UNDER WATER
AT A TME OF WHOLESALE BAILOUTS, RESISTANCE STIFFENS TO REFORMS THAT MIGHT HELP AVOID FORECLOSURES

The Sun - Baltimore, Md.
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Date: Apr 5, 2009
Start Page: A.22
Section: BUSINESS
Text Word Count: 1080

Document Text

We always hear how bad foreclosures are for everybody.

The homeowner is put out on the street. The bank goes through an expensive process of unloading a house it didn't want. And neighbors see the value of their homes drop.

Yet bankruptcy reform legislation that could help avoid foreclosures is meeting stiff resistance. That legislation would allow bankruptcy judges to reduce the principal and interest on mortgages, something called "cramdown," on a primary residence.

Lenders are up in arms, contending that such a move would raise interest rates for every homebuyer. Opponents add that it would refreeze credit markets.

"May as well draw up plans for TARP 3," says Todd Zywicki, a law professor at George Mason University.

But what Congress is proposing is a lot less radical than opponents suggest.

Bankruptcy judges already have the power to modify mortgages on farmhouses and vacation homes.

And they regularly modify loan terms for businesses filing under Chapter 11, says Illinois bankruptcy lawyer David Leibowitz. Congress, he says, would be giving homeowners the same rights as Donald Trump, whose casino enterprise recently filed for bankruptcy protection for the third time.

Basically, the legislation passed early last month by the House would require that you first try to modify your mortgage with the lender. If that didn't work, you could file for bankruptcy protection under Chapter 13, in which the judge would be able to adjust the principal based on the home's current market value and change the interest rate to the average rate for prime borrowers.

For example, if your mortgage loan is $300,000, but your home's value has fallen to $220,000, the loan could be reduced to that amount. The $80,000 would be lumped with other unsecured debt, such as credit cards, and be repaid, as much as possible, with disposable income over five years.

If you sell the house within that five years, the lender could recoup part of the profit if your house has appreciated. So if you sell the house in the first year for $250,000, the lender would get the return of the principal plus 90 percent of the $30,000 profit. The lender's slice of any profit drops each year you own the home until disappearing.

The bankruptcy relief would apply only to existing mortgages at the time the law is enacted, helping those caught up in the current crisis, not future borrowers.

Reform seems a better alternative than cash-strapped people walking away from homes that are worth less than the mortgage.

Bankruptcy reform had momentum earlier this year, but it seems to have stalled in the Senate. But proponents and opponents say don't let the lull fool you. They expect the Senate to come to some sort of agreement after Congress returns from its Easter recess.

Likely, it will be more restrictive than the early House version.

Some congressional conservatives, for instance, want to limit relief to subprime borrowers. (That's a bad idea. It would deny relief to prime borrowers who might have temporarily lost a job and gotten behind on mortgage payments. Just the people Congress should want to help.)

Fierce lobbying by lenders could further narrow the scope of any legislation.

Lenders fear leniency in the bankruptcy law would lead to a rush of filings. And lenders don't trust Congress not to make this relief permanent.

"These things always have a way to start as temporary and then to be made permanent," says Francis Creighton, chief lobbyist for the Mortgage Bankers Association. "Because of that future risk, lenders will have to account for that in how they price their loans."

The group's Web site says consumers could see mortgage rates go up by 1.5 percentage points if such legislation passes. The site also calculates how much that would mean in different markets. Baltimore homebuyers would pay an extra $1,533 a year on the typical $128,218 mortgage here, the site contends. (Mortgage rates have been falling, dipping last week to the lowest level in the 38 years that Freddie Mac has tracked them.)

"No basis in fact. Humbug," says Robert Lawless, a University of Illinois law professor. "This is the bankers' scare tactic to any change to consumer lending: 'Interest rates will skyrocket.' "

Even George Mason's Zywicki, no fan of the legislation, says the bankers overstate the impact on rates.

Undoubtedly, homeowners are hurting, and an economic recovery isn't around the corner.

We always hear how we are in extraordinary times, which is why taxpayers must bail out some of the very financial institutions that helped bring the economy to its knees. But given these extraordinary times, we should be able to extend some temporary bankruptcy relief to some of these same taxpayers.

bankruptcy: a primer

Some familiar names of late have filed for bankruptcy protection: Circuit City, Magna Entertainment, Ritz Camera Centers, Baltimore Opera Company and The Greenbrier resort. And there is talk among government and auto officials that General Motors could be next.

Debtors file for protection under one of several chapters of the bankruptcy code. Family farms and fishermen, for instance, file under Chapter 12; municipalities use Chapter 9. And the newest chapter, 15, applies to debtors and creditors from more than one country.

Here are the most common chapters used by consumers and businesses:

Chapter 7

Immediately staves off creditors, while the assets of a company or individual are liquidated and the proceeds used to pay off creditors. As part of 2005 bankruptcy reform, individuals whose monthly income is above the state median - $4,629 in Maryland - must pass a means test to file under Chapter 7. Also all individuals, no matter what bankruptcy chapter, must undergo credit counseling within six months before filing and take a financial management course before debts are discharged. A company or person usually voluntarily files for bankruptcy. But in certain cases, creditors can file an "involuntary" petition if an individual or company is insolvent.

Chapter 11

Allows a business to keep creditors at bay while reorganizing finances so it can survive, or in some cases, liquidate. Individuals can file under Chapter 11 if debt is too high to file under Chapter 13.

A "prepackaged" Chapter 11, something GM may undertake, allows the company, creditors and others to work out a reorganization plan before filing for bankruptcy protection.

Chapter 13

Filed by individuals, usually homeowners wanting to stop foreclosure proceedings. Filers must have a regular income and repay all or part of their debt over three to five years.

Abstract (Document Summary)

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