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Bankruptcy Mortgage Cramdowns Would Hurt Housing Market

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Bad policy is not improved by limiting it to certain situations. The Helping Families Save Their Homes Act (H.R. 1106) would allow bankruptcy judges to reduce the principal owed on a mortgage, a practice often referred to as a "cramdown." Judges would also be able to reduce interest rates or lengthen the term of the mortgage. This is a huge policy mistake that will help only a few people while raising the cost of borrowing for thousands of moderate-income and first-time homebuyers.

Although supporters claim that this is a limited provision that applies only to existing mortgages, the cramdown language can easily be amended to make it permanent at a later date—which would then be priced into future mortgages will be priced into future mortgages. In addition, the House bill even lacks many of the targeted limitations designed to make sure that bankruptcy is a last resort—limitations that were included in President Obama's poorly considered housing plan.[1] It even weakens language passed earlier by the House Judiciary Committee that was designed to keep those who filed fraudulent mortgage applications from taking advantage of cramdowns.

Problems with Cramdowns. Allowing bankruptcy judges to modify mortgages would:

- *Raise mortgage costs.* Cramdowns would add additional risk that mortgages will not be repaid as the contract requires. Lenders must charge for that added risk, and experts estimate that the additional costs would raise mortgage rates by as much as two full percentage points or substantially increase required down payments.

  These added costs would fall hardest on moderate-income and first-time homebuyers, who have a higher risk of defaulting on a mortgage. This will price many families out of the housing market.
- *Further undermine the value of mortgage-backed securities.* Banks and other investors are already facing heavy losses because mortgage-backed securities have lost much of their value because of uncertainties about whether the mortgages will be paid. The language in H.R. 1106 increases this uncertainty. Investors will be at risk of both foreclosure and cramdowns that reduce the earnings of these securities. Many cramdown mortgages will later go into foreclosure. Since investors have no idea what this new provision will do to the value of their securities, prices will drop further.
- *Fail to help many homeowners.* Only one-third of all Chapter 13 filers complete the process successfully and get the fresh start that bankruptcy promises. The other two-thirds "pay court fees, pay attorney's fees, pay fees to the bankruptcy trustee, invest time and money to restructure

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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."[2]

Other Provisions in H.R. 1102. The Helping Families Save Their Homes Act also contains a mixture of other housing and financial provisions, including a vain attempt to "fix" the failed Hope for Homeowners program that Congress passed last summer. These include:

- *Liability waivers for mortgage servicers that modify mortgages.* Mortgage servicers receive payments from mortgages and forward them (after fees) to the owners of the mortgages. As the main contact with homeowners, mortgage servicers should be able to refinance or alter mortgages in order to ensure that the owners get the best possible return, but many fear that unhappy mortgage owners would sue them. The legislation provides these servicers with a safe harbor so long as they act within certain specified boundaries. This is a needed change.
- *Making $250,000 FDIC and NCUA deposit insurance levels permanent.* Last fall, Congress increased deposit insurance coverage by FDIC and NCUA to $250,000 until December 2009. This bill makes that change permanent and also increases the agencies' borrowing authority to cover their losses. Borrowing authority is used only if the deposit insurance fund runs out.
- *Trying to fix the Hope for Homeowners program.* Last summer, Congress created Hope for Homeowners, an FHA-based program that it originally claimed would help up to 2 million homeowners. To date, according to the FHA, it has actually helped about 500. The legislation makes a number of changes that will raise the cost of it by $2.3 billion but is unlikely to otherwise improve it. This would throw good money after bad.
- *Keeping predatory lenders from taking advantage of FHA programs.* Section 203 of H.R. 1106 makes it easier for HUD and the FHA to prevent predatory lenders from underwriting FHA-guaranteed home loans. This is a needed reform.

Making the Problem Worse. Mortgage cramdowns would further destabilize an already damaged housing market while increasing mortgage costs for future borrowers. This is the essence of bad policy at the wrong time, and it should be avoided at all costs. Adding a couple of good provisions to a huge policy mistake does not make it better. Changing the bankruptcy code in this manner is extremely misguided.

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1. The Obama housing plan suffers from many policy errors that will be detailed in a forthcoming WebMemo.
2. Andrew M. Grossman, "Mortgage Modifications in Bankruptcy Would Undermine Homeownership, Prevent Few Foreclosures," Heritage Foundation *Backgrounder* No. 2242, February 13, 2009, at *http://www.heritage.org/Research/LegalIssues/bg2242.cfm.*