



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT  
WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-  
FEDERAL HOUSING COMMISSIONER

**JAN 13 2009**

The Honorable Randy Neugebauer  
U.S. House of Representatives  
Washington DC 20515-4319

Dear Representative Neugebauer:

Thank you for your letter of January 11, 2009, requesting the Department of Housing and Urban Development's assessment of the impact of proposals to allow bankruptcy judges to modify the terms of mortgages of the Federal Housing Administration (FHA) and Ginnie Mae. This is a critical matter for the Department and I appreciate the opportunity to respond.

The key statutory provision of any legislation allowing bankruptcy judges to modify mortgages that affects FHA, Ginnie Mae, and the entire mortgage market, is removal of the special status now provided for home mortgages under Chapter 13 of the U.S. bankruptcy code. The import of that special status is that the courts may *not* bifurcate mortgage loans into separate secured and unsecured pieces, as is permissible with other debts. That special status was first interpreted by the U.S. Supreme Court in 1993, and was then codified by the Congress in Section 303 of the Bankruptcy Reform Act of 1994.<sup>1</sup>

The Department is concerned about the effects of legislative proposals, such as S. 61 and H.R. 200, that would remove the special status for principal residences that exists under the Bankruptcy Act of 1994. The proposed changes would permit the courts to modify or "cramdown" the principal obligation to an amount equal to the current value of the secured property. The residual amount owed would then be recast into an unsecured debt obligation. In Chapter 7 liquidation cases, the secured loan has primacy over sale proceeds of the security property, while the unsecured piece is grouped with all other unsecured debt in payment priority. In a Chapter 13 bankruptcy reorganization, payment plans are structured first to cover payments on secured debts. The Court then determines the amounts the household can afford to pay toward monthly debt obligations to satisfy unsecured debts, a portion of which may not receive payment. In either Chapter 7 or Chapter 13 proceedings much or all unsecured debt is not required to be paid by the debtor leaving lenders with no option but to write-off the unpaid amount as an uncollectible debt.<sup>2</sup>

### **Impacts of Cramdowns on FHA**

<sup>1</sup>The Court actually ruled first on Chapter 7 cases in *Dewsnup v. Timm*, 112 S.Ct. 773, 22 BCD 750 (1992), and then on Chapter 13 cases in *Nobelman v. American Savings Bank*, 113 S.Ct. 2106 (1993). Statutory clarification was in Title III, section 301 of the 1994 Act and can be found at 11 USC 1322.

<sup>2</sup> It is also the case that many Chapter 13 cases progress to Chapter 7 liquidations where the unsecured second mortgage is completely written-off by the lender.

FHA insurance coverage for lenders is only on secured debt. Thus, the immediate effect of a bankruptcy court cramdown would be that the lender has an uninsured loss. This would introduce a new risk to lenders, and create a situation wherein FHA no longer provides 100 percent insurance coverage of the mortgage amount. Such a change would increase the interest rates charged for FHA-insured loans as lenders purchase other guarantees to cover that risk. If such guarantees are not available, or prove to be very expensive, the availability of FHA insurance will be reduced. Because FHA loans have historically had higher default and foreclosure rates than conventional mortgages, the interest rate increase for FHA-insured borrowers would be more substantial than it would be for conventional borrowers.

If S. 61 or H.R. 200 were adopted, every property in jeopardy of foreclosure would also be a potential candidate for a bankruptcy court cramdown. In theory, Chapter 13 cramdowns would be limited to borrowers with commitments to their properties, meaning they have both the willingness and ability to continue to support the mortgage at some level. However, significant percentages of current Chapter 13 repayment plans fail and a property foreclosure ensues.

Having the option of a cramdown would increase the attractiveness of Chapter 13 filings versus working directly with lenders to find an appropriate loss mitigation workout plan. The fundamental difference between a bankruptcy cramdown and loss mitigation is that typical loss mitigation default workouts do not absolve the borrower of any obligation to repay the entire mortgage.

