



# State Foreclosure Law: A Neglected Element of the Housing Finance Debate

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More than a decade after U.S. mortgage lending sparked a global financial crisis, Washington's treatment of the mortgage-finance industry has taken a deregulatory turn.

In the first 21 months of the Trump administration, activity levels across the federal government—from CFPB consumer-protection enforcement actions, to SEC fines against banks, to Justice Department lending-discrimination lawsuits—are markedly lower than during the final 21 months of the Obama administration. Proponents of a robust mortgage-finance regulatory framework are playing defense: focusing on maintaining *ex ante* federal regulations concerning the availability of credit to borrowers and the appropriateness of the mortgage products offered by lenders.

These proponents would be well served by also devoting attention to the states. In this Issue Brief, I show how the legal framework governing *ex post* borrower protections—specifically, state foreclosure procedures—can help address this challenging policy problem. State legislators would do well to understand how various foreclosure regimes across all 50 states affect mortgage lending so that they can tailor their state's foreclosure regime to their state's specific needs. Given the deregulatory trend at the federal level, advocates of strong regulation of lending practices

## SUMMARY

- The momentum in Washington currently trends toward deregulation of the mortgage-finance industry. Given these circumstances, proponents of maintaining a more robust regulatory framework should look to the power of the states, and specifically to state-mandated judicial foreclosure.
- Judicial foreclosure, which is authorized in almost half of U.S. states, requires that lenders seeking to foreclose on a mortgage file an action in state court. This not only provides borrowers with a forum for holding lenders accountable for their behavior and obligations, but puts the onus on the lender to show that the requirements for foreclosure have been met. It also aids borrowers by delaying the foreclosure process and allowing them to remain in their homes for longer periods while in default.
- New empirical research discussed in the brief indicates that judicial foreclosure also alters lender behavior in ways that are beneficial to borrowers, and that mirror regulatory goals. Lenders exhibit greater caution in loan-approval decisions and offer fewer subprime loans. These results are amplified for lower-income borrowers.
- Importantly, the costs imposed on lenders by judicial foreclosure do not appear to get passed on to borrowers in the form of higher rates.



ought to look to the states—including to state foreclosure law as a form of *ex post* mortgage-finance regulation.

Almost half of U.S. states mandate judicial foreclosure, which requires that lenders seeking to foreclose on a mortgage file an action in state court. In these states, courts provide a forum for borrowers to challenge both lenders' adherence to the state's foreclosure procedures (the back-end) and their behavior at the loan origination stage (the front-end). Borrowers in all states may raise a broadly similar set of arguments, as defenses to the lender's foreclosure action in judicial foreclosure states or as causes of action in non-judicial foreclosure states. The key difference between the two procedures is that judicial foreclosure places on the lender the burden of demonstrating that the requirements to foreclose are met. In other states, by contrast, the burden is on the borrower to affirmatively file suit to claim that the lender did not meet these requirements.

The benefits to borrowers of mandatory judicial foreclosure are readily apparent. Judicial supervision helps to ensure that lenders meet all requirements to foreclose, and court involvement slows down

the foreclosure process, enabling borrowers to remain in their homes, without making payments, for a longer period. The *costs* to borrowers of a mandatory judicial forum, however, are contested. If the procedure's obvious costs to lenders are passed on to borrowers in the form of higher interest rates, then—depending on one's view of delinquent borrowers—judicial foreclosure either serves as an inefficient form of insurance paid by all borrowers (through those potentially higher rates) to compensate unfortunate ones or provides an unfair windfall to irresponsible borrowers at the expense of responsible ones.

