



Credit Union National Association

Issue Summary

MORTGAGE BANKRUPTCY

ISSUE: Beginning in 2007 and continuing through today, the financial sector began experiencing an unprecedented crisis of confidence. At the epicenter of this storm is the collapse of the housing market. Whether it is the increasing uncertainty regarding mortgage backed securities or the rapidly rising foreclosure rates across the country, Congress is determined to not only address the causes of this crisis, but also its symptoms. Therefore, Congress has passed legislation to encourage loan modifications to help keep deserving borrowers in their homes and avoid foreclosure. In addition, regulatory agencies have implemented programs to encourage loan modifications and reduce foreclosures. However, some legislators believe these efforts do not go far enough to stem the rising tide of foreclosures.

In the 111th Congress, legislation has been introduced to allow bankruptcy courts to modify all types of primary residence mortgages in bankruptcy. The practice is referred to as a “cramdown” because the bankruptcy court could reduce the principal of the mortgage loan.

CUNA POSITION: CUNA acknowledges bankruptcy as a legitimate option for eligible borrowers who have no other way to address their indebtedness. Yet, we believe that the Bankruptcy Code must fairly balance the rights of both credit grantors and borrowers, and it must recognize the impact that bankruptcy has on the cost of credit to borrowers who do have the ability and determination to repay their obligations.

CUNA agrees that this crisis must be addressed and applaud well meaning efforts by the Congress to remedy the problem. However, CUNA is concerned about the unintended consequences of pending legislative proposals that would open the federal bankruptcy code and allow for broad loan term modifications for homes in bankruptcy.

Any mortgage bankruptcy cramdown legislation considered by Congress should include limitations on 1) the primary residence mortgages eligible for cramdown or other modification, and 2) the actions the bankruptcy court must take with regard to primary residence mortgages.

1. Define eligible primary residence mortgages

First, the primary residence mortgages eligible for bankruptcy relief must be clearly defined to target the solution to the actual problem. A lender who made a mortgage loan using good underwriting standards should not bear the risk of a decline in the house’s value. The adoption of a broad amendment could result in a number of bankruptcy filings by people who are capable of paying their current mortgages. We do not want to see borrowers who are not even delinquent on their mortgage loans and who have not lost their jobs, suddenly stopping payments and triggering foreclosure because they just no longer want to make large mortgage payments on houses which have dropped notably in value.

We believe that any amendment to the Bankruptcy Code must target certain types of loans and be limited in duration. Mortgage bankruptcy cramdown should be limited to:

- Loans that are determined to be “subprime” loans with large re-sets of interest rates;
- Loans with negative amortization; or
- Loans that a court reasonably determines were fraudulent or abusive when made with no reasonable underwriting standards and expectation the borrower could actually repay the loan.

Adopting such an amendment would not only provide relief to certain debtors, but would serve the important purpose of helping to ensure that these types of lending products do not re-emerge.

With government actions underway to improve disclosures, curtail unfair and deceptive mortgage practices, and require the registration or licensing of mortgage lenders and brokers, CUNA believes that the mortgage market in the future will be quite different and that bankruptcy courts will not continue to see the types of mortgages where debtors should reasonably be granted some form of relief in Chapter 13 cases. Therefore, CUNA believes eligibility should be limited to mortgage loans made before 2008.

We recognize that in the current economic environment there is growing interest in Congress to give bankruptcy courts the authority to modify any mortgage loans secured by the debtor’s principal residence. Many press reports erroneously state that this issue involves only first mortgages; however, home equity loans and other secured secondary loans would also be impacted. And many supporters of a broad bankruptcy amendment cite the fact that a bankruptcy court can modify the terms of a loan secured by the debtor’s vacation home but not a loan secured by the debtor’s principal residence. We think it is very unlikely that courts allow debtors to maintain second homes that are used even for occasional vacations while eliminating debts owed to other creditors. But if this is a real concern, we would support an amendment to forbid debtors from maintaining vacation homes if they file for Chapter 13 relief, if other bankruptcy amendments are adopted.

2. Define Bankruptcy Court mortgage cramdown abilities

Second, the law must clearly describe the actions the bankruptcy court shall take regarding an eligible mortgage. For any loan falling within this category, we believe the bankruptcy court should have the authority to:

- Cancel prepayment penalties;
- Lower the interest rate to the current conventional fixed market rate;
- Extend the maturity of the loan; and
- Adjust the principal balance to no lower than the current market value of the house; and when the house is eventually sold by the debtor, the debtor would not only have to repay the remaining loan balance established by the plan, but also have to turn over to the original first and junior lien holders any net proceeds up to the original mortgage balances, even after discharge (also known as recapture).

