

The Effect of Principal Reduction on Household Distress: Evidence from Mortgage Cramdown

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● Mechanism

- ▶ Potential debt overhang consideration

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- Step 2: Direct effect of mortgage cramdown
 - ▶ Exploit pre-1993 variation in courts where cramdown was allowed
 - ▶ Exploit the ruling of 1993 where cramdown was prevented by Supreme Court

$$y_i = \alpha_{ot} + \beta D_i + \eta D_i \times \text{Cramdown}_i + \delta D_i \times \text{Post} + \lambda D_i \times \text{Cramdown}_i \times \text{Post} + \gamma' X_i + \epsilon_i$$

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- There has been a dichotomy in the way default should be reduced:
 - ▶ Many economists have argued that permanently forgiving mortgage principal was a missed opportunity and one of the biggest policy mistakes of the Great Recession.
 - ▶ Others have argued instead that if borrowers are liquidity constrained, focusing on short-term payment reductions is more cost-effective

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- Principal reduction should negatively affect foreclosure if short-term liquidity is not the only binding constraint.
- Some work shows that if the principal reduction is small then this might not have any impact on foreclosure.
- Given this premise, this paper indeed finds that cramdown which reduces the principal a significant effect on foreclosure.
- While it is an interesting impact to document, I think it would also be interesting to study the effect of cramdown on the ex-ante changes in lending by banks.

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- To get a broad-based understanding of the welfare cost of cramdown it would be important to compare the relative importance of foreclosure vis-a-vis ex-ante credit supply.
 - ▶ This could lead to state-contingent policy implication

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- Is the effect driven by a selection of individuals who gets access to loans in the two regimes?

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 - ▶ Instead, compliers are likely to be contentious cases in which multiple forms of interpretation by the judge could be legally justified
- Thus, the LATE might not generalize to cases other than compliers.
- The authors could use the random assignment of judges to estimate a structural model following [Antill, 2022](#)
 - ▶ Would enable to move from LATE to ATE, which could be more policy-relevant

Other Comments

- The leniency variable is estimated every period in time
 - ▶ Every period the ranking across judges could change.
 - ▶ The experiment potentially relies on judges biased towards being lenient.
 - ▶ Would be good to use long-term averages.
- Identification uses office \times me fixed effects
 - ▶ more and less lenient judges could have opposite effects.
 - ▶ Could lead to over-estimation of the intended effect.
- Report F-statistics for the first stage results.
- Could report the OLS result of discharge on foreclosure. Would be interesting to compare how the IV estimates vis-a-vis the OLS estimates.
- There seems to be a strong divergence across Republican and Democrat
 - ▶ Could there be partisanship across judges in implementing the policy?

Conclusion

- Important research question to study the potential way foreclosure could be reduced.
- Highlights that principal reduction can have a significant effect.
- Mortgage cramdown could be a very relevant policy tool.
 - ▶ Would be good to get an estimate of ATE.
- However, mortgage cramdown may have some cost inflicted on potential lenders.
- Would be very interesting if an attempt could be made to estimate the welfare cost