To determine the effect of judicial foreclosure requirements on mortgage pricing, I compared loan application decisions in 14 pairs of neighboring states, where both states have substantially similar foreclosure procedures but for the fact that one state mandates judicial foreclosure and the other does not. To account for differences in states' real estate markets or economies, I focused exclusively on loan applications within metro areas that straddle state lines and in state border regions in these 14 pairs of states.<sup>1</sup> To ensure that I was comparing similar individuals

across state lines, I included a battery of individual- and neighborhood-level demographic variables. Finally, to address differences in the regulatory treatment of different lenders, I restricted my analysis to nationally chartered banks in 2005, because the federal Office of the Comptroller of the Currency (OCC) was the exclusive banking regulator of these entities in that year.<sup>2</sup>

Judicial foreclosure affects borrowers and lenders, and it has implications for policymakers. To preview the results, I find that lenders adopt a more conservative posture in judicial foreclosure states, exhibiting greater caution in loan-approval decisions, and—for those applicants that are approved—lenders offered fewer subprime loans. Importantly, these results were amplified for lower-income borrowers.

That *ex post* foreclosure law can have a similar effect on lenders' origination behavior as does *ex ante* regulation should interest state lawmakers who are concerned about Washington's deregulatory turn in mortgage-finance regulation. State governments looking to maintain conservative lending behavior—particularly to lower-income people—in the face of potential federal

## NOTES

- <sup>1</sup> This Issue Brief is based on Brian D. Feinstein, "Judging Judicial Foreclosure," *Journal of Empirical Legal Studies*, 15(2), 406-451 (2018).
- <sup>2</sup> These data were obtained from the federal Home Mortgage Disclosure Act (HMDA) Final Loan Application Register dataset. In 2005, 8,848 lenders filed 33.6 million loan application reports under the HMDA. The OCC regulated 1,255 of these institutions, which filed 7.3 million HMDA reports that year. See Federal Financial Institutions Examination Council. *HMDA Raw Data Software 2004 (version 3.1)* (computer file), Washington, D.C.: Federal

Financial Institutions Examination Council.

- <sup>3</sup> Once established, states have rarely changed their foreclosure regimes. Since 1938, only eight states have switched between non-judicial and judicial foreclosure. For more, see Ghent, Andra C. 2012. "The Historical Origins of America's Mortgage Laws." Research Institute for Housing America, Washington, D.C. Further, states' current foreclosure regimes do not appear related to current state-level economic conditions or other factors, including mortgage default rates. See Mian, Atif, Amir Sufi, and Francesco Trebbi. 2015. "Foreclosures, House Prices,

and the Real Economy." *Journal of Finance* 70:2587-2634.

- <sup>4</sup> Gerardi, Kristopher, Lauren Lambie-Hanson, & Paul S. Willen, 2013. "Do borrower rights improve borrower outcomes? Evidence from the foreclosure process." *Journal of Urban Economics* 73:1.
- <sup>5</sup> Demiroglu, Cem, Evan Dudley, & Christopher M. James. 2014. "State Foreclosure Laws and the Incidence of Mortgage Default." *Journal of Law & Economics* 57:225.
- <sup>6</sup> For each of these borrower protections, the number of states with a corresponding provision is as follows: (1) 50 states, (2) 27 states, (3) 22 states, and (4) 13 states.

deregulation should consider enacting judicial foreclosure or otherwise strengthening foreclosure protections.

