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Mortgage Cramdowns: Problems with Involving Bankruptcy Judges

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According to several reports, negotiators in the Senate may be on the verge of finalizing a compromise version of legislation that would give bankruptcy judges the power to modify home mortgages, a practice known as "cramdown" or "strip-down." This potential compromise, unlike the House's version of the legislation (H.R. 1102), would limit a judge's discretion in reducing the portion of a mortgage that must be repaid and otherwise altering the terms of the loan.

However, no matter how strict those limits seem, they do not alter the fundamental problems caused by mortgage cramdowns. Even with these limits, this proposal would still increase the cost of homeownership and especially hurt both first-time homebuyers and families with low to moderate incomes. It would also deal a blow to banks and other lenders at a time when many are faltering. Worst of all, allowing bankruptcy judges to rewrite mortgages would prevent few foreclosures while imposing high costs on many who tried this approach.

A False Compromise. 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. 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 while still making regularly scheduled mortgage payments. In addition, homeowners frequently obtain relief outside of bankruptcy by renegotiating the terms of their mortgages with those who hold or service them.

Congressional cramdown proposals, including the reported compromise, would upset the current law's careful balance. According to reports, the Senate compromise would allow bankruptcy judges in Chapter 13 cases to cramdown the value of an outstanding mortgage loan to a "fair market value" and reduce interest payments. The judge may also be able to modify other terms of the loan, such as its duration and scheduled changes in interest rates or payments.

Though these powers would apply only to loans made before 2009 and worth less than about $730,000, the proposal would still give judges enormous discretion to rewrite the terms of billions of dollars in millions of outstanding mortgage loans.

Problems with Cramdowns. Granting judges the power to modify mortgages in this way would:

- *Raise mortgage costs.* The added risk that a mortgage contract would not be repaid as written would require lenders to demand increased down payments from mortgage borrowers—as much as $60,000 for a median house. In addition, lenders would also require higher interest rates and fees as compensation for taking on the added risk of

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losing money if the loan is crammed down. While all borrowers, no matter their creditworthiness, would face higher rates on mortgages, the biggest increases would fall on first-time homebuyers and moderate and lower-income families—those who could least afford the additional costs.

- *Worsen the bank crisis.* U.S. banks and thrifts hold about $315 billion worth of highly rated mortgage-backed securities. As a result of the added uncertainty about mortgage repayment produced by even limited cramdown authority, many of these securities would be downgraded to a lower credit rating. This, in turn, would force banks and other financial firms 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.
- *Tighten consumer lending.* Allowing cramdowns could encourage millions more Americans to file for bankruptcy. 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 credit standards and reduce the ability of many moderate income borrowers to get the credit that they need. Alternately, certain lenders would greatly increase fees to enable them to recoup their loans faster and to generate additional profits to offset increased losses through bankruptcy.
- *Fail to help homeowners.* Only one-third of all Chapter 13 filers complete the process successfully and get the fresh start that bankruptcy promises. The rest 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. Nearly one-thirds go on to file for bankruptcy again. Further, a Chapter 13 bankruptcy damages credit scores and impairs access to credit for a significant period of time. These facts clearly show that an approach that promises 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 some foreclosures while imposing enormous costs on those who are already financially vulnerable and losing their access to credit.
- *Undermine more promising approaches.* Fannie Mae and Freddie Mac, private banks, or portfolio lenders all have the power to renegotiate the mortgages that they hold and face strong incentives to do so. Cramdowns, however, would undermine these efforts by encouraging some homeowners to believe that they can get an even better deal in a bankruptcy court. As a result, cramdown proposals would only delay foreclosures while blocking more promising alternatives that protect consumers' financial security.
- *Subvert the rule of law.* When an individual borrows money and signs a mortgage agreement, he accepts the responsibility to repay the loan under its terms and pursuant to the law. When Congress changes the law in the middle of the game to benefit one or another party to an agreement, it weakens the rule of law and the enforceability of private agreements across the entire economy. And the precedent of such an act, even if it is limited and temporary, undermines the certainty of all agreements, increasing the costs of doing business across the economy.

A Dangerous Policy. By causing additional write-downs of mortgage-backed assets, mortgage cramdowns would prolong and worsen the banking crisis, delaying economic recovery. In exchange, the policy would provide only temporary and extremely limited assistance to a fairly small number of homeowners while subjecting many more to the pain and expense of failed bankruptcies.

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. Even with the recent compromise, mortgage cramdowns are the essence of bad policy and should be avoided at all costs.

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