U.S. Senate Rejects Mortgage Modification in Chapter 13 Cases

Sens. Durbin, Kyl Debate the Response to America's Foreclosure Crisis

Editor's Note: On April 30, 2009, the U.S. Senate again rejected a bill (S. 896) to allow bankruptcy judges to modify mortgage terms on the primary residences of chapter 13 debtors. Sen. Dick Durbin (D-Ill.) proposed the bill as an amendment to a comprehensive housing bill. The Senate defeated the cramdown amendment 51-45 as 12 Democrats joined all Republicans opposing the amendment. The vote was well short of the 60 votes required to pass the amendment. The House passed its version of cramdown legislation by a vote of 234-191 on March 5. The mortgage industry has twice succeeded in helping to kill the bankruptcy proposal since Sen. Durbin introduced the legislation in 2007. The second-ranking Democrat said that "this is not the last time" he will raise the issue. For this issue, Legislative Update features excerpts from the Congressional Record of Sen. Durbin's comments in favor of the proposal and the comments of Sen. Jon Kyl (R-Ariz.) against the proposal.

Comments of Sen. Dick Durbin (D-III.)

merica is facing a crisis, and this is what it looks like: Two buildings next to one another, one a well-kept home; next door, a foreclosed property, boarded up, vacant, vandalized. Sadly, this is a crisis which is affecting every community in America. I have seen it in the streets of Chicago. I have seen it in suburban towns. I have seen it in my downstate communities... 8.1 million homes are facing foreclosure in America today. That isn't my estimate; it is the estimate of Moody's. They are supposed to be good predictors of our economy. What does 8.1 million foreclosed homes represent? One out of every six home mortgages in America in foreclosure—one out of every six. It is a reality. It is a reality that affects the five out of six, our homes where we continue to make our mortgage payments and wonder what the problem is. Why is the value of my home going down? I am making the payments. It is going down because, sadly, somewhere on your block is another home in foreclosure, boarded up, an eyesore at best, a haven for criminal activity at worst—a reality that continues to grow.

Two years ago, before we even started in on this crisis as we know it, I proposed a change in the bankruptcy law, a change which I think could have forestalled this crisis we know today. Along the way, there has been resistance to this change. By whom? The banks that brought us this crisis in America have resisted this change to do something about mortgage foreclosure. That is a fact.

Last year, I offered this amendment to change the bankruptcy law, and the banking community said: Totally unnecessary; we don't need this kind of a change. This mortgage foreclosure is not going to be all that bad.

In fact, the estimates were of only two million homes in foreclosure last year from our friends in the banking community, the so-called experts. Here we are a year later. The estimate is now up to 8 million homes in foreclosure.

Who are these people facing foreclosure? Were they speculators and investors who were buying up properties and they thought that maybe they would different amendment to the Bankruptcy Code than my colleagues have seen before. This amendment would integrate assistance in bankruptcy to the two primary foreclosure prevention efforts already underway: the Obama administration's Homeowner Assistance and Stability Plan and the congressionally created Hope for Homeowners refinancing program which the other title of this bill will greatly improve.

Our objective is to keep as many families in their homes as we can. Ideally none of these families would have to go through the painful process of a chapter 13 bankruptcy.

So this amendment would help only troubled homeowners who could not find other assistance outside of bankruptcy first.

Let me put it another way: Mortgage servicers would be given full veto power over which of their borrowers could go

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double in value and they could quickly sell them? There may be a handful of those folks out there. By and large, they are families—families who are trying to keep it together, under a roof, the most important asset they own, their home, trying to make payments when they discovered that the mortgage that was peddled to them by the same banking industry and mortgage banking industry turned out to be a fraud on its face.

My amendment would make a small change to the Bankruptcy Code to give these families a little bit of leverage as they work with their lenders to create a modified mortgage that they can afford.

When we can avoid foreclosures and families can stay in their homes, everyone wins—the families, their neighbors, their lenders and the government. We can save 1.7 million homes with one vote.

I have come to the floor each day this week to talk about the scale of the problem and what we believe we should do about it, in very general terms.

Now I would like to get specific. Let me be clear: This is a very to bankruptcy—they would be given the keys to the courthouse door.

All a servicer would have to do to block a borrower from going to bankruptcy for a mortgage modification would be to offer the borrower a modification that conforms to the standards of the Homeowner Affordability and Stability Plan or Hope for Homeowners—regardless of whether the borrower accepts the offer or not.

For banks and credit unions that aggressively offer modifications to borrowers who are in trouble, the total number of their borrowers who will be eligible for bankruptcy assistance will be exactly zero.

For these borrowers that the servicer chooses not to help, the courts would be constrained as follows: The judge could only reduce the loan principal to fair market value, which is much more than the lender would collect if the home were to be sold in foreclosure. The judge could only reduce the interest rate to the conventional rate plus a reasonable premium for risk,

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which at the moment would equal around 6.5 percent to 7 percent.

And the judge could only lengthen the term to the longer of 40 years, reduced by the period for which the mortgage has been outstanding or the remaining term of the mortgage.

