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Federal Housing Help Falls Short: The Housing and Economic Recovery Act of 2008

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FEDERAL HOUSING HELP FALLS SHORT: THE HOUSING AND ECONOMIC RECOVERY ACT OF 2008

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INTRODUCTION

The impact of the subprime mortgage foreclosure crisis on homeowners is, to put it simply, staggering.[1] In July alone, banks took back 77,295 homes.[2] Projections indicate that almost 2.2 million subprime foreclosures will occur primarily late in 2008 through the end of 2009.[3] The spillover impact of such foreclosure rates will result in 40.6 million homes suffering price declines at a value of 352 billion dollars.[4] Nationally this averages out to over eight thousand dollars in the decrease in home value per unit, while in Illinois the average exceeds ten-thousand.[5] As a result of this current subprime mortgage crisis, Congress has taken a number of affirmative steps to help out homebuyers.

The largest and most attention-grabbing maneuver thus

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[1] *See generally* Stan J. Liebowitz, *Anatomy of a Trainwreck*, The Independent Institute, Oct. 3, 2008, http://www.independent.org/pdf/policy_reports/2008-10-03-trainwreck.pdf (for a straightforward discussion of why the mortgage market failed).

[2] Les Christie, *Another bad jump in foreclosures in July*, Aug. 14, 2008, *available at* http://money.cnn.com/2008/08/14/real_estate/foreclosures_up _in _july/index.htm?postversion=2008081409 (last visited Oct. 5, 2008) (The foreclosure rate jumped up 8% in a month and 183% in a year, according to reports).

[3] Ctr. for Responsible Lending, Updated Projections of Subprime Foreclosures and their Impact on Home Values and Communities, Aug. 2008, *available at* http://www.responsiblelending.org/pdfs/updated-foreclosure-and-spillover-brief-8-18.pdf [hereinafter Updated Projections].

[4] *Id.*

[5] *Id.*

far has been the government takeover of mortgage giants Fannie Mae and Freddie Mac.[6] This rescue plan will work in a number of ways, including:

> The Federal Housing Finance Agency will oversee all operations, and chief executives will be replaced with significantly lower compensated outsiders;
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> The government will inject money if liabilities exceed assets, an assessment made quarterly;
>
> Holders of debts in the companies will be protected against losses;
>
> No dividends will be issued to shareholders, and the current shareholders will have their stakes reduced to 20 percent;
>
> The government will receive $1 billion worth of stock from each company that puts taxpayers' interests ahead of shareholders' interests;
>
> The companies will not be permitted to lobby or participate in any other political involvement;
>
> Fannie Mae and Freddie Mac will increase mortgage funding between now and the end of 2009;
>
> Beginning in 2010, they will reduce the volume of funded mortgages by 10 percent per year for 10 years, to reduce risk;
>
> The government will also start a program to buy pools of mortgage-backed securities guaranteed by Fannie Mae and Freddie Mac, in an effort to reduce the interest rates of home loans.[7]

Despite the pointed focus on the government takeover, a recent piece of housing legislation, the Housing and Economic

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[6] *How the Rescue Plan Will Work*, Wash. Post, Sep. 8, 2008, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2008/09/07/AR2008090702485.html?sub=new (last visited Oct. 5, 2008).

[7] *Id.*

Recovery Act of 2008 ("HERA"), has been given relatively little attention.[8] President Bush signed the sizable package of housing legislation into law on July 30, 2006.[9] One of the smaller, yet nevertheless important provisions of the HERA is a tax credit designed for first-time homebuyers to get the housing market moving again.[10] This Note will focus on the aforementioned tax credit, and how it will affect consumers.

Section II will provide a brief overview of the HERA, including regulation of Fannie Mae and Freddie Mac, and providing new loans to those at risk of foreclosure. Section III will move to the first-time homebuyers tax credit, including the purpose of the credit, eligibility requirements, and argument against the credit as an effective incentive to bolster the housing market. Last, section IV will argue that as an alternative to the tax credit and many parts of the HERA, court-supervised restructuring of mortgages on families' homes will save more homes from foreclosure.

