



December 16, 2008

The Honorable Richard J. Durbin
United States Senate
Washington, D.C. 20510

Dear Senator Durbin:

Thank you for the opportunity to testify before the Committee on the Judiciary regarding the issue of mortgage cramdown through bankruptcy. As we discussed in the hearing, the Mortgage Bankers Association believes that passing this legislation will result in increased costs for borrowers. During the hearing, you asked that I explain how we came to a specific figure in the increased cost and I am happy to give you more information about our analysis.

Primary residence mortgage bankruptcy cramdown legislation will change how lenders price for risk. Lenders price risk based on the credit worthiness of the borrowers and the current value of the property relative to the loan size, based on the idea that a borrower's past credit performance is the best indicator of future performance. The future value of the property is not a significant factor because lenders are ill-equipped to estimate future property values for any particular locale.

Under this proposed legislation, lenders will now have to take potential changes in property values into account. Particularly for loans on the types of houses that have the most potential for decline, such as new subdivisions, inner city areas, rural areas, and regions with steady declines in population and employment, lenders will charge higher rates, charge more fees at closing, tighten underwriting and, perhaps most importantly, increase downpayment requirements on loans where the lender has a significant risk of the collateral declining in value. To the extent the mortgage market remains competitive, different lenders will respond differently, and the degree to which rates change will vary from market to market and by property type.

We expect that, taking into account all of the increased costs borrowers will face and capitalizing those costs into the rate alone, borrowers will be forced to pay approximately 1.5 percent more for their loan than if cramdown legislation were not passed. For some borrowers, this may be a low estimate; for others this may be high. But an additional 1.5 percent is on the low range of our estimates. The actual average will depend, for example, on how many new homes are financed without very large downpayments.



If one were to assume a 30-year fixed-rate mortgage for \$300,000 at a 6 percent interest rate, and rates were to increase by 1.5 percent to 7.5 percent, the principal and interest payment for that loan would increase by \$298.99. The increase attributable to cramdown would fluctuate with the loan amount.¹

Our analysis is based on the fact that the mortgage market prices for risk. Cramdown legislation would introduce significant new risks for lenders, servicers and securitizers of primary residence mortgages. Higher default incidence rates, higher loss severity rates, higher administrative costs, increased political risk and increased market uncertainty combine to increase costs for consumers. To avoid or offset these risks, entities would not only increase the cost of a new mortgage, but would also require larger downpayments, tighten credit standards and restrict credit, especially in declining or volatile markets such as rural, urban and new property development areas.

The following are our underlying assumptions and a further explanation of the increased market costs of passing this bankruptcy legislation.

Higher default incidence rates would increase mortgage rates by 70-85 basis points.

If cramdown legislation is approved, default rates would increase for two reasons. First, more mortgages would be drawn into consumer bankruptcy filings. The result would be that defaults would increase by the number of people who previously would default on everything except their mortgage. In addition, bankruptcy filings would increase due to the asymmetrical nature of the filing. Giving people the option to write-down their mortgage when values are at their lowest point, without the option of lenders recovering the lost principal when values go up, will increase bankruptcy filings, particularly if the debtor expects to sell the house in a few years. This option of wiping out part of the loan while keeping the house and its future appreciation would make bankruptcy more attractive and could subsequently drive up the number of defaults. These higher default rates would result in a 70-85 basis points increase in mortgage rates.

¹ Rates have declined in recent weeks. If one were to take the average loan size in November 2008 (according to the MBA Survey of Mortgage Applications) of \$229,400 and apply a common interest rate in today's market, 5.54 percent, the principal and interest payment would be \$1,308.27. If the interest rate were to increase to 7.04 percent, the new principal and interest payment would be \$1532.37, a difference of \$224.10 per month. A \$300,000 mortgage at 6 percent is an example we have been using since debate on this issue began, as the numbers are easier to quickly understand and remember. The principal and interest payment on that loan would be \$1,798.85. If that same borrower were then forced to pay an additional 1.5 percent on his rate, the payment would be 2,097.64.