## THE BASICS OF FORECLOSURE

State law governs the foreclosure process.<sup>3</sup> In 2005, eighteen states

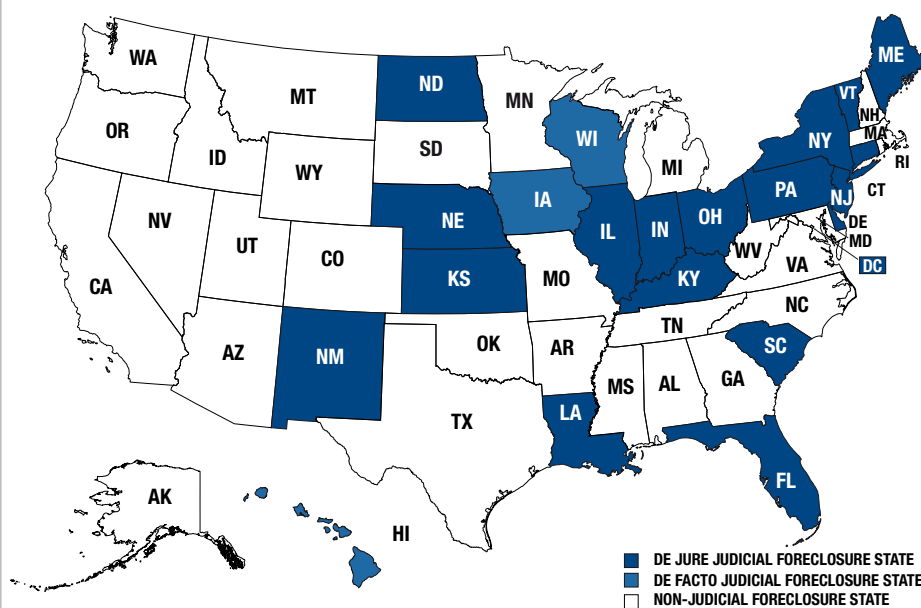
foreclosure so as to severely discourage the use of that procedure. These three states can be considered *de facto* judicial foreclosure states (see Figure 1).

The effects of foreclosures on borrower behavior at the back-end are well established. We know that borrower protections, including mandatory judicial foreclosure, serve

default.<sup>5</sup> However, the manner in which the legal environment influences lender behavior at the front-end (i.e., approval decisions and the loan terms offered) remains hotly contested, with two competing strands of research reaching contrary conclusions about whether borrower protections, including judicial foreclosure, increase or decrease loan costs.

In addition to judicial foreclosure, states impose a range of requirements on lenders seeking to foreclose, concerning (1) the number and timing of notices that the lender must send, (2) whether the borrower holds a statutory right to cure the default, (3) the length of any post-sale redemption period, and (4) whether the lender is permitted to pursue a post-sale deficiency judgment, allowing it to seize other borrower assets.<sup>6</sup> All four protections impose costs on lenders and, therefore, presumably all four could affect the market for mortgages, as lenders change their front-end behavior in response to back-end borrower protections. For this reason, I focus on borders between states with substantially similar foreclosure laws, with the only material difference being the presence or absence of a judicial foreclosure requirement.

**FIGURE 1 MANDATORY JUDICIAL FORECLOSURE PROCEDURES, BY STATE**



and the District of Columbia mandated judicial foreclosure. Another three states—Hawaii, Iowa, and Wisconsin—set such stringent requirements for non-judicial

to delay, but typically not to avoid, foreclosure.<sup>4</sup> Additionally, some researchers find that, by lowering the costs to borrowers of default, these laws can even encourage strategic

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- <sup>7</sup> Nelson, Grant A. & Dale A. Whitman. 2012. *Real Estate Finance Law*. Eagan, Minn.: West Publishing.
- <sup>8</sup> Demiroglu, *supra* note 5.
- <sup>9</sup> Collins, J. Michael, Ken Lam, and Christopher E. Herbert. 2011. "State Mortgage Foreclosure Policies and Lender Interventions: Impacts on Borrower Behavior in Default." *Journal of Policy Analysis & Management* 30:216.
- <sup>10</sup> Fox, Judith 2015. "The Future of Foreclosure Law." *Washburn Law Journal* 54:489.
- <sup>11</sup> Mian, *supra* note 3.
- <sup>12</sup> Wassmer, Robert W. 2011. "The Recent Pervasive External

- Effects of Residential Home Foreclosure." *Housing Policy Debate* 21:247.
- <sup>13</sup> Poppe, Emily S. Taylor. 2016. "Formalities on the Books, Foreclosures in Action: An Empirical Investigation of the Foreclosure Process." Working paper. Cornell University Law School.
- <sup>14</sup> *Ibid.*
- <sup>15</sup> Porter, Katherine. 2008. "Misbehavior and Mistake in Bankruptcy Mortgage Claims." *Texas Law Review* 87:121.
- <sup>16</sup> Challenges to allegedly improper fees comprise an important subcategory of challenges to the amount owed.