II. HOUSING AND ECONOMIC RECOVERY ACT

A. Purpose

The purpose of the HERA is to strengthen and modernize regulation of Fannie Mae and Freddie Mac and the Federal Home Loan Banks.[11] The largest portion of the Act creates a new program at the Federal Housing Administration that will help at

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[8] Max Baucus, Committee on Finance, Baucus Tax Measure Wins Passage in Housing Bill, July 26, 2008, *available at* http://finance.senate.gov/press/Bpress/2008press/prb072608.pdf [hereinafter Baucus] ("This is an enormous win for millions of American families facing foreclosure and for our housing sector at the core of this economic downturn").

[9] David Herszenhorn, *Bush Signs Sweeping Housing Bill*, N.Y. Times, July 31, 2008, *available at* http://www.nytimes.com/2008/07/31/business/31housing.html?_r=2&hp=&adxnnl=1&oref=slogin&adxnnlx=1220724728-suIu7vlypJ2X/XyY3fYhsQ [hereinafter Herszenhorn] (last visited Nov. 13, 2008).

[10] Les Christie, *Beware the $7,500 'tax credit,'* Aug. 18, 2008, *available at* http://money.cnn.com/2008/08/15/real_estate/buyers_tax_credit/index.htm [hereinafter Christie] (last visited Nov. 13, 2008).

[11] U.S. Senate Committee on Banking, Housing and Urban Affairs, *Summary of the "Housing and Economic Recovery Act of 2008,"* http://banking.senate.gov/public/_files/HousingandEconomicRecoveryActSummary.pdf [hereinafter Summary of the "Housing and Economic Recovery Act of 2008"].

least 400,000 families prevent foreclosure by providing for new loans after lenders take deep discounts.[12] Listed below are a number of provisions that will most affect homeowners at risk of foreclosure.

B. Federal Housing Finance Regulatory Reform Act of 2008

A regulator for Fannie Mae, Freddie Mac, and Federal Home Loan Banks, the housing government-sponsored enterprises (hereinafter "GSEs"), was created in the "Federal Housing Finance Regulatory Reform Act of 2008."[13] Broad authority is granted this regulator, including the power to:

> establish capital standards;
>
> establish prudential management standards, including internal controls, audits, risk management, and management of the portfolio;
>
> enforce its orders through cease and desist authority, civil money penalties, and the authority to remove officers and directors;
>
> restrict asset growth and capital distributions for undercapitalized institutions;
>
> put a regulated entity into receivership; and
>
> review and approve new product offerings.[14]

By raising the loan limits in high cost areas from $417,000 to $625,000, the Act also affords more families the opportunity to qualify for Fannie Mae and Freddie Mac loans.[15] In addition, the law raises the United States' debt limit to $10.6 trillion, an

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[12] *Id.*

[13] Democratic Policy Committee, *H.R. 3221, the Housing and Economic Recovery Act of 2008*, July 25, 2008, *available at* http://www.dpc.senate.gov/dpc-new.cfm?doc_name=lb-110-2-123.

[14] Summary of the "Housing and Economic Recovery Act of 2008", *supra* note 11.

[15] *Id.*

additional $2 trillion.[16] The Act also enhances the affordable housing component of these GSEs by requiring the enterprises to assist underserved markets, such as rural areas, manufactured housing, and the preservation market.[17] Lastly, the Act creates funds, financed by contributions for the enterprises, to construct affordable housing.[18] Though this section of the HERA grants broad new authority, increases the Nation's debt limit, and raises the loan limits of GSEs' loans in high cost areas, it is not as central to preventing foreclosure as the next portion of the HERA: the HOPE for Homeowners Act of 2008.

