Backgrounder

Published by The Heritage Foundation

No. 2242
February 13, 2009

Mortgage Modifications in Bankruptcy Would Undermine Homeownership, Prevent Few Foreclosures

Andrew M. Grossman

Federal housing policy, we now know, has caused catastrophic economic failures. Programs designed to expand homeownership did so at the expense of sound lending and borrowing, to the ultimate detriment of economic stability and many families' finances.

But one federal housing policy worked to reduce the price of housing credit and to extend its availability without contributing to the mortgage mess: denying bankruptcy judges the power to modify home mortgages, a practice known as "strip-down" or "cram-down." This added certainty allowed lenders to accept smaller down payments and offer lower interest rates to millions of American homeowners without providing any incentive to make irresponsible loans.

Now Congress is considering snuffing out this one bright spot by giving judges the power to discharge mortgage debt in bankruptcy and rewrite repayment terms. If enacted, these proposals would increase the cost of homeownership and put it out of reach for many Americans, especially those of lesser means. They would also deal a blow to banks and other lenders at a time when many are faltering, thereby undermining government efforts to increase stability in that sector. Worst of all, allowing bankruptcy judges to rewrite mortgages would prevent few foreclosures while causing harm to those it is intended to protect.

Fundamentally, strip-down is a poor "fit" for the problem of rising foreclosure rates. Its benefits would fall disproportionately to those who can afford their mortgage payments and do not need relief, while those whose homes are at risk would typically obtain

Talking Points

- Allowing judges to modify the amount and terms of mortgages—known as "strip-down"—would put homeownership out of reach for many Americans.
- To protect against the risk of strip-down, mortgage lenders would have to raise interest rates on loans and demand bigger down payments—as much as $40,000 to $60,000 for the median home. First-time buyers, who cannot draw upon existing home equity, and lower- and middle-class families would bear the brunt of these responses.
- Judge-imposed strip-downs would prevent few foreclosures. Two-thirds of Chapter 13 filings fail, with the filer receiving no relief from debt. In most cases, strip-down would only delay foreclosure at enormous expense to the homeowner in legal fees and damaged credit.
- Strip-down's benefits would fall disproportionately to those who can afford their mortgage payments and do not need relief, threatening the availability of credit and stability of lenders.

This paper, in its entirety, can be found at:
www.heritage.org/Research/LegalIssues/bg2242.cfm

Produced by the Center for Legal and Judicial Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

only temporary relief at a great personal cost. The result would be to impose enormous expenses on mortgage and consumer lenders—at a time when doing so would be destabilizing and counterproductive—in exchange for extremely limited benefits for vulnerable homeowners.

Congress should look beyond the following myths about mortgage strip-down and recognize that its costs, in the form of unintended consequences, would far outweigh its limited benefits.

Myth: Current law provides no relief from foreclosure for primary residences.

Reality: Under Chapter 13 of the Bankruptcy Code, individuals can stop foreclosure proceedings and spread delinquent payments over a period of time, and most mortgage servicers are willing and able to renegotiate loans when mutually beneficial.

The current Bankruptcy Code carefully balances the need for predictability and stability in mortgage lending with the needs of borrowers who have temporarily fallen behind on their payments. Unlike a Chapter 7 liquidation, in which most of an individual's assets are sold to pay his or her debts, a Chapter 13 bankruptcy puts an immediate halt (known as the "automatic stay") to foreclosure proceedings from the moment of filing and then gives the individual an opportunity to catch up on late payments.

Specifically, instead of being forced to bring a mortgage up to date all at once, a borrower suffering a temporary financial setback can spread the burden over a period of up to three to five years, depending on his or her income and expenses. During this period, the borrower must also continue to make regular scheduled mortgage payments. Once the deficiency has been made up, the payment schedule continues pursuant to the terms of the mortgage until the house is paid off or sold.

Moreover, homeowners can obtain relief by renegotiating the terms of their mortgages with those who hold or service them. When the alternative is a foreclosure valued at far less than the principle remaining in the loan, both homeowners and mortgage investors benefit by modifying the loan to reduce the principle and ease the terms of repayment. This standard is the same that bankruptcy courts would apply under mortgage strip-down proposals but is applied in a way that avoids the blunt, one-size-fits-all approach of strip-downs. Though some mortgages have been privately securitized in ways that present barriers to renegotiation, the vast majority are not subject to such limitations.

