MODIFYING PRIMARY RESIDENCE MORTGAGE LOANS IN BANKRUPTCY WILL NOT ADVERSELY IMPACT HOME MORTGAGE MARKET

October 7, 2007

Eric Stein and Julia Gordon (919) 313-8500

SOME HAVE ARGUED THAT ALLOWING LOAN MODIFICATIONS IN BANKRUPTCY MIGHT HURT THE HOME MORTGAGE MARKET. WE DO NOT BELIEVE THE BANKRUPTCY CHANGE WILL HAVE THIS IMPACT FOR THE FOLLOWING FIVE REASONS:

No Observable Impact from Time When Such Modifications Were Permitted.

For the first fifteen years between the enactment of the 1978 Bankruptcy Code and the Supreme Court's 1993 *Nobleman* decision, numerous bankruptcy courts modified mortgages on primary residences by placing the portion above the market value of the house on par with other unsecured debts. There is no evidence that the cost or availability of credit for mortgages on primary residences was negatively impacted in those jurisdictions whose courts allowed modifications during this time period, either as compared with jurisdictions that did not allow these modifications or as compared with lending experience before and after 1993.[1]

Market Works Well for Asset Classes that Already Can Be Modified in Bankruptcy.

The claim that allowing modifications of home mortgages will adversely impact the cost or availability of credit is similarly belied by the past thirty years of experience in which bankruptcy courts have been modifying mortgage loans on family farms in chapter 12,[2] commercial real estate in chapter 11,[3] vacation homes and investor properties in chapter 13,[4] with no ill effects on credit in those submarkets. Debt secured by all of these asset types, in addition to credit cards and car loans, are readily securitizable even though they can be modified in bankruptcy.[5]

Only a Fraction of All Loans Involved.

Our estimates are that this change to the bankruptcy law will allow 600,000 families to keep their homes. While this number would make a significant difference in the current foreclosure epidemic, it still only represents just 1.4% of all homeowner households with outstanding mortgages.

Investors Receive More from Modification than Foreclosure.

For the 600,000 families whom we expect this legislation to help, the alternative to a loan modification is the loss of the home in foreclosure. Foreclosures cost lenders and investors more than chapter 13 modifications would, which would guarantee at least the value of the property that the lender took as collateral. The secured portion of the loan would not be reduced below fair market value, plus the borrower must make payments on the unsecured portion during the course of the three to five year plan. At foreclosure, the lender would get liquidation value rather than fair market value, would face one to two year delays, incur expenses in fixing up the property, and need to pay for legal and selling costs. Further, the unsecured portion would simply be written off altogether. Moreover, a loan modification ensures a continued stream of interest income and, to the extent the lender is involved with other properties in the area, it prevents the further decline in overall property values. Finally, this bankruptcy change responds to the request by loan servicers for "cover" from investor law suits, the fear of which has prevented modifications even where the best interests of investors as a whole as well as borrowers would be served.

Preventing Foreclosures Will Preserve Home Prices and Assist Overall Housing Market.

Foreclosures depress housing prices overall. Millions of families *not facing foreclosure*—those who have faithfully paid their mortgages on time—lose equity through property value declines every time there is a foreclosure in their neighborhood**.** Averting 600,000 foreclosures will save an additional $72.5 billion in wealth lost by American families *not* facing foreclosure.[6] This in turn will save local governments property tax revenues, as well as the significant costs of police and administrative support that foreclosures require.[7]

---

[1] CRL reviewed data on homeownership rates, for the years 1984 to 2000, from the United States Census Bureau, as well as data on mortgage interest rates for the same period, from the Federal Housing Finance Board's Monthly Interest Rate Survey, comparing both states that permitted modifications in bankruptcy and those that did not, as well as trends in "modification states" before and after the 1993 *Nobleman* decision. The data revealed no observable connection between the modification of home mortgages by bankruptcy courts and either homeownership rates or the cost of mortgage credit.