C. HOPE for Homeowners Act of 2008

Of particular significance to this bill is a Federal Housing Administration (hereinafter "FHA") program titled the "HOPE for Homeowners Act of 2008" that will allegedly help approximately 400,000 homeowners avoid foreclosure.[19] In effect, the program pays off troubled mortgages and replaces them with more affordable, government-insured loans.[20] A key feature of the Act is that the lenders of the troubled mortgages agree to take a significant loss.[21] Thus, federal insurance is provided to refinanced 30-year mortgages for homeowners struggling to make payments.[22] This was enacted in light of the fact that past efforts at voluntary loan modifications have failed to keep up with the recent wave of foreclosures.[23]

The program is based on the following principles: long-term affordability, no investor or lender bailout, no windfalls for

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[16] Roger Runnigen, *Bush Signs Measure for Homeowners, Fannie, Freddie*, Bloomberg, July 30, 2008, *available at* http://www.bloomberg.com/apps/news?pid=20601103&sid=am2yQYThqmxQ&refer=us [hereinafter Runnigen] (last visited Nov. 13, 2008).

[17] Summary of the "Housing and Economic Recovery Act of 2008", *supra* note 11.

[18] *Id.*

[19] Runnigen, *supra* note 16.

[20] Herszenhorn, *supra* note 9.

[21] *Id.*

[22] Runnigen, *supra* note 16.

[23] Allen Fishbein, On the Enactment of the "Housing and Economic Recovery Act of 2008", July 30, 2008, http://www.consumerfed.org/pdfs/CFAStatementHousingStimulusBillEnactment73008.pdf ("The most recent HOPE NOW Alliance report indicates that almost four times as many families lost their home or are in the process of losing their home as compared to those receiving loan modifications.").

borrowers, voluntary participation in the program, and restoration of confidence, liquidity and transparency in the credit markets.[24] Only owner-occupants, and not investors, will qualify, and they must have a mortgage debt to income ratio greater than 31 percent as of March 1, 2008.[25] The size of the new federally insured loan will be the lesser of the amount the borrower can repay, or 90 percent of the current value of the home.[26]

Of important note here is that the borrower must also share his or her newly-created equity and future appreciation equally with FHA, until the borrower sells the home or refinances the mortgage.[27] From this provision alone, it is apparent that the American borrower can give up potentially large amounts of gains in equity and home values if the market does in fact improve over time. To further put this program in perspective, the numbers indicate that the program is authorized to insure up to $300 billion in mortgages.[28] The program does not last indefinitely; it sunsets on September 30, 2011.[29]

This portion of the HERA may in fact help a number of families at risk of foreclosure, but there is strong criticism that the HOPE Act will only make a modest dent in the rate of foreclosures.[30] Nothing is created to help those who aren't at risk of foreclosure but are rather seeing some or even all of their net worth disappear in a very short period of time.[31]

D. Foreclosure Prevention Act of 2008

An additional Act within the HERA, though not as large as HOPE or the Federal Finance Housing Regulatory Reform Act is the "Foreclosure Prevention Act of 2008". It is designed to further assist families and communities in light of the foreclosure

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[24] Summary of the "Housing and Economic Recovery Act of 2008", *supra* note 11.

[25] *Id.*

[26] *Id.*

[27] *Id.*

[28] *Id.*

[29] Summary of the "Housing and Economic Recovery Act of 2008", *supra* note 11.

[30] Paul Krugman, Op-Ed., *Another Temporary Fix*, N.Y. TIMES, July 28, 2008, *available at* http://www.nytimes.com/2008/07/28/opinion/28krugman.html [hereinafter Krugman] (last visited Nov. 13, 2008).

[31] *Id.*

crisis.[32] The Act provides $3.92 billion to communities hit the hardest by foreclosures and delinquencies, with funds being used to purchase foreclosed homes and rehabilitate or redevelop such homes in order to stabilize neighborhoods.[33] $180 million is provided to counsel families on avoiding foreclosure and to provide legal services to distressed borrowers.[34] Last, a provision is included to help returning soldiers avoid foreclosure, whereby the time a lender must wait to start foreclosure is lengthened from three months to nine months, giving returning soldiers one year of relief from increases in mortgage interest rates.[35]

The Federal Housing Finance Regulatory Reform Act, HOPE for Homeowners Act, and Foreclosure Prevention Act are all honest attempts at preventing foreclosure, and each serves HERA's broader goal of strengthening the currently tumultuous housing and credit markets. A critical aspect of the HERA that is of more interest to this note, however, is the package of tax measures within the HERA, which will be discussed below.

