Borrower protection and the supply of credit: Evidence from foreclosure laws☆

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ABSTRACT

Laws governing the foreclosure process can have direct consequences for the costs of foreclosure and, therefore could affect lending decisions. We exploit the heterogeneity in judicial requirements across US states to examine their impact on banks' lending decisions in a sample of urban areas straddling state borders. A key feature of our study is the way it exploits an exogenous cutoff in loan eligibility to government-sponsored enterprises (GSEs) guarantees, which shift the burden of foreclosure costs onto the GSEs. We find that judicial requirements reduce the supply of credit only for jumbo loans, which are ineligible for GSE guarantees, i.e., in the nonsubsidized segment of the market. Thus, while we find a significant effect on credit supply, the aggregate impact is muted by the indirect cross-subsidy by the GSEs to borrower-friendly states.

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1. Introduction

The foreclosure crisis and the ensuing regulatory reforms of the mortgage market have revived an old debate surrounding the trade-off between borrower protection and credit access.[1] The importance of this issue also lies in the fact that regulations are persistent and thus their cumulative costs could be considerable. Unfortunately, the impact of borrower protection laws on credit supply remains relatively understudied in the empirical literature.

In this paper, we investigate the impact of foreclosure laws on lending decisions by banks. Foreclosure laws govern the process through which creditors can take repossession of real estate following a default by the borrower. These laws have important implications to the foreclosure process, its duration, and the associated costs and risks to borrowers and creditors. Because borrower-friendly foreclosure laws typically impose additional costs to creditors in the event of default and could increase borrowers' incentive to default, one wonders whether and to what extent they also reduce the supply of credit. Our main focus is on judicial foreclosure laws, i.e., whether states require that the foreclosure process be handled by the court system. Judicial procedures are more costly than power-of-sale alternatives, as they are more time

[1] See, e.g., Bipartisan Policy Center (2013); Evans and Wright (2009); US House of Representatives (2012), and Kupiec (2014).

consuming and require the use of legal professionals [see, e.g., Clauretie and Herzog, 1990 and Schill, 1991].[2] The foreclosure crisis has highlighted the stark differences in the foreclosure timelines between so-called judicial and nonjudicial states and their implication to foreclosure levels, house prices, and the economy, as recently shown in Mian, Sufi, and Trebbi (2015).

To provide a convincing answer to our main question, one has to be able to trace the impact of the laws on the supply of credit, controlling for potentially confounding factors. We, therefore, design an empirical strategy that takes advantage of a quasi-experimental setting. We exploit two sources of exogenous variation. The first is the variation in foreclosure laws across state borders. The second variation is the discontinuity in loans' eligibility to guarantees from government-sponsored enterprises (GSEs), guarantees that shift the financial burden of foreclosure costs onto the GSEs. The role of the GSEs cannot be ignored on the mortgage market. The GSEs guarantee a large share of mortgages in exchange for guarantee fees that are uniform across states. Whether a loan is conforming, i.e., eligible for GSE guarantees, is determined by an exogenous regulatory loan-limit cutoff set by their regulator. Ignoring the role of GSEs could lead one to underestimate or misinterpret the effects of foreclosure laws. The use of this exogenous cutoff also allows us to considerably sharpen our empirical strategy to further address concerns related to unobservable factors.

While the costs associated with judicial foreclosure are directly related to the longer foreclosure timelines, the extant literature has so far relied on a binary variable to capture this difference. One of the contributions of this paper is that it brings in more direct and continuous measures of differences in foreclosure time frames. Our favorite variable is based on data collected by the US Foreclosure Network (USFN), which, through its legal expertise, provides an estimate of the number of days it takes to foreclose on a property solely based on state laws.

Using a comprehensive data set on mortgage lending in the US, we study the impact of foreclosure laws on banks' probability of rejecting a loan application in urban areas straddling state borders while exploring the variation between conforming and non-conforming (jumbo) loans. One of the advantages of a loan-level analysis is that it allows us to study the decision by banks, which is more directly linked to the supply side of the market [see, e.g., Loutskina and Strahan, 2009], and to control for bank fixed effects. We show that the banking sector is heterogeneous across borders even within an urban area, an issue that has not been sufficiently highlighted in the literature.

Our findings point to a significant and economically meaningful impact of judicial foreclosure laws on the supply of credit. The aggregate effect of these laws on credit supply is muted, however, due to the GSE cross-subsidization of borrower-friendly states. We find that judicial foreclosure laws are associated with a significant increase in the relative rejection rate on jumbo loans. Their

impact on the rejection rate of conforming loans is weak and overall not statistically significant. These results are in line with our hypothesis, as the foreclosure costs on GSE-securitized conforming loans are borne by the GSEs. While the supply of credit is unevenly affected by foreclosure laws around the jumbo cutoff, we show that the demand for loans does not exhibit such variation. The relative number, volume, and characteristics of jumbo loans in comparison with conforming loans do not correlate with judicial foreclosure laws across borders. All these results hold for either the standard binary measure used in the literature, or the foreclosure time frames we obtain from authoritative sources on state foreclosure requirements.[3] We subject our findings to a battery of robustness and falsification tests (included in an Online Appendix). We find that they help strengthen our results and support our interpretation.

While the literature on foreclosure laws is extensive, the impact of foreclosure laws on mortgage lending has received limited attention. An important exception is Pence (2006), which offers a rigorous treatment of the subject using Home Mortgage Disclosure Act (HMDA) data focusing on urban areas that straddle state borders. Pence (2006) studies the impact of these laws on the size of the loan and finds that loan sizes are 3–7% smaller in defaulter-friendly states. Our paper differs along several important aspects. Key to our empirical analysis is the focus on isolating supply side factors and the distinction in loans' eligibility to GSE guarantees based on the exogenous jumbo cutoff. Our analysis also differs in that we focus on the decision by banks to reject a loan and in that we control for the heterogeneity in the banking landscape across borders. We also make use of new data that provide a more direct measure of the costs associated with judicial foreclosures.

A related strand of literature has examined the impact of foreclosure laws on bank losses, borrower behavior, and foreclosure rates. For example, Clauretie and Herzog (1990) find that judicial foreclosure and the right of redemption increase the cost of foreclosure. Ghent and Kudlyak (2011) find that recourse laws lower the sensitivity of default to negative equity. The literature also points to evidence that longer foreclosure duration, associated with judicial requirements, increases the incentive to default [see, e.g., Gerardi, Lambie-Hanson, and Willen, 2013; Zhu and Pace, 2011, and Calem, Jagtiani, and Lang, 2014]. These findings provide an additional channel through which judicial foreclosure can affect the supply of credit. Mian, Sufi, and Trebbi (2015) study the impact of judicial foreclosure on the incidence of foreclosure and use this as an instrumental variable to find that foreclosures lead to a large decline in house prices. A related strand of literature studies the impact of bankruptcy law on credit supply [see, e.g., Berkowitz and White, 2004; Gropp, Scholz, and White, 1997, and Goodman and Levitin, 2014]. Our paper is also related to the broader literature that studies the impact of

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[2] These losses typically include foregone interest, attorney fees, court costs, property taxes, repairs, hazard insurance, and other indirect costs.

[3] All our regressions control for two other weaker variations in foreclosure laws (discussed in Section 2) related to deficiency judgments and right of redemption, but we do not highlight them due to lack of sufficient variation in the cross-border sample.