There are many further restrictions. Loans originated after 2008 are not eligible for bankruptcy assistance.

Loans that are larger than the largest conforming loan limit are not eligible for bankruptcy assistance. Loans that are not 60 days delinquent are not eligible for bankruptcy assistance. Loans that are not in foreclosure are not eligible for bankruptcy. And the whole amendment would sunset at the end of 2012 when the Housing Affordability and Stability Plan expires.

The banks hold the keys to the courthouse. And, even those borrowers the banks refuse to help can only receive assistance that still makes the banks far more money than the only other alternative: foreclosure.

Yet even with all of these restrictions, Mark Zandi from Moody's Economy.com estimates that this change would save 1.7 million families from foreclosure. Why? Because for most lenders, the Obama administration's foreclosure prevention plan is voluntary. This change to the Bankruptcy Code would encourage lenders to participate, because offering these modifications allows lenders to effectively veto a modification in bankruptcy. That is a large part of why the President supports this provision, and why he included it as a key element in his plan.

This amendment would prevent foreclosures, which would help us find the bottom in the housing market, which would help the housing markets turn around more quickly, which would help the entire economy start moving again. Perhaps best of all, this amendment wouldn't cost the taxpayers a penny.

Comments of Sen. Jon Kyl (R-Ariz.)

Sen. Durbin sincerely believes his amendment would help save homeowners who are at risk of losing their homes in foreclosure, and I respect that. But many experts believe the cramdown provision would have pernicious, unintended consequences on the mortgage market.

First, it would result in higher interest rates for all home mortgages, exactly what we do not want while we are trying to entice people back into the market. Interest rates on home loans are substantially lower now than other types of consumer loans because of the guarantees current law provides to lenders. If all else fails, the lender always has the right to take back the house for which it lent the money. If we eliminate this security for lenders and increase the risk inherent in making a home loan, then lenders will have to charge higher rates on interest for home loans to cover the risk. The net result of the amendment, in other words, will be higher interest rates for home loans and fewer Americans who will be able to afford to buy a house—not what we need to end the housing crisis.

While attempting to solve a specific problem for a particular group of people, we could end up exacerbating this situation for all the people who would want to refinance or to take out loans in the future. As I said, experts agree and studies show cramdown will result in higher interest rates. That is why it is opposed by virtually all in the industry.

Proponents of the bill argue it should be allowed because, after all, bankruptcy law already allows a version of this for vacation homes. Big difference. What proponents do not mention is that to qualify for cramdown on a vacation home mortgage, the debtor is required to pay off the entire amount of the secured claim within the five-year length of the chapter 13 plan. The Durbin amendment, of course, does not include the requirement that the debtor must pay off the security claim within five years. He does not purport to treat cramdown on primary homes the same way the Bankruptcy Code treats them on secondary homes.

There is a third point with respect to this particular amendment. As I said, it is different from what we tabled before. It is a much broader amendment. It is not the sort of narrow, targeted approach to the problem some people like to characterize it as.

Unlike prior proposals, this bill is not limited to the high-risk or subprime loans or other nontraditional loans but allows cramdown for all loans. Let me repeat that. Unlike what we dealt with before in prior proposals, this cramdown amendment is not limited to high-risk or subprime loans or other nontraditional loans. It would allow cramdown for all loans. The only limitation, as I said, is that the loan

had to originate before Jan. 1, 2009, and the maximum amount—not much of a limitation—is \$729,000, and the borrowers would have had to apply for relief under the Loan Modification Program. Other than that, there is no limitation, and as I said, it would apply to any kind of mortgage. This would, obviously, allow millions of borrowers to enter into bankruptcy and simply walk away from the debt owed on their homes.

There are other programs available. I mentioned one. There is the Hope Now program, the Hope for Homeowners program and the President's new \$75 billion program that helps borrowers who are facing foreclosure to modify their loans and allow the so-called underwater borrowers to refinance into lower rate mortgages. These are the people whose home value is less than the amount owed on their mortgage.

There are programs available. All of us are talking to banks about working out loans with the people who face foreclosure. But a solution that may be well meaning but would have the unintended consequences this particular amendment has is not the answer. We should not simply grab onto something because it promises to provide some relief to some people, when the reality is that I think all the experts agree the interest rates would be increased, making it much more difficult for the 95 percent or so—I am not sure of the exact percentage—of the other people who would like to see this home mortgage crisis come to an end.

Bottom line: Cramdown will not fix the recent downturn in the housing market but only prolong the recovery by increasing interest rates. Instead of encouraging homeowners at risk of foreclosure to file for bankruptcy, the federal government should continue to encourage lenders to work with owners to modify loans where it is economically viable for homeowners to remain in their homes. Obviously, not all homeowners are going to be eligible for loan modification. But the answer is not to incentivize bankruptcy by making it as the only means to save one's home.

I hope that when it comes time to vote against the Durbin amendment, we will recognize we have already tabled an amendment which was much more narrowly written and that this is an amendment which deserves to be defeated.

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