**Higher severity rates would increase the cost of a mortgage by 20-25 basis points.**

Enactment of the current cramdown proposal would increase loss severity in the event of default. Because approximately two-thirds of bankruptcy plans fail, lenders would be forced to take a loss up-front with the write-down, and subsequently incur other costs associated with a foreclosure. In a dynamic housing market, the foreclosure might take place during worse market conditions than existed at the time of the bankruptcy filing. Given that the borrower will be in the house for a longer period with little incentive to do maintenance or improvements, it is likely that repair costs will be much higher.

Bankruptcy administrative costs would add 10 basis points to mortgage rates.

When dealing with foreclosures, lenders face high administrative costs, which are not always recoverable from private mortgage insurers. In addition to the foreclosure costs, cramdown would force lenders to take on the additional cost of protecting their legal interests in the event of a bankruptcy filing. For example, lenders would have to order separate appraisals to defend against appraisals ordered by the bankruptcy judge or other claimants. Such costs could run into thousands of dollars for one loan, but would vary as a percentage of the loan amount. In order to cover these new administrative costs, lenders would have to add an average of 10 basis points to individual mortgages.

Market uncertainty and increased political risk would result in an additional 50-60 basis points.

Market uncertainty over new default and severity rates would drive up interest rates until the market is reasonably comfortable with the incidence rates associated with the new legal regime. Mortgage interest rates would increase considerably for several years until investors have some comfort in the new overall loss rates. Rates might then narrow somewhat but would still remain above traditional levels. In the short-term, the market would overprice this risk. At a time when the real estate finance industry and mortgage rates are already under stress, this would be especially difficult on borrowers and mortgage originators.

Additionally, a change to the bankruptcy laws would increase political risk and further alienate international investors. The U.S. has always been a safe haven for international investment because contracts are honored and are free from political influence. It would take the markets years to reverse the effects of Congress stepping in to alter financial contracts ex post for perceived short-term benefits. Not only would it have an effect on the appetite for mortgage paper, it would raise the question of what other steps Congress might take and would add a political risk premium to all U.S. debt. In order to protect against an increase in political risk and market uncertainty, international and domestic investors would likely demand an additional risk premium that would add an additional 50-60 basis points to each mortgage.



Using the low end of the range from these factors, we arrive at 150 basis points. The number is an approximation, as there is no market parallel from which we can make exact comparisons. Many of our member companies' risk officers, credit specialists, economists and production experts believe this number is too conservative. Others believe that our number is too large. Again, the actual number will be a function of property type and downpayment. We believe that the range we have presented is based on today's market and supportable assumptions about how the market will respond.

Cramdown will impact urban and rural areas and new developments in particular.

Not only will cramdown make it more difficult for many people to obtain financing for a mortgage, particularly first-time homebuyers and those with less than perfect credit, it would also subject inner cities, rural areas and new subdivisions, where prices are historically more volatile, to significantly more cautious lending. Certain geographic areas such as the Midwest that for years have seen job losses and population outflows will also suffer. By reforming the bankruptcy law to give judges the unilateral authority to alter the terms of a mortgage contract, Congress will increase the cost of getting and keeping a mortgage in the very areas it has sought to stabilize.

These volatile price fluctuations are confirmed in a recent research piece by David Stiff, Chief Economist for Fiserv Lending Solutions, which is the company that produces the Case-Shiller Home Price Index. In reviewing its data, he determined that:

During market downturns, home prices fall the least in the most desirable areas of a metropolitan region. As housing affordability improves, home buyers who were previously priced out of their preferred towns and neighborhoods will be able to purchase properties in these areas. So, even as overall sales volume drops, relatively stronger demand for housing will limit price declines in neighborhoods with shorter work commutes, better schools, and easier access to parks, recreation, and retail centers... (T)his shift in preferences will mean that prices for homes in outlying neighborhoods will continue their more rapid decline and will be slower to rebound when housing markets finally start to recover.²