- <sup>17</sup> Pollock, John. 2010. "Lassiter Notwithstanding: The Right to Counsel in Foreclosure Actions." *Journal of Poverty Law & Policy* 43:448.
- <sup>18</sup> The particular documentation needed to foreclose, e.g., proof of mortgage assignments, varies somewhat by state (Fox, 2015).
- <sup>19</sup> Poppe, *supra* note 13.
- <sup>20</sup> Carpenter, David H. 2015. "Robo-Signing" and Other Alleged Documentation Problems in Judicial and Non-judicial Foreclosure Processes." *CRS Report for Congress*.
- <sup>21</sup> These costs include not only legal fees, but also



## JUDICIAL FORECLOSURE ON-THE-GROUND

Judicial foreclosure benefits borrowers in two respects: it provides a *legal forum* for borrowers to contest predatory loans and ensure that lenders seeking to foreclose meet the legal requirements to do so; it also serves as a *transfer payment*, delaying foreclosures and allowing borrowers to remain in their homes for longer periods while in default.

The on-the-ground consequences of judicial versus non-judicial foreclosure differ in at least one important respect: the former takes substantially longer to complete than the latter—about 363 days longer in 2010.<sup>7</sup> By one estimate, foreclosures cost an average of \$3,112 in judicial foreclosure states but only \$2,269 in other states.<sup>8</sup>

The longer procedural periods in judicial foreclosure states also have second-order effects. Because lenders bear the costs of delay, they are more likely to pursue alternatives to foreclosure—namely, negotiating loan modifications with delinquent borrowers—in judicial foreclosure states.<sup>9</sup> And the data back this up: fewer foreclosures per default occur in judicial foreclosure states.<sup>10</sup>

Owners of nearby properties and municipal governments also benefit when foreclosures are avoided. Spillover costs—e.g., failures to adequately maintain properties, increased vacancy, and feelings of decreased neighborhood stability among residents—often accompany foreclosures. These features tend to lower neighborhood property values and discourage new investment.<sup>11</sup>

Similarly, because foreclosures reduce property tax assessments, the decreased likelihood of foreclosure in judicial foreclosure states benefits municipal coffers.<sup>12</sup>

However, borrowers generally do not avail themselves of important rights that the judicial process affords. One study found that only 21% of borrowers were represented by counsel at any point in the foreclosure process. Only 24% of borrowers even filed an answer. And when borrowers did participate, they rarely alerted the court to potential defects in lenders' claims.<sup>13</sup> Should such findings imply that judicial foreclosure requirements do not exert any effect? Probably not. Lenders in these states could decline to initiate foreclosure proceedings in marginal cases in these states; more rigorously adhere to legal requirements at the loan origination

stage; and tighten their lending standards and lean towards offering prime rather than subprime loans. But the lack of borrower engagement, even in judicial foreclosure states, is unfortunate. Here is a brief summary why.

## CHALLENGES TO A FORECLOSURE

There are six major issues that borrowers facing foreclosure can raise, as defenses or counterclaims in judicial foreclosure states or as claims in a suit filed by the borrower to enjoin foreclosure in other states.

*First*, the borrower may challenge the amount owed. In a random sample of almost 1,000 foreclosures filed in New York—a judicial foreclosure state—one researcher found that 20% of borrowers claimed that the lender failed to credit payments received.<sup>14</sup> Further, another study of bankruptcy filings found that, in 70% of bankruptcies, creditors' assertions regarding the size of the mortgage debt exceeded the borrowers' figures, whereas borrowers' assertions exceeded creditors' figures in 25% of cases.<sup>15</sup> That the borrower self-reported greater debts than the creditor in one-quarter of the cases

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additional property taxes, insurance, and maintenance or depreciation costs, because judicial foreclosures tend to take more time to complete. See Fox, *supra* note 10.

<sup>22</sup> Bocian, Debbie Gruenstein, Keith S. Ernest, & Wei Li. 2008. "Race, Ethnicity and Subprime Home Loan Pricing." *Journal of Economics & Business* 60:110.