The current Chapter 13 process, as well as voluntary and mutually beneficial relief provided by mortgage servicers, serves to separate borrowers whose income is likely to be sufficient to make payments that exceed the foreclosure values of their home from those who have borrowed beyond their means and lack the earning capacity to afford the home that they nominally own but in which (usually) they have little equity. Granting judges new power to modify mortgage terms would blur this line, encouraging both those who have taken on excessive debt and those who have borrowed reasonably and need no relief to reject voluntary renegotiation and seek better terms in bankruptcy.

Myth: Allowing strip-down will not increase the cost or reduce the availability of mortgage loans.

Reality: If forced to shoulder greater risk and expense, mortgage lenders will demand higher interest rates and bigger down payments, putting homeownership out of reach for many low- and middle-income Americans.

Congress cannot repeal the laws of economics. Thus, it is unreasonable to expect that lenders would not adjust their up-front terms in response to changes in the law that weakened loan enforcement. Experience and research show that any proposal that has the effect of undermining the certainty of mortgage agreements or imposing losses on mortgage lenders will serve to reduce the availability and increase the cost of mortgage loans.

Strip-down proposals would impose massive and unjustifiable costs on lenders. Despite the current state of the economy, less than 5 percent of homeowners are more than 60 days behind on their mortgages—the usual measure of delinquency. Yet strip-down would be available as well to the more than 50 million homeowners who are current on their mortgages if they filed bankruptcy. If even a small percentage of these homeowners chose to take

The Heritage Foundation
LEADERSHIP FOR AMERICA

advantage of bankruptcy to discharge some of their mortgage debt, their numbers, as well as the total value of the debt they would discharge, would far exceed the number of those in dire straits obtaining strip-downs. Thus, hundreds of billions in debts that likely would have been paid would be relieved.

These costs, in turn, would be reflected in the availability and price of mortgages. To protect themselves from future strip-downs, lenders would have to demand increased down payments from mortgage borrowers. Requiring that borrowers put down enough money to cover any foreseeable decline in the value of their homes is the only way to avoid the risk of a future strip-down.

Home price volatility provides some indication of the magnitude of the down payments that would be required. Over the past year, U.S. home prices have declined by about 12 percent, with some regions seeing drops as high as 30 percent, and prices are still falling. Under current law, down payments are typically 10 percent to 20 percent of the price of a home, but this amount would be insufficient to protect lenders in a volatile market. If the risk of strip-downs led to down payments of 20 percent to 30 percent, a down payment on the median house, valued at just over $200,000, would be $40,000 to $60,000—far more than many families could scrape together. Hardest hit would be first-time home buyers, who cannot draw upon existing home equity, and lower- and middle-class families.

Additionally, lenders would demand higher interest rates and fees as compensation for taking on the added risk of losing money if the loan is stripped down. Because strip-down is such a blunt and indiscriminate tool, all borrowers, no matter their creditworthiness, would face higher rates on mortgages. The biggest increases, though, would fall on first-time home buyers and lower-income families, as lenders demand larger risk premiums.

Recent research confirms this effect. In one study, Karen Pence, a senior economist at the Federal Reserve Board who studies household and real estate finance, determined that state laws that impose costs on lenders (as much as 10 percent of the value of the loan balance) prior to foreclosure reduce the availability of credit for residents of those states. As a result of these laws, families "may pay more for their mortgages, purchase smaller houses, or have difficulty becoming homeowners." If strip-downs impose larger costs on lenders, they would likely have an even greater effect on interest rates and mortgage availability.[1]

Similarly, economists Emily Lin and Michelle White found that unlimited homestead exemptions, which allow individuals to shelter home equity from creditors in bankruptcy, significantly reduce the availability of mortgages and home-improvement loans.[2]

The result, then, of allowing the discharge of home mortgage debt in bankruptcy would be to put home lending out of reach of many Americans and to raise the cost of borrowing for those who are able to secure mortgages, further weakening the housing market. This is a perverse result, considering that the long-standing aim of U.S. housing policy has been to encourage homeownership by promoting affordability in the mortgage market.

That some proposals are temporary in nature would not prevent this outcome, because mortgage lenders (as well as borrowers) would reasonably expect Congress to reinstate strip-downs in the next economic crisis. Indeed, a repeat of this policy would be even more likely once the precedent is set and lenders' and borrowers' expectations are altered.

Myth: The Bankruptcy Code allows mortgages on vacation homes, boats, and expensive cars to be stripped down.

