Center for American Progress

Saving American Homes 101

The Helping Families Save Their Homes Act of 2009 boasts key measures to slow foreclosures and help the housing market recover. We unpack the legislation for you.

Homeowners in the United States are still staring at record numbers of mortgage foreclosures and falling housing prices. Congress and the Obama administration are coming to grips with the housing crisis in new ways after two years of inaction by the Bush administration. The Obama administration's plans to tackle the root cause of what ails our economy—the crippled housing market—at last offer help for homeowners. Now Congress is poised to do its part.

Below are the key features of the Helping Families Save Their Homes Act of 2009. This legislation deserves bipartisan support given the depth of problems in the housing market and the nationwide sweep of 8 million homeowners facing foreclosure this year in neighborhoods desperately in need of an end to plummeting home prices. Specifically, this legislation will:

1. Allow homeowners facing foreclosure to protect their home in bankruptcy proceedings. The legislation would allow a bankruptcy judge to write down the secured loan amount owed to equal the fair market value of the house, creating an opportunity to offer affordable monthly mortgage payments. This would allow more homeowners to stay in their homes and avoid foreclosure. Just as importantly, the possibility of a judicially mandated change in loan terms would encourage home mortgage lenders and investors to negotiate with homeowners facing foreclosure outside of bankruptcy courts.

- Avoiding foreclosures also has positive side effects, such as providing a floor on neighborhood housing values and protecting communities from multiplying home vacancies.

- This bankruptcy write-down is often misunderstood as wiping out the debt owed by the borrower, when it actually just reduces the secured amount of the debt and makes the rest of the loan unsecured debt. Unsecured debt, like credit card debts and most other loans, is paid off *pro rata*—each one getting their percentage share—by the borrower to the extent he or she can afford it. This change to the bankruptcy rules is perfectly reasonable; if the collateral used to secure the debt—in this case a house—has fallen in value, it seems unwise to artificially inflate its value when the alternative to restructuring the loan—repossession via foreclosure—will yield only the current market price.

- Because the losses incurred by lenders and investors when a property goes into foreclosure are so high, modifications benefits them as well by providing them with more value than they would get from foreclosure and repossession of the home. To the extent that home mortgages are now securitized—bundled up into a large pool of loans, with shares in the pool sold off to numerous shareholders like stock—the values of affected mortgage-backed securities would also be better protected by a bankruptcy write-down than from foreclosure.

2. Modify the Hope for Homeowners program passed in 2008 to lower the monthly payments of borrowers refinancing under the program, while streamlining some program features to make it reach more families. Under the program, a family would refinance into a new loan equal to 96.5 percent of the current value of the property. In exchange for taking the loss between the previous loan amount and the new one, the investors would be given a guarantee for the amount of the new loan. Considered in conjunction with the bankruptcy change, servicers should be more willing to participate in Hope for Homeowners, as the write-downs in both cases are comparable, but program participation guarantees the remaining balance whereas judicial modification does not.

3. Provide legal safeguards for mortgage service companies—the companies that collect monthly payments from homeowners—to work with homeowners facing foreclosure on affordable mortgage terms. The legislation would create so-called "safe harbor" provisions for mortgage servicers to allow them to modify mortgage terms. Currently, mortgage servicers say one reason they are modifying so few mortgages is because they could be liable to investors who might object to modification even if it's in their long-term best interest.

So how would these changes to our bankruptcy law help turn around our housing crisis and help homeowners?

Under current bankruptcy law, a working family can only delay but not avoid foreclosure on their primary residence. The Helping Families Save Their Homes Act would allow bankruptcy judges to reduce the principal amount of a homeowner's loan to current fair market value, known as a "cram down" in bankruptcy parlance.

The judge also could extend the term up to 40 years and modify the interest rate. These provisions would not help borrowers whose incomes are so low that they cannot afford even such modified payments.

According to a recent study by Credit Suisse, these changes might directly help roughly 20 percent of borrowers facing foreclosure stay in their homes. Clearly, this provision is designed only for those responsible homeowners who can afford to meet their obligations once their mortgages are modified alongside their other debt obligations.

Moreover, Credit Suisse predicts that this change will incentivize wider loan modifications because mortgage service companies will be encouraged to modify loans outside of bankruptcy courts and provide legal protection to do so. This will enable even more homeowners to stay in their homes.

For nearly two years the Bush administration urged primarily purely voluntary efforts at getting mortgage loan servicers to work out loan modification terms with homeowners. It has long been clear that the voluntary approach is failing to stave off many foreclosures that could be avoided. The new legislation may well allow several million homeowners the chance to force lenders to restructure a loan when it would avoid foreclosure, and incentivize servicers to modify more loans to avoid ending up in bankruptcy court. And the fewer foreclosures, the less fuel to the national economic crisis stemming from plunging house prices and destabilized neighborhoods.

What's in it for mortgage lenders and investors?

The act also includes features to protect lenders (and the investors in these home mortgages) whose loans are modified in bankruptcy by recapturing for them a large share of any sales profit above the new loan amount. Lenders would reap 80 percent of any profit above the reduced loan principal amount approved by the bankruptcy judge if the house is sold within a year, and 60 percent within two years, phasing down another 20 percent per year over the next three years.

In addition, the "safe harbor" provisions for mortgage service companies should allow them to safely modify mortgages before they go into foreclosure or into bankruptcy court. Between the foreclosures avoided because of bankruptcy judges and the foreclosures avoided because of the "safe harbor" for mortgage servicers, the act could prevent enormous amounts of losses incurred in the expensive foreclosure process. Overall, this should stabilize the value of these loans, and dramatically improve the value of investors' mortgage portfolios.

But won't greater access to bankruptcy courts have harmful side effects or unintended consequences?

Opponents of the "cram down" option for homeowners argue that it will clog the courts, drive up interest rates for all borrowers, and bail out undeserving homeowners. Many analysts and observers believe these arguments are at best vastly overstated, and that the benefits to the national economic crisis far outweigh any likely potential side effects.

One detailed paper by Professor Adam Levitin of Georgetown Law School examines the claims of opponents and concludes: "Bankruptcy modification is an immediately available form of foreclosure relief that has no cost to taxpayers, does not create moral hazard, can address both unaffordable and underwater mortgages, and provides an important future defense against systemic financial system risk."

It is well worth recognizing that bankruptcy judges restructure debt in accordance with clearly defined guidelines. The notion that lenders or investors would be completely wiped out is entirely without merit. Nevertheless, opponents of changes to the bankruptcy code argue that interest rates will rise dramatically to counter the new risk these changes would bring. Various studies and experts have rebutted these largely unsupported claims that mortgage interest rates would shoot up after such a change in law.

Chances are, though, that bankruptcy filings might shoot up markedly if legislation is enacted. After all, millions of homeowners are facing financial distress. Our bankruptcy courts, however, can handle a large uptick in filings. Prior to the more sweeping changes to personal bankruptcy laws in 2005 our courts handled a flood of new cases with any major problems. Many experts believe that the system can handle the expansion in demand.