[2] *See, e.g.*, Hon. Greg Zerzan, Deputy Assistant Secretary for Financial Institutions Policy, Dep't of the Treasury, *Congressional Testimony Before the House Committee on Agriculture* (June 2, 2004) ("There are many providers of credit to farmers and ranchers, including commercial banks, insurance companies, the Farm Credit System, and specialized agricultural credit providers. … Farmer Mac is providing a secondary market outlet for lenders to dispose of loans, much the same way that other financial institutions would purchase or participate in agricultural real estate mortgage loans from one another."); Peter J. Barry, Paul N. Ellinger and Bruce J. Sherrick, *Valuation of Credit Risk in Agricultural Mortgages*, American Journal of Agricultural Economics (Feb. 1, 2000) ("Agricultural mortgage markets in the United States are experiencing a major transition toward greater institutional lending, wider geographic dispersion, larger lending systems, increased standardization of financing arrangements, greater reliance on nondeposit funding, and expanded potential for securitized loan pools.").

[3] Stacey M. Berger, *Does anyone (other than the borrowers) care about servicing quality?*, Mortgage Banking (July 1, 2005) ("The commercial real estate finance industry has been reshaped by the strong influence of global capital markets. … A high proportion of fixed-rate loans are now securitized.");
Kenneth P. Riggs, Jr., *A new level of industry maturity: commercial real estate has earned its place in the pantheon of stable and attractive investment classes*, Mortgage Banking (Jan. 1, 2005) http://www.encyclopedia.com/doc/1G1-127789084.html; Amos Smith, *Lenders are renewing their interest in real estate*, Los Angeles Business Journal (Oct. 16, 1995) ("Investors and developers are once again being courted by lenders and mortgage bankers seeking to finance commercial property. … Real estate lending is also providing attractive yields relative to other investments.")

[4] While interest rates are generally higher on investment properties than on primary residences, this is due to the increased credit risk associated with lending to investors (an owner-occupier has to live somewhere, and the amount that otherwise would have gone to rent can be applied to the mortgage; in contrast, an investor who cannot find a tenant and lacks sufficient resources to cover the mortgage payments from resources other than revenues generated by the property is at greater risk of default). For example, Genworth Mortgage Insurance's "A-Minus Rate Sheet" dated December 1, 2005 shows a 0.5% premium for investor loans for coverage on 90% LTV A minus loan with credit score of 600-619.

[5] See http://www.riskglossary.com/link/securitization.htm (All sorts of assets are securitized: auto loans, mortgages, credit card receivables); http://jobfunctions.bnet.com/whitepaper.aspx?docid=105734 ("credit card ABS market has become the primary vehicle by which the card industry funds unsecured loans to consumers").

[6] Families lose 1.14% of their own house's value for every foreclosure that occurs on their block. Woodstock Institute, "There Goes the Neighborhood: The Effect of Single-Family Mortgage Foreclosures on Property Values," June 2005, http://www.woodstockinst.org/content/view/104/47/. Assuming the median house value equals $212,000 (National Association of REALTORS® Median Sales Price of Existing Single-Family Homes for Metropolitan Area, 2007 Q2, http://www.realtor.org/Research.nsf/files/MSAPRICESF.pdf/$FILE/MSAPRICESF.pdf), $212,000 value per home * 1.14% value lost per foreclosure* 50 homes per block = $121,000 value lost per foreclosure * 600,000 foreclosures avoided = $72.5 billion in home value saved.

[7] *See* Jim Rokakis, *The Shadow of Debt – Slavic Village Is Fast Becoming a Ghost Town. It's Not Alone*, (Sept. 30, 2007) http://www.washingtonpost.com/wp-dyn/content/article/2007/09/28/AR2007092801331.html?hpid=opinionsbox1; Noelle Knox, "Rising foreclosures reshaping communities," USA TODAY, 4/07, A1 http://www.usatoday.com/money/economy/housing/2007-04-12-foreclose-cover-usat_N.htm.