Reality: Instead of changing loan terms, courts regularly require the liquidation of luxury and "lifestyle" assets to increase distributions to other creditors.

1. Karen Pence, "Foreclosing on Opportunity: State Laws and Mortgage Credit," *Review of Economics and Statistics*, Vol. 88, No. 1 (February 2006), pp. 177–182, at *http://works.bepress.com/cgi/viewcontent.cgi?article=1001&context=karen_pence* (February 1, 2009).
2. Emily Y. Lin and Michelle J. White, "Bankruptcy and the Market for Mortgage and Home Improvement Loans," *Journal of Urban Economics*, Vol. 50, No. 1 (2001), pp. 138–162, at *http://econ.ucsd.edu/~miwhite/lw-jue-reprint.pdf* (February 11, 2009).

Proponents of strip-down proposals make much of the fact that Chapter 13 allows for the modification of most debts other than those secured by a primary residence. Current law, notes Representative John Conyers (D–MI), who has sponsored legislation that would permit strip-downs, permits judicial modification of "loans secured by second homes, investment properties, luxury yachts, and jets" but not primary residences.[3]

In reality, luxury and "lifestyle" assets are rarely afforded this treatment because they are not considered to be necessary to the support of the filer or his family. Though a filer may propose a plan that modifies claims secured by luxury items, bankruptcy judges have extremely broad discretion to reject such modifications when they impair the rights of other creditors.

Further, unlike mortgage strip-down proposals, current law requires the filer to pay off in full any secured claim that is modified, including any arrearages, during the duration of the plan within just three to five years. For example, a debtor who manages to strip down a $300,000 mortgage on a vacation home to $200,000 would have to make equal monthly installments over the course of just a few years to retire that debt.

Thus, in most cases, luxury and "lifestyle" items—things like vacation homes and yachts—that are encumbered by debt are surrendered to the creditor and liquidated to pay off the debt and, in many instances, obtain funds that can be used to pay other creditors. The debts encumbering them are not stripped down. And in the rare cases where this does not occur and the debt is stripped down, the filer is required to pay off the remaining secured portion of the debt, including arrearages at the time of filing and any penalties and fees, over the course of the Chapter 13 plan and may also have to pay off a portion of the remainder of the loan—that is, the part that was crammed down—which remains as an unsecured debt.

Myth: Allowing strip-downs will help consumers.

Reality: Encouraging more families to file for bankruptcy will undermine more promising means of refinancing mortgage debt, hurt consumer credit, and ultimately prevent few foreclosures.

Filing for Chapter 13 bankruptcy is an expensive and disruptive process. While the total fees for filing are only about $300, guideline attorney's fees range from about $2,500 to $5,000 in simple cases, depending on the district; in complex cases, the fee can be much higher. Indeed, the difficulty of stripping down a home mortgage could be expected to increase fees by several thousand dollars.

In addition, filings are included on credit reports immediately upon filing and remain there for seven years. Thus, Chapter 13 bankruptcy damages credit scores and impairs access to credit for a significant period of time.

Many Chapter 13 bankruptcies fail; that is, the filer never obtains a discharge of his debts. Nearly 20 percent of Chapter 13 cases fail before the court has confirmed the filer's plan. Another 55 percent fail between confirmation and discharge because the filer has been unable to carry out his plan. This means that only one-third of all Chapter 13 filers complete the process successfully and get the fresh start that bankruptcy promises. The rest—two-thirds of all filers—pay court fees, pay attorney's fees, pay fees to the bankruptcy trustee, invest time and money to restructure their financial affairs, and then wind up with nothing more than temporary relief. It is therefore not surprising that a substantial number of Chapter 13 filers—nearly one-third—go on to file for bankruptcy again.[4]

These statistics suggest that holding out the promise of significant relief from mortgage debt to encourage more individuals to file for Chapter 13 bankruptcy is bad policy. At best, Chapter 13 would serve only to delay foreclosures in most case where the home is at risk while imposing enormous costs on those who are already financially vulnerable and losing their access to credit.

---

3. "Statement of John Conyers, Jr.: Markup of Bankruptcy Foreclosure Legislation (H.R. 200)," January 27, 2009, at *http://judiciary.house.gov/hearings/pdf/Conyers090127.pdf* (February 12, 2009).
4. Wenli Li, "What Do We Know About Chapter 13 Personal Bankruptcy Filings?" Federal Reserve Bank of Philadelphia *Business Review*, Fourth Quarter 2007, pp. 19–26, at *http://www.philadelphiafed.org/research-and-data/publications/business-review/2007/q4/li_chapter-13-filings.pdf* (February 11, 2009).