III. TAX MEASURES

A. Housing Rescue Credit Structure

An important section within the HERA that alters the tax treatment of many homeowners is the "Housing Assistance Tax Act of 2008."[36] Like the HERA, the tax package aims to help homeowners and potential buyers obtain affordable loans.[37] The cost of this tax package to the nation is approximately $15 billion over ten years.[38] The most significant portion of this tax package in terms of cost is the refundable first-time home buyer credit,

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[32] Summary of the "Housing and Economic Recovery Act of 2008", *supra* note 11.

[33] *Id.*

[34] *Id.*

[35] *Id.*

[36] CCH Inc., *"CCH Tax Briefing: Housing Assistance Tax Act of 2008,"* July 30, 2008, http://tax.cchgroup.com/legislation/2008-Housing-Assistance-Act.pdf?cm_sp_o=1wTblkzfbBE%20VzTwCjCZBAlw%20Vzllwl%20ftw%20ZBAlbET%20-llblfzEgw%20azo%20-gf%20Bu%20niioCjCawof%20kbEL [hereinafter CCH, Inc.] (last visited Nov. 13, 2008).

[37] Baucus, *supra* note 8. ("...I'm pleased to say that we passed a bill that will bring property tax relief to tens of millions of homeowners, help refinance subprime loans, and reduce the number of vacant homes on the market.").

[38] *Id.*

estimated at $4.853 billion.[39] However, the credit's true immediate impact is much larger, since homeowners are predicted to claim the credit at a cost of $13.6 billion in 2009.[40]

Other tax provisions included in the Act, but not discussed in this note, include: additional standard deductions for real property taxes, an enhanced low-income housing tax credit, increased mortgage revenue bonds, REIT reforms, merchant payment card information reporting, reduced home sale exclusion, delayed worldwide interest allocation, and an acceleration of large-corporation estimated tax.[41]

The drafters of the Act, in an attempt to offset the large cost of the package, included provisions requiring that banks provide information reporting annual credit card sales to the IRS and to merchants, that homeowners pay taxes on gains made from the sale of a second home to reflect the portion of time the home was used as either a vacation or rental property, and that there be a delay in implementation of worldwide allocation of interest, i.e. a tax benefit for businesses.[42]

B. First-Time Homebuyer Credit

The first-time homebuyer credit is not a completely new tax idea; for instance, a similar program was utilized in the District of Columbia up until 2008.[43] Under the credit in the HERA, there are, at first blush, valuable benefits to a first-time homebuyer. A taxpayer who is a first-time homebuyer is allowed a refundable tax credit equal to the lesser of $7,500 or 10 percent of the purchase price of a principal residence.[44] This provision applies exclusively to homes purchased on or after April 9, 2008 and before July 1, 2009.[45] A taxpayer is considered a "first-time homebuyer" if, during the three years preceding their tax credit

[39] *Id.*

[40] CCH Inc., *supra* note 36 at 1.

[41] Summary of the "Housing and Economic Recovery Act of 2008", *supra* note 11.

[42] Baucus, *supra* note 8.

[43] Joint Committee on Taxation, *Technical Explanation of Division C of H.R. 3221, the "Housing Assistance Tax Act of 2008,"* 25, July 23, 2008, http://www.house.gov/jct/x-63-08.pdf [hereinafter Joint Committee on Taxation] ("...first-time homebuyers of a principal residence in the District of Columbia were eligible for a nonrefundable tax credit of up to $5,000 of the amount of the purchase price.").

