NATIONAL CENTER FOR POLICY ANALYSIS

Cram-down Bankruptcy Reform

(The following document is two pages in length.)

The "Helping Families Save Their Homes Act of 2009" is sponsored by Rep. John Conyers (D-MI). The bill allows bankruptcy courts to reduce mortgage principal, adjust interest rates, extend maturity dates, and limit recovery of mortgage-related creditor fees. These are often called "cram down" provisions.

Higher Interest Rates and Higher Down Payments

- The cram-down provisions of the legislation will result in increased risk for lenders, leading to higher interest rates and higher down payment requirements throughout the mortgage market. For example, the Mortgage Bankers Association estimates that the interest rate for a 6 percent, 30-year, $300,000 fixed-rate mortgage could go up to 8 percent. That translates into an annual increase of $4,824, and more than $144,000 in higher costs over the life of the loan.
- According to a 2008 New York Federal Reserve report, after Congress ended bankruptcy modification (cram-down) for auto loans in 2005, auto loan terms on average decreased by 2.65 percent (265 basis points). See Don't Let Judges Tear Up Mortgage Contracts by Todd J. Zywicki (Wall Street Journal)
- Tighter credit will hurt all future borrowers, and this legislation will only shift the cost of saving today's troubled loans to borrowers who were more responsible.

Redistribution of Taxpayers' Wealth

- The "cram down" provisions will leave taxpayers vulnerable to liabilities through federal mortgage guarantees.
- Outstanding mortgage and debt guarantees from Freddie Mac and Fannie Mae alone amount to more than $5 trillion, and the government is also exposed for guarantees of Citigroup, Bank of America, Indy Mac, Washington Mutual, Federal Housing Administration, Veterans Administration, and Rural Housing Service mortgages.
- Bankruptcy "cram down" provisions will not simply redistribute losses from *borrowers to lenders* as some contend. It will also redistribute losses in turn from *lenders to taxpayers*, producing a massive redistribution of wealth from responsible, accountable taxpayers to borrowers and irresponsible lenders who will not be held accountable.

Moral Hazard and Destabilization of Existing Mortgages

- Because this legislation makes bankruptcy "cram down" available to all existing mortgages, it will reduce the incentives for approximately 50 million solvent home borrowers to keep making payments on their mortgages.
- Congress can expect many borrowers to stop paying their mortgages, trigger foreclosure notices, and petition for bankruptcy to restructure their mortgages and restructure or eliminate all of their other debts – including credit card purchases, auto purchases, and other consumer credit transactions essential to struggling sectors of our economy.
- This bill would create a disincentive for efforts to work out or modify troubled loans. It is unclear how the credit system will react if most borrowers think they can play this game, although it is clear the bankruptcy system would face an overwhelming avalanche of cases.

A Return to the Financial Meltdown

- The "cram down" provisions will force ratings downgrades for broad classes of mortgage-backed securities – requiring banks and insurance companies to increase capital reserves by up to *hundreds of billions of dollars*.
- This is because many mortgage-backed securities include contractual agreements that require sharing of losses between highly rated and lower rated tranches (mortgage-backed securities).
- The legislation attempts to get around this problem by including a provision that declares these lawful, pre-existing contract clauses are "contrary to public policy" and unenforceable.
- This legislative "fix" will likely either be invalidated by the courts or lead directly to massive federal takings liabilities.

(Continued on next page)

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The Mortgage Mess

I'm finding it hard to think originally about how best to fix the mortgage mess; I keep falling back on the homilies of childhood. My Dad used to say it rained on the just and the unjust alike. I accepted that even though I wasn't always sure if the rain was a good thing helping the unjust or a bad thing hurting the just. Sentiment these days seems to be more negative regarding the first option than the second. Those not standing in line for help themselves seem to feel more strongly about not helping the unworthy than about helping the worthy. The Prodigal Son probably wouldn't be welcomed home these days either.

If we had all followed Shakespeare's caution to "neither a borrower nor a lender be," we wouldn't be in this mess, but then again we probably would be even less prosperous than we are. Presumably, until recently, lending and borrowing helped raise our standard of living; but we carried a good thing too far.

Since this feels like a learning moment, let's go to the source for elaboration: ***Hamlet***, Act 1 scene 3:

Neither a borrower nor a lender be;
For loan oft loses both itself and friend,
And borrowing dulls the edge of husbandry.
This above all: to thine own self be true,
And it must follow, as the night the day,
Thou canst not then be false to any man.

The solution we are looking for is how to help the truly worthy needy borrower whose predicament is not of his own making without also helping those less innocent. That, of course, is an impossible task for the government, which, almost by definition, must use one-size-fits-all solutions. The Rick Santelli **rant** on CNBC's Squawk Box reflects the anger this creates in much of the populace.

There are no good options acceptable to all. Probably one of the more effective, but least desirable, options is to authorize bankruptcy judges to change the terms of the mortgage contract for the benefit of the borrower and to the detriment of the lender. That's known as a "cram down" provision. That may be a practical solution since the revised terms may still be more advantageous to the lender than foreclosure, but the price paid by compromising the sanctity of contracts is steep. Apparently, bankruptcy judges already have that authority for homes that are not the owners' primary residence, but that doesn't sit too well either. I guess there's not much desirable about bankruptcy.

Another program the Obama Administration recommends is for the government to split the cost difference with the lender or the mortgage servicer for relaxing the terms of the original mortgage. To provide a reward for good ongoing behavior, a "pay for success feature" would reward servicers if the loan is kept current, up to a $1000 per year.

Another approach recommended by the Administration is for the government to add another $100 billion each to the capital of Fannie Mae and Freddie Mac to "shore up confidence" in these organizations that are already under government control. With more capital and more confidence, Fannie and Freddie would be in a stronger position to help solve the problem with more low-cost mortgage generation and guarantees. Some hair of the dog.

Even mortgage debtors who are current with their payments are to be helped to bring their monthly payments down to no more than 31% of their income. Presumably, these will be people who started off with their debt in good alignment with their income, but whose position worsened with the financial crisis and the declining economy and declining home prices.