Obviously, any amendment to the Code permitting the adjustment of the mortgage value to current market value should also require that current market value be established by an independent appraisal, and require the debtor to demonstrate the ability to make the monthly payments under the new terms. It is also important that the amendment prohibit a debtor receiving such relief from using the house as collateral for any future loans. In addition, the powers of the bankruptcy court outlined above would sunset in five years from date of enactment to ensure the remedy is targeted toward this current crisis.

In conclusion, credit unions have recognized the need for Congress to take steps to try to keep people in their homes in light of the foreclosure crisis. In fact, credit unions were the first – and only – group of mortgage lenders to be open to legislation that would provide limited loan modifications in bankruptcy. CUNA has worked since that time to ensure that this legislation be targeted to the mortgages that have caused the problem, and limited to address the crisis at hand.

STATUS/OUTLOOK:

Legislative History in the 110th Congress

During the 110th Congress, the House Judiciary Committee passed a more limited mortgage bankruptcy cramdown bill by a vote of 17 to 15. The modified bill would have allowed cramdowns for homeowners with subprime or “nontraditional” mortgages already in the foreclosure process or at least 60 days in arrears. The legislation would have limited the cramdown provisions to mortgage loan originated between January 1, 2000, and the date of the bill's enactment into law. In addition, the bill had a sunset in seven years. Also, the mortgage repayment period could have been extended up to 30 years and a bankruptcy judge could have the authority to reduce the mortgage principal to the home's current market value, a provision designed to help those homeowners in areas where home prices have fallen dramatically. These provisions would have applied to homeowners who were in Chapter 13 bankruptcy and had passed a strict means test.

During Senate consideration of mortgage bankruptcy cramdown in the 110th Congress, Senator Durbin put the issue in the spotlight in numerous hearings and floor debates. On April 3, 2008, the Senate Judiciary Committee passed a narrower version of S. 2136, Senator Durbin's mortgage bankruptcy cramdown bill. The modified bill, passed on a party line vote of 10-9, would have authorized bankruptcy courts not only to roll back or delay interest rate resets in bankruptcy proceedings but also to reduce (“cramdown”) loan principals to the current values of the homes. The committee rejected much narrower legislation as introduced by the Committee's Ranking Member, Senator Arlen Specter, S. 2133. The Senate Judiciary Committee held hearings on mortgage restructurings under the bankruptcy code (December 5, 2007 and November 19, 2008). Senate Banking Committee Chairman Christopher Dodd (D-CT) also highlighted mortgage bankruptcy cramdown as a worthy legislative proposal in his committee's hearings on the housing market crisis.

In addition, the Senate unsuccessfully attempted to attach the Durbin mortgage bankruptcy proposal to an economic stimulus bill designed to prop up the housing sector (February 13, 2008). CUNA worked with Senator Durbin to craft a cramdown compromise to significantly narrow the types of mortgages subject to the loan modifications.

The compromise language agreed to would have allowed a bankruptcy court to adjust the terms of certain mortgage loans made before the enactment of the law. It would have covered subprime and nontraditional mortgages and excluded all other mortgage loans, including interest-only loans originated with proper underwriting to a fully-indexed rate. The CUNA-Durbin compromise would have defined a subprime mortgage loan as one that had an annual percentage rate greater than 3% over the yield on a comparable security issued by the Treasury Department. If it was subordinate loan, subprime would have been defined as a loan greater than 5% plus the equivalent Treasury security. Finally, the compromise included a "means test" to qualify for the special relief and the bankruptcy court would have had the authority to reduce the claim to an amount no lower than the current market value of the property. On February 28, 2008, with banker opposition and the threat of a Presidential veto, the Senate was unable to garner the sixty votes necessary to proceed to consider the housing stimulus bill that included compromise mortgage bankruptcy language negotiated between Durbin and CUNA.

During the 110th Congress, CUNA offered a compromise in which elimination of the current exemption for first mortgages from modification during Chapter 13 bankruptcy proceedings would only be permitted if such legislation included the following limitations:

- Permits bankruptcy judges to lower the principal amount of a loan, no less than the value of the house at the time the mortgage was made.
- Permits bankruptcy judges to lower interest rates on mortgages, no less than current market rates for standard mortgage loans.
- Permits bankruptcy judges to extend the remaining term of a loan secured by a borrower's primary residence by up to five years, but to no more than 40 years.
- Permits the cancellation of prepayment penalties.
- Extends the authority for bankruptcy judges to modify the terms on loans secured by a borrower's primary residence only to loans made between January 1, 2003 and the date of enactment of the bill.

