Bankruptcy Cramdown:
What Do the Experts Say?

- The vast majority of economists, mortgage experts, and even the Congressional Budget Office (CBO) believe that the Durbin bankruptcy provisions lifted from S. 2136 and inserted into S. 2636 would have an adverse impact on interest rates and credit availability, though there is disagreement over the size of the impact.
- For example, CBO noted in its analysis of economic stimulus options that one of the costs of cramdown proposals "could be higher mortgage interest rates."[1]
- Professor Joseph Mason of Drexel University testified before the Senate Judiciary Committee that "it is straightforward to conclude" that cram downs will increase the cost of mortgage credit.
    - **Professor Mason responded to written questions from the Committee in more detail: "Allowing bankruptcy judges to unilaterally change the terms of a mortgage to those less favorable to the lender will impose unexpected and un-forecastable costs upon lenders and therefore raise the cost of providing funds to borrowers that can qualify for such treatment."**
- Academic studies also show negative consequences for lending where cramdown has been permitted. For example, Columbia University professor Charles Calamaris and Professor Mason concluded the following:

> **There is concrete evidence of the adverse effects of imposing cram-down on borrowing contracts. In response to increasing agricultural distress in 1978, Congress instituted a temporary provision for mortgage cram-downs for family farmers under Chapter 12 of the Bankruptcy Act. Bankers confirm that Chapter 12 cram-down has indeed made lending to small farmers a substantially riskier proposition, and they consequently have largely withdrawn funds from this business line.**
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> **The withdrawal of agricultural lenders took place when family farmers sorely needed capital from all sources. Cram-down radically affects credit allocation and does not support orderly and efficient allocation of resources in bankruptcy. Cram-downs significantly hurt mortgage lending in agriculture in the 1980's. Cram-downs for home mortgage debt would result in the same type of credit contraction witnessed in the agricultural sector.**[2]

- In studying the impact of cramdowns for farm real estate in Chapter 12 bankruptcy, the United States Department of Agriculture (USDA) estimated that cramdowns raise the interest rates on farm real estate loans by 25 basis points to 100 basis points.[3] This means as much as a 10 percent increase in the monthly mortgage payments because of the uncertainty surrounding the collateral value.

- Professor Mark Scarberry of Pepperdine Law School testified that permitting home mortgage cramdown would cause difficulties in the secondary mortgage market and would cause unjustified harm to the holders of home mortgage-related securities with a negative effect on investors of modest means by denying investors the benefit of the upturn in the real estate market that ordinarily follows a downturn.
    - Professor Scarberry further testified that "home mortgage strip down would substantially change the risk characteristics of home mortgages," echoing the conclusion of economists about the ill effects of the Durbin legislation.

- U.S. Supreme Court Justice Stevens, concurring in the 1993 judgment in Nobleman v. Am. Sav. Bank, wrote about the bankruptcy's law's special protection for home mortgages: "…(that) the legislative history indicat(es) that favorable treatment of residential mortgages was intended to encourage the flow of capital into the home lending market."[4]

- Wade Henderson, the President and CEO of the Leadership Conference on Civil Rights and a board member of the Center for Responsible Lending said in his recent Congressional testimony in support of the bankruptcy reform provision, "I don't dispute the fact that the down payment will go up…" (as a result of bankruptcy cram-down.) [5]

- Georgetown University Law Center professor Adam Levitin and Columbia University Ph.D. candidate Joshua Goodman in their paper *The Effect of Bankruptcy Strip-Down on Mortgage Interest Rates,* which is being used to advocate for bankruptcy reform, acknowledge that permitting bankruptcy judges to cram down mortgage payments will increase mortgage interest rates.[6] According to the paper, some evidence shows that allowing cram downs "…in an unlimited regime historically had a larger impact on interest rates in states where Chapter 13 filing is more common."

- Prudence dictates that Congress heed the call of the CBO and independent experts and not rush to enact bankruptcy legislation that will worsen the current housing downturn, increase costs for future borrowers and harm innocent investors.

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[1] See, CBO Paper – Options for Responding to Short-Term Economic Weakness (January 2008) at 25. http://www.cbo.gov/ftpdocs/89xx/doc8916/Frontmatter.2.1.shtml

[2] Calomiris, Charles W. and Mason, Joseph R., "High Loan-to-Value Mortgage Lending: Problem or Cure?" AEI Studies on Financial Market Deregulation, 1999.

[3] "Do farmers Need a Separate Chapter in the Bankruptcy Code?" *Issues in Agricultural and Rural Finance*, United States Department of Agriculture, Economic Research Service, October 1997.

[4] Nobelman v. Am. Sav. Bank, 508 U.S. 324 (1993.)

[5] January 29, 2008 *Hearing on the Growing Mortgage Foreclosure Crisis: Identifying Solutions and Dispelling Myths,* House of Representatives, Subcommittee on Commercial and Administrative Law, Committee on the Judiciary. P. 77.

[6] *The Effect of Bankruptcy Strip-Down on Mortgage Interest Rates*, Adam J. Levitin, Joshua Goodman, Georgetown University Law Center, Business, Economics and Regulatory Policy Working Paper Series Research paper NO. 1087816. February 6, 2008.