Going forward, underwriting standards for these areas would tighten significantly. Lenders would be forced to engage not only in credit valuation for the borrower, but projections of real estate values. Such predictions would never be accurate and lenders are likely to err on the side of caution. An appraisal representing current property value would no longer be sufficient to make a credit decision. Lenders would have to assume some level of market decline. If mortgage insurance is still available, it is likely to be

² "Housing Bubbles Collapse Inward," (2008) David Stiff, Chief Economist, Fiserv Lending Solutions. Accessed at http://www2.standardandpoors.com/spf/pdf/index/052708_Housing_bubbles_collapse.pdf.



curtailed for high loan-to-value (LTV) loans, less creditworthy borrowers and volatile real estate markets.

Cramdown will have a negative impact on loans with VA, FHA and private mortgage insurance.

Comparing loans for different property types alone fails to quantify the price impact of the loss of credit enhancements for home loans. Cramming down a mortgage, or lien stripping, renders ineffective certain portions of government mortgage insurance and private mortgage insurance that currently protect lenders and servicers against foreclosure losses. As a result, lenders and servicers will be taking on significant additional credit risk on new and existing loans and will have to price for that risk.

Some studies that analyze the impact of mortgage cramdown on home mortgage credit have failed to recognize the tremendous impact that this loss of creditor protection will have. Claiming that lenders experience the same loss from a lien strip as they do from a foreclosure ignores the critical role of mortgage insurance, whether public or private, in preserving affordable credit or fails to understand its basic operation.

The extinction of credit enhancements has a particularly significant impact on mortgage companies that service loans with backing from the Federal Housing Administration (FHA) and Department of Veterans Affairs Home Loan Guaranty Program (VA). Servicers and investors are also at risk of losing much of the benefits of private mortgage insurance.

When Congress created the FHA and VA loan programs, there was no risk of cramdown on home mortgages. As a result, authorizing statutes and regulations of the government programs fail to deal appropriately with the risk cramdown would create. Statutes were developed to deal with foreclosures, not bankruptcy modifications and strip downs. Accordingly, combining a cramdown with existing investor accounting and claim policies will create perverse results, including the loss of government insurance.

By law, servicers cannot receive FHA insurance or a VA guarantee for the amount of any lien strip. Nevertheless, servicers are still required by contract to remit scheduled payments of principal and interest (“P&I”) to Ginnie Mae. Reduced collections without reduced P&I payments to investors increase servicer’s advancing costs.

Making matters worse, once the borrower successfully completes the Chapter 13 repayment plan, the loan would have to be purchased out of the Ginnie Mae pool based on the scheduled amortization amount, not the crammed down balance. In effect, the servicer would have to advance the amount that was stripped down to Ginnie Mae security holders and absorb the principal loss. This is a substantial shift in liability that servicers certainly did not contemplate when they agreed to service loans in Ginnie Mae securities. Servicers rarely take principal losses today. The severity of losses to which



servicers would now be exposed would be comparable to what FHA and VA lose with each foreclosure – more than \$30,000 per property. Yet, if those loans went to foreclosure sale, FHA insurance and VA guarantees would kick in to protect the servicer against principal loss.

Adding to the servicers' cost is the uncertainty about the eligibility of these loans for re-securitization into GNMA II pools. Wall Street has little appetite for bankrupt debtors. If bankruptcy modifications cannot be resecured, servicers will have to place these assets on their books and hold capital and loan loss reserves against them, in addition to taking the risk of principal loss, which they do not typically do today. The servicer would also continue to pay the debt service on the commercial loan used to originally buy the loan out of the pool. Expanding bankruptcy cramdown will dramatically increase the number of Chapter 13 modifications and cause such a substantial increase in costs to the servicing industry that servicer safety and soundness would be threatened.