FHA has been very successful with its loss mitigation program. One tool in this program is known as a Partial Claim. Under this program, FHA pays up to 12 months of mortgage payments to the lender, on behalf of a defaulted borrower, to bring the loan current. The borrower, in turn, signs a promissory note to pledge that any future home equity will be used to repay HUD when the property is sold.<sup>3</sup> That promissory note bears no interest and is secured by a property lien. If implemented, S. 61 and H.R. 200 would potentially render these liens to be worthless. Repayment of those liens today contributes to the health and stability of the FHA Mortgage Insurance Fund. As of December 31, 2008, FHA had partial claims that totaled \$464 million.

### **Impact of Mortgage Cramdowns on Lenders, Ginnie Mae and Homeowners**

To the extent that S. 61 and H.R. 200 add increased credit risk to FHA-insured loans, financial regulators could choose to implement capital requirements on federally-insured depository institutions that hold such loans on their balance sheets. If FHA loans were considered to have increased credit risk for lenders, then financial regulators could also revisit the rules regarding zero capital requirements on Ginnie Mae's mortgage backed securities (MBS).

Ginnie Mae guarantees MBS investors no disruption in mortgage-payment cash flows with

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<sup>3</sup> Many borrowers choose to repay the note when they refinance their properties, prior to moving and selling the home.

its lenders/servicers responsible for making full pass-throughs to the security trustee until the first-lien mortgage is paid off. Pass-through payments are based on the original mortgage and not any new, reduced mortgage created by a bankruptcy court. Thus, even if a borrower is successful in a Chapter 13 reorganization plan, the lender would always have a cash-flow shortfall because of the cramdown. Therefore, lenders will re-purchase Chapter 13 loans out of Ginnie Mae pools and take the immediate write-off of principal, rather than incur this ongoing responsibility to MBS investors. Should the lender experience an increase in borrowers that receive cramdowns, its financial status could be severely impacted. If a lender then has financial difficulties and cannot meet its other pass-through obligations, Ginnie Mae will step in, take over the servicing portfolio, and itself absorb the residual loss created by the cramdown.<sup>4</sup>

There is one additional problem for homeowners who receive court-ordered mortgage cramdowns: property casualty insurers often limit coverage to the principal balance of the mortgage, which is the minimum required for loan approval. If a catastrophic insurable event occurs, homeowners will be exposed to financial loss because a crammed-down mortgage may not fully reflect the replacement cost of a property even if it reflects its current market value. The most likely outcome would be that the lender receives the proceeds of the insurance policy rather than the property being restored. As occurred in areas damaged by Hurricane Katrina, this leads to property abandonment and other problems in those impacted neighborhoods.

### **Conclusion**

Proponents of bankruptcy court cramdowns of mortgage loans likely intend to induce subprime lenders to be more proactive with foreclosure avoidance options. Broad-sweeping measures that affect all home mortgages fundamentally change the expectations of all parties involved in housing finance -- from originating lenders, to loan servicers, to mortgage insurers, and to ultimate investors. Because those parties have outstanding contracts that specify their respective financial responsibilities to one another, many will be immediately liable for additional costs not accounted for in the initial transaction. Future mortgage contracts will reflect increased interest rates to compensate for this increased risk. Interest rates on new loans will increase not only to cover the projected cost on those new loans but to cover the added cost on outstanding loans as well.

It is the Department's conclusion that S. 61 and H.R. 200 create a fundamental change in the quality and value of residential real estate as collateral for a mortgage loan. It is this uncertainty that will lead to higher mortgage costs for most borrowers.

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<sup>4</sup> Ginnie Mae resells these loan-servicing portfolios, but a portfolio with crammed-down mortgages will sell at a discount that reflects the cramdowns.

Thank you again for your correspondence on this important topic, and I trust this information will be useful as Congress contemplates providing bankruptcy judges the authority to modify mortgages.

Sincerely,

A handwritten signature in black ink, appearing to read "BDM", with a large, stylized flourish extending from the end.

Brian D. Montgomery  
Assistant Secretary for Housing –  
Federal Housing Commissioner