<sup>23</sup> *Ibid.*

<sup>24</sup> These 14 state pairs are: Connecticut-Massachusetts, Delaware-Maryland, Florida-Georgia, Iowa-Minnesota, Kentucky-Missouri, Kentucky-Virginia, Louisiana-Mississippi, Louisiana-Texas, Nebraska-Colorado,

Nebraska-South Dakota, Ohio-West Virginia, South Carolina-Georgia, South Carolina-North Carolina, and Wisconsin-Minnesota. In each of these pairs, the state that requires judicial foreclosure is listed first.

<sup>25</sup> FFIEC, *supra* note 2.

<sup>26</sup> Metzger, Gillian E. 2011. "Federalism under Obama." *William & Mary Law Review* 53:567.

<sup>27</sup> See, e.g., Landes, William M. & Richard A. Posner. 1987. *The Economic Structure of Tort Law*. Cambridge, Mass.: Harvard University Press.



indicates that the issue is not simply systemic underreporting by borrowers, but rather often reflects a genuine uncertainty on the part of one or both parties regarding the size of the debt.<sup>16</sup>

*Second*, borrowers may utilize state common-law doctrines—most prominently, fraud and unconscionability—in foreclosure proceedings. Courts allow these claims and defenses in a variety of situations, including extensions of credit to low-income borrowers for whom default was reasonably foreseeable; rate- and term refinances with inferior terms; and approving loans with balloon payments to borrowers with fixed or declining income.

*Third*, where the lender provided misinformation or failed to disclose certain information prior to loan origination, the Truth in Lending Act enables the borrower, in limited circumstances, to rescind the loan agreement.

*Fourth*, the borrower may challenge the lender's ownership of both the note and the mortgage document, and, thus, the lender's right to foreclose. As loans are sold and resold repeatedly, the likelihood that the parties to these transactions fail to properly assign the note increases. Unsurprisingly, gaps in the chain of title are common. One study found that the foreclosing entity did not show proof of ownership of the note in approximately 40% of a sample of 1,700 foreclosures.<sup>17</sup> Where the lender lacks standing based on these defects, it cannot foreclose, regardless of whether the borrower is delinquent.<sup>18</sup>

*Fifth*, the borrower may argue that the lender failed to properly serve notice. Although the details differ by state, lenders generally must send several notices to borrowers in default (e.g., a notice of default and notice of foreclosure sale). Allegations that the lender failed to serve a notice of default were raised in 46% of the answers filed in one sample.<sup>19</sup>

And *sixth*, the borrower may claim that the documents that a lender proffers are false or fraudulent. In a practice known as “robo-signing,” some lenders attempt to create a chain of title *post hoc*, fraudulently creating backdated assignments of notes. In the wake of robo-signing scandals and, relatedly, lenders' inability to show ownership of mortgages during and after the financial crisis, three major servicers voluntarily stayed foreclosure sales in judicial foreclosure states. Notably, this stay did not extend to foreclosure sales in non-judicial foreclosure states, indicating that mandatory judicial process is more effective than granting borrowers an opt-in right to adjudicate.<sup>20</sup>

Given all of these scenarios in which lenders either can fail to uphold their obligations or deliberately disadvantage borrowers, providing borrowers with automatic access to the judicial system by requiring lenders to obtain judicial approval to foreclose would seem preferable to placing the burden on them to file suit. But is it?

## A CASE FOR MANDATORY JUDICIAL FORECLOSURE

I set out to answer three questions. *First*, since judicial foreclosure saddles lenders with greater costs than they otherwise would incur if permitted to foreclose,<sup>21</sup> are lenders less likely to approve mortgage applicants in judicial foreclosure states than otherwise similar applicants in non-judicial foreclosure states?

*Second*, based on the theory that more costly judicial foreclosures may be avoided by offering borrowers more manageable terms, are approved applicants less likely to be offered subprime products in states that mandate judicial foreclosure?