While some might argue that lenders will convince the above mentioned government entities to merely change their policies, it is not so simple. FHA, for example, is not permitted by statute to pay an insurance claim for the strip down amount. The benefit of the FHA program is that the lender is insured against losses from borrowers who choose to take advantage of the program. This legislation would mean that the FHA insurance would not cover the risk of loss that would result from bankruptcy.

Private mortgage insurance may be extinguished in the event of a lien strip. Private mortgage insurance was created to pay claims against losses suffered from foreclosure, not court ordered write-downs, which were clearly prohibited when the insurance contracts were written. It is unclear whether private mortgage insurance companies would extend their contracts to lien strips. If the private mortgage insurance industry does agree to pay on these unanticipated lien strips, that industry will incur significant costs that may trigger substantial hardships and corporate failures.

If private mortgage insurance companies do not pay these unanticipated claims, the servicer or noteholder must absorb the principal losses making the private mortgage insurance worthless. As you know, private mortgage insurance has historically been a key driver in helping first-time homebuyers overcome the hurdle of a required high downpayment. If this protection evaporates, downpayments will increase. We estimate lenders will require 20-30 percent down as a general rule. If lenders are willing to make loans with less than 20 percent down, rates will increase to balance the risk.

Costs are higher today for mortgages on properties eligible for cramdown.

Our analysis was informed by a series of other factors. As you know, single-family, owner-occupied residences are protected from bankruptcy cramdown under current law. Bankruptcy cramdown is, however, allowed for investor properties, vacation homes and



multifamily residences in which the owner occupies a unit. A comparison between loans for properties protected from cramdown and loans for properties without this protection is useful.

At the outset, it is important to note that there are differences among these property types beyond vulnerability to cramdown. For example, investment properties have a higher risk of default and foreclosure, especially during economic downturns, because investors are quick to divest themselves of bad investments. There is also greater loss severity on each foreclosed investment property due to the increased wear and tear commonly experienced on rental properties. These factors lead to higher costs, regardless of the bankruptcy situation.

In a limited public source survey of lenders, MBA examined the difference in interest rates between primary residences and non-owner-occupied properties. At the time of our examination in the 4th Quarter of 2007, we found that the interest rate on investment properties ranged from 37.5 to 100 basis points higher than the rate on owner-occupied properties. In addition to interest rate, lenders required that points³ be paid at closing in the range of 50-150 basis points. Downpayment requirements were also higher. There is evidence that these rates have gone up more recently, with spreads between owner- and non-owner-occupied housing increasing to 200-250 basis points with a LTV of 70 to 80 percent. It is rare today to find a lender willing to provide greater than 80 percent LTV financing on an investment property.

If cramdown legislation is enacted, downpayment requirements would increase as lenders attempt to limit the risk of losing part of their security by loaning only in amounts below the perceived risk of cramdown. Given that lenders do what they can to bring new borrowers into the market, downpayments would be higher than they are in today's market, but not high enough to account for all of the risk. The balance of that risk will be accounted for in higher rates, fees and other costs.

Conclusion.

Passage of bankruptcy cramdown legislation would significantly impact mortgage costs and terms. It would introduce new risks into the system for which lenders will have to price. Given the uncertainty this law would introduce to the mortgage market, it would result in increased costs. Our analysis is that this change would result in an increase in mortgage costs in the range of 150 basis points, particularly for those loans made in new developments, as well as rural and urban areas. MBA urges Congress to consider these important points before acting on any changes to the Bankruptcy Code related to mortgages.

³ Points are prepaid interest that reduces the note rate.



Homeownership remains the best way to build, maintain and grow wealth for American families. For that reason, we do not believe that public policy should eliminate the preference the Bankruptcy Code currently gives to ownership of one's primary residence. Thank you again for the opportunity to testify before your committee and to provide you with this supporting information.

Sincerely,

David G. Kittle, CMB
Chairman