This approach not only limited "cramdowns" to amounts that result from: (a) high fees that were financed into the mortgage, (b) negative amortization, and (c) greater than 100% loan-to-value lending; but it also set a timeframe to target the solution to the specific problem. Without this time limitation, there could be significant increases in the cost of mortgage credit in the future for those with less than perfect credit. This time limitation would also reduce substantially any impact the law might have on the secondary market's willingness to buy mortgage-backed securities in the future.

Legislative History in the 111th Congress

In 2009, foreclosure rates increased as the financial crisis impacted not only Wall Street, but Main Street as well. Credit unions did not make the types of mortgage loans that triggered the mortgage crisis, but credit unions and their members are certainly being affected. There is significant interest in Congress to give bankruptcy courts the authority to modify a mortgage loan secured by the debtor's principal residence, in an effort to increase the number of out-of-bankruptcy loan modifications and reduce the number of foreclosures. To protect credit unions' interests, CUNA strongly opposed the legislation considered in Congress, while working with supporters of the measures to ensure credit unions were not adversely affected if legislation became law.

In March 2009, the House of Representatives passed legislation that would permit bankruptcy courts to adjust the terms of mortgages in Chapter 13. H.R. 1106 (known as the housing package) also included language making permanent increases in FDIC and NCUSIF insurance coverage, increasing borrowing authority for FDIC and NCUSIF, and extending the time by which these funds must be replenished when they drop below authorized levels. CUNA opposed the bankruptcy provisions of H.R. 1106 because they were overly broad in application, scope and duration. Thanks to credit unions' strong grassroots efforts, a full House vote on H.R. 1106 was delayed when it was initially scheduled for consideration in the House of Representatives in February. This delay gave opponents of the legislation more time to secure additional concessions on the legislation. Nevertheless, the changes were not significant enough for CUNA and other financial services trade groups to drop their opposition to the bill when it was ultimately considered, and passed, in March.

When the legislation moved to the Senate (S. 896), it was also paired with the corporate stabilization plan. The joint legislation was expected to have a judicial title that included mortgage modification language, and a banking title that included several changes to the deposit share insurance funds as well as changes to the Administration's Hope for Homeowners Program.

Supporters of judicial mortgage modification legislation reached out to opponents, including CUNA, in an attempt to craft a compromise. As a condition for negotiations, supporters insisted that parties would only be eligible to negotiate the provisions of the banking title as long as they continued to negotiate in good faith on the judiciary title. At one point, CUNA, NAFCU, ABA, ICBA and several large banks were at the table with supporters of judicial modifications in the Senate in an attempt to find a compromise, if it were possible.

Discussions focused on giving lenders the opportunity of avoid bankruptcy court if they offered a borrower in foreclosure a loan modification consistent with the Obama administration loan modification plan. Ultimately, issues involving the treatment of second mortgages could not be overcome. However, CUNA stayed at the table until it was apparent that no agreement could be reached that would earn the necessary votes to pass the Senate. Senator Durbin's judicial mortgage modification amendment to the housing bill (S. 896) failed by a vote of 45-51 on April 30, 2009.

Supporters of judicial mortgage modification in the House attempted to add the provision back into the bill, but were not successful in persuading Leadership to consider their language. Judicial mortgage modification language was not included in the housing package when it passed Congress and was enacted on May 20, 2009.

The 111th Congress continues to keep the possibility of judicial modification of mortgages in the spotlight. On July 9, 2009, the House Judiciary Committee Subcommittee on Commercial and Administrative Law held a hearing entitled, "Foreclosures: Will Voluntary Mortgage Modifications Help Families Save Their Homes." On July 23, 2009, the Senate Judiciary Committee Subcommittee on Administrative Oversight and the Courts held a hearing entitled, "The Worsening Foreclosure Crisis: Is it Time to Reconsider Bankruptcy Reform?" As policymakers express their frustration with increasing foreclosure rates and the lack of progress on voluntary loan modifications, they are continuing to seek legislation to allow the judicial modification of mortgages. It is highly likely that Congress will revisit this issue in the fall.

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RELATED DOCUMENTS:

[February 24, 2009: Letter from CUNA President and CEO Dan Mica to the Members of the United States House of Representatives regarding H.R. 1106, the Helping Families Save Their Homes Act](#)

[February 9, 2009: Letter from CUNA President and CEO Dan Mica to Senator Evan Bayh \(D-IN\) regarding mortgage bankruptcy legislation](#)

[February 9, 2009: Letter from CUNA President and CEO Dan Mica to House Judiciary Committee Chairman John Conyers \(D-MI\) regarding Section 3 of H.R. 200, the Helping Families Save Their Homes Through Bankruptcy Act](#)

[January 22, 2009: Letter from CUNA President and CEO Dan Mica to House Judiciary Committee Chairman John Conyers \(D-MI\) and Ranking Member Lamar Smith \(R-TX\), regarding H.R. 200](#)

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