*Third*, are approved applicants with lower socio-economic status (e.g., racial or ethnic minorities or lower-income applicants) even less likely to be offered subprime products in judicial foreclosure states?

On this last question, we know that mortgage-finance outcomes are markedly worse for African American and Hispanic borrowers. When minority applicants are approved, they are substantially more likely to receive subprime loans, even when controlling for other borrower demographic characteristics.<sup>22</sup> These disparities persist after loan origination. During the financial crisis, the foreclosure rates for African American and Hispanic borrowers were 76% and 71% higher, respectively, than the rate for non-Hispanic white borrowers. Once again, this racial gap endures after controlling for income and other factors.<sup>23</sup> We should expect the benefits of judicial foreclosure to be amplified for these borrowers.



To answer these questions, I examined lender behavior in 14 pairs of neighboring states, where one state mandated judicial foreclosure and the other did not.<sup>24</sup> Importantly, this analysis controlled for not only the demographic characteristics of loan applicants and those of their communities on either side of the state border—it also examined only the subset of loan applications for which the governing legal regime (namely, mortgage-finance and banking regulations and other aspects of state foreclosure law) were nearly identical in both states within each of the 14 pairs.

This analysis revealed that the answer to each of the three questions is ‘yes.’ Overall, judicial foreclosure requirements are associated with an approximate 2.1-2.8% reduction in the likelihood of loan approval and, conditional on loan approval, a 0.2-1.0% reduction in the likelihood of being offered a subprime loan. While not monumental, reductions of this size in a sample of 7.3 million loan applications are noteworthy.<sup>25</sup> Further, there is suggestive evidence that these effects are amplified for lower-income borrowers, although I do not find more pronounced effects for racial or ethnic minority borrowers. Finally, the notion that lenders “pass on the costs” of this borrower protection in the form of higher rates is firmly rejected.

## POLICY IMPLICATIONS

With the post-financial crisis turn towards federalism in consumer protection law,<sup>26</sup> and more recent cracks in the federal banking regulatory infrastructure, policymakers need a firm grasp of the effects of foreclosure law on housing finance markets. Specifically, they should understand that judicial foreclosure can serve a similar function as *ex ante* regulation.<sup>27</sup>

The prospect that a lender seeking to foreclose on a mortgage may be penalized for its earlier behavior may incent the lender to alter its behavior at the loan origination stage, taking greater care to abide by the Truth in Lending Act and other laws. Lenders also may take greater care not to engage in lending practices—like offering balloon payments to low-income borrowers—that increase the likelihood of default. In this way, borrower protections at the foreclosure stage may function as a form of back-end regulation of mortgage lending.

Here, there is a clear role for states to play. Although historically states have been reluctant to switch foreclosure regimes, there is now a compelling case that borrowers (and local communities) fare better when the legal burden to file suit falls to lenders. On the one hand, judicial foreclosure adds to state courts’

dockets and increases lenders’ costs by allowing borrowers to remain in their homes for longer. On the other hand, it provides a way for state legislatures to help some of their most economically vulnerable citizens and communities. That judicial foreclosure can be established at the state level, without the need for buy-in from federal banking and consumer financial protection regulators, should be particularly attractive for states looking to alter lender behavior—especially subprime lending to lower-income borrowers—at a time when federal regulators may be going in retreat. Regardless of how one weighs these considerations, given the importance of mortgage-finance to the overall economy and the psychological value that Americans place on homeownership, the stakes are too high not to appreciate the effects of judicial foreclosure laws on mortgage lending.



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Brian D. Feinstein examines the structure and function of regulatory agencies and the interplay between these agencies and other institutions. His articles have charted the connections between mortgage finance regulation and state foreclosure law, considered the impact of partisan polarization on regulatory agencies, and shed light on Congress’s use of oversight hearings as a means of influencing agency behavior. A political scientist and lawyer by training, Feinstein’s research incorporates insights from the social sciences and law. His articles have appeared in the *Columbia Law Review*, *Journal of Empirical Legal Studies*, and *Journal of Politics*, among other journals.

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