cannot pay by permitting bankruptcy courts to restructure the debt on home mortgages and discharge unaffordable student loans.

We aim to accomplish two broad interrelated goals: to ensure that all Americans have a chance to move into the middle class and, second, to ensure greater security for those in the middle class. The 14 policies we offer are rooted in mainstream American values and able to command strong public support over the long term. Together, they go beyond the confines of the current policy debates and are of sufficient scale to firmly establish a middle-class America.

Our policy agenda is based on the three broad pillars of middle-class opportunity and security: investments in human capital and education; support for growth, job creation, and career development; and helping Americans build assets. This policy is part of the **Helping Americans Build Assets.**

POLICY: FAIRNESS IN BANKRUPTCY ACT

Allow bankruptcy judges to reduce the mortgage principal on a primary residence and to discharge student loan debt.

POLICY RATIONALE

Household debt is burdening millions of families and stifling economic growth in the nation as a whole. In the first half of 2011, 11 million American households – more than one in five homeowners – owed more on their mortgages than their homes were worth.[1] Millions of families have already lost their homes to foreclosure. Meanwhile, the nation's outstanding student loan debt is likely to top an unprecedented $1 trillion this year, and student loan default rates are rising.[2] As Americans struggle to pay back debt, they have less to spend and invest, creating a drag on economic recovery. These staggering debt levels are compounded by bankruptcy rules that direct the flow of money toward banks and other mortgage lenders rather than American households.

The forces at play go far beyond personal responsibility and have battered even those who played by the rules. The nation's $8 trillion housing bubble was less a problem of borrowers who lived beyond their means than of mortgage brokers and lenders who made irresponsible and often predatory loans while lax government regulators looked the other way. Yet individual homeowners have been left to watch their single largest family asset plummet in value. Similarly, states have defaulted on their historic commitment to funding higher education, contributing to the growth of college tuition even as family incomes have stagnated.[3] For many students, borrowing is the only way to finance an education, even as high unemployment for recent graduates makes it difficult to pay loans back.[4] High interest rates for private student loans and questionable marketing practices by student lenders contribute to making student loan debt unsustainable.

Bankruptcy is the traditional last resort for Americans overwhelmed by debt they cannot pay. The ability to discharge debts in an orderly way was seen as such a critical part of the nation's economy from its founding days that the U.S. Constitution explicitly grants Congress the power to establish national laws on bankruptcy.[5] Scholars have even linked America's comparatively lenient personal bankruptcy laws to the nation's entrepreneurial dynamism, arguing that ability to make a fresh start is essential to the willingness to take risks that may ultimately pay off.[6]

OPINION SNAPSHOT

- 62 percent of self-identified "middle class" adults favor the idea of allowing bankruptcy judges to change mortgage payments in order to prevent foreclosure.[7]
- Almost two thirds of recent student borrowers report that they've had difficulty making monthly college loan payments: they postpone payments, become delinquent, or default within five years of leaving school.[8] In the abstract, Americans are almost evenly divided on the question of forgiving college loan debt[9] and support would likely rise if forgiveness were provided only within the stringent context of bankruptcy.

But in 2005, Congress and the Bush Administration clamped down on bankruptcy filings, placing hurdles in the path of Americans trying to file and making it more difficult to discharge debts. In particular, the 2005 law made private student loan debt, like federal student loans, impossible to discharge in bankruptcy except under a difficult to meet hardship exemption. Today, bankruptcy allows for the discharge of credit card debt and auto loans but not student loan obligations. At the same time, the law permits judges to modify loans used for commercial real estate, vacation homes, and even yachts, but not a family's primary residence. Two of the largest investments Americans make in order to enter the middle class – in their homes and their educations – are thus excluded from the relief offered to other debtors.

By enabling bankruptcy judges to write down mortgages to the current value of the home, the Fairness in Bankruptcy Act would make it more affordable for Americans to stay in their homes, reducing foreclosures at no cost to taxpayers and powerfully stabilizing the housing market. Knowing that homeowners have the option to reduce their principal in bankruptcy would also give lenders a greater incentive to mortgage reductions long before a borrower even considers bankruptcy. Finally, by allowing Americans to discharge student loan debt in bankruptcy, the policy will give young Americans battered by the recession a chance at a fresh start.

POLICY DESIGN

The mortgage sections of the Fairness in Bankruptcy Act are based on the Helping Families Save Their Homes in Bankruptcy Act, the major provisions of which were considered in various forms since 2008. One version of the bill passed the House of Representatives in 2009 but failed in the Senate. It is currently before Congress again as H.R. 1587. The student loan sections of this policy build on the Fairness for Struggling Students Act (S. 1102) but go beyond this bill to include federal as well as private student loans.

- Permit bankruptcy courts to restructure the debt on home mortgages by setting interest rates and principal at commercially reasonable market rates and extending repayment periods.
- Limit mortgage restructuring to homeowners who cannot afford to make mortgage payments and are in danger of foreclosure.
- If a bankruptcy court reduced the mortgage's principal to the current fair market value of the property and the value later rose, a lender would be entitled to receive the net proceeds from a sale of the property.
- Allow federal and private student loans to be discharged in bankruptcy.

ENDNOTES

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