The Heritage Foundation
LEADERSHIP FOR AMERICA

Worse, allowing discharge of home mortgage debt in bankruptcy would undermine more promising approaches to preventing foreclosures. While there have been difficulties in renegotiating certain types of securitized mortgages, the bulk of outstanding mortgages are controlled or owned by Fannie Mae and Freddie Mac, private banks, and portfolio lenders, all of which have the power to renegotiate mortgages and face strong incentives to do so to preserve the value of homes.

Strip-downs, however, would undermine their efforts by eliminating homeowners' incentives to accept modification offers, even ones that are targeted to their situation and less disruptive than bankruptcy is likely to be. In this way, strip-down proposals would only delay foreclosures while blocking more promising alternatives that protect consumers' financial security.

Myth: Allowing strip-downs will help the economy.

Reality: Undermining the certainty of loan agreements threatens the availability of credit, and thereby market stability, and will only delay recovery, especially in the housing sector.

Some claim that allowing strip-downs in bankruptcy would ease turmoil in the housing markets and slow or reverse declines in home prices. This is a pipe dream.

Merely allowing strip-downs in bankruptcy could be enough to trigger bank instability and failures. U.S. banks and thrifts hold about $315 billion worth of highly rated mortgage-backed securities that would suffer immediate and permanent downgrades. This, in turn, would force banks to write down these assets to reflect their lower value and set aside additional capital to satisfy regulatory requirements. Some banks' already overburdened balance sheets could not absorb those hits.

And as described above, allowing strip-downs could push millions of Americans, who are current on their mortgages and whose homes are not at risk of foreclosure, into bankruptcy. Any reductions in loan principle that they achieved would come at the expense of lenders, increasing the likelihood of their insolvency and further tightening credit markets. Resulting declines in the valuations of mortgage-backed securities and other "troubled assets" could also affect banks' capital statements, leading to more failures and the need for additional capital on top of that already being provided by the federal government. Some of these losses would fall to taxpayers through Fannie Mae and Freddie Mac (which guarantee over $5 trillion in mortgage debt), other government entities, and recent government investments in the financial sector. The drawn-out bankruptcy process would also put a brake on efforts to value mortgage-backed securities and begin to clean up banks' balance sheets, thereby prolonging current financial instability.

Further, increases in bankruptcy filings would harm the financial health of many additional industries. In Chapter 13, unsecured creditors (those whose loans are not backed by property that can be repossessed or foreclosed) typically receive less than 20 percent of what they are owed. Facing this risk, lenders would further tighten the availability of credit, dealing a new blow to the demand side of the economy. This result would be perfectly opposed to Congress's current efforts to stimulate consumer demand.

Conclusion

It should not be surprising that there is no free lunch. Congress cannot enact a policy that imposes major, unexpected losses on home lenders without raising the cost of and reducing access to home loans. Claims to the contrary are unsupported either by experience or by the available data.

What is a surprise, though, is the minuscule benefit that such a policy would achieve. Allowing the strip-down of home mortgage debt in bankruptcy would prevent very few foreclosures even as it undermined better alternatives for homeowners.

That this policy would have any positive effect at all is premised on wishful thinking: that Chapter 13's deliberately weak protections for debtor assets, which are ultimately unavailing in the majority of cases, will do anything more than delay some foreclosures at an enormous cost to the economy. At the same time, this policy would open the door to achieving mortgage reductions for tens of millions of homeowners who can afford their mortgage payments and whose homes are not at risk.

The growing but still relatively small foreclosure rate may warrant a policy response, but Congress must take care not to rush into ill-conceived fixes that threaten to cause more harm than they would alleviate. To avoid that risk, proposals must be carefully targeted and proportionate to the problems they are intended to address.

Opening the door to modification of *all* home mortgages is both overbroad and extreme and, for that reason, risky. Rather than risk adding to the turmoil in the housing and financial markets, Congress should consider approaches that do not undermine investors' expectations and, ultimately, homeownership.

—Andrew M. Grossman is Senior Legal Policy Analyst in the Center for Legal and Judicial Studies at The Heritage Foundation.

The Heritage Foundation
LEADERSHIP FOR AMERICA