[44] *Id.*

[45] Baucus, *supra* note 8.

claim, they had no ownership interest in a principal residence.[46] Additionally, the credit phases out for individual taxpayers with modified adjusted gross incomes between $75,000 and $95,000 for the year of purchase of the principal residence.[47] The Senate Finance Committee estimates that about 1.6 million people will make use of the credit.[48]

Thus far, the tax credit appears to give first-time homebuyers up to $7,500 worth of help on their loan.[49] However, as with many tax credits, there are certain limits to claiming the credit. First, the credit may not be claimed if the taxpayer's financing is from tax-exempt mortgage revenue bonds.[50] Second, nonresident aliens do not qualify for the credit.[51] Third, if the taxpayer either disposes of the residence or ceases to make it a principal residence before the close of a taxable year for which the credit is allowed, then the credit cannot be claimed.[52] Thus, if a homeowner claims the credit and then subsequently sells or turns the home into a secondary residence during the year the credit is claimed, he or she will have to pay back the credit. Also important to note is that the IRS is not giving the credit as cash at closing; rather, an individual wishing to utilize the credit must claim it on their tax return.[53] For example, if an individual's tax liability were normally $10,000, they would pay only $2,500 if they claimed the credit.

C. Beware the Credit's True Nature

The biggest and most misleading aspect of the tax credit here, however, is that it is more akin to a loan than a tax credit. This is because the credit is recaptured over fifteen years beginning in the second taxable year after the year in which the home was purchased.[54] Put simply, the credit given to qualifying first-time homebuyers must be repaid over fifteen years in an interest-free loan of sorts. This credit is unlike any other federal

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[46] Joint Committee on Taxation, *supra* note 43, at 26.

[47] *Id.* at 25.

[48] Christie, *supra* note 10.

[49] Summary of the "Housing and Economic Recovery Act of 2008", *supra* note 11.

[50] Joint Committee on Taxation, *supra* note 43, at 26.

[51] *Id.*

[52] *Id.*

[53] CCH Inc., *supra* note 36 at 2.

[54] *Id.*

tax credit in that it must be paid back.[55]

If the credit must be paid back, then how will it really get the housing market moving again? One argument is that mortgage lenders will take the tax credit into consideration, which will in turn make it easier for buyers to get loans.[56] The main argument for this credit is that it will prevent more borrowers from defaulting on their payments, since it gives them a nest egg should they run into financial trouble down the road.[57] However, both of these pro-credit arguments are based on the assumption that the credit will be saved rather than spent.

D. Tax Credit Criticism

Despite the favorable arguments that the credit will make lenders more willing to grant loans to buyers and that it will prevent homeowners from falling into default, there are enough overriding factors to make this tax credit not only ineffective, but dangerous as well. The back story to the current housing crisis will be discussed, followed by arguments against the tax credit.

Over recent years, traditional banks have been pushed aside by unregulated financial players.[58] Traditional banks are those with federally insured deposits, which have limits on the risk they can take and the amount of leverage they can take on.[59] The unregulated financial players here have no such federal insurance, and assume more risk in their lending practices. Borrowers were assured that the market itself would impose discipline risk-taking by these companies, yet that was simply not the case; such lenders disregarded the ability of borrowers to repay.[60]

As house prices soared to seemingly unrealistic levels, lenders ignored the warning signs, both because many mortgage originators did not care about the solvency of borrowers, and because the loans were quickly sold off to investors who had no idea what they were buying.[61] At its core, a financial framework of fast and loose lending by lenders who should have known better to lenders who took on more than they could afford has

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[55] *Id.*

[56] Christie, *supra* note 9.

[57] *Id.*

[58] Krugman, *supra* note 28.

[59] *Id.*

[60] *Id.*

[61] *Id.*

ultimately led the housing market to its current degenerated state.

One of the key problems with this tax credit is that it is considered a credit for tax purposes, but has to be repaid like a loan.[62] Because of the misleading nature of this credit, it may appear to be free money to many consumers who claim the credit.[63] If consumers treat the credit as though it is a free gift from the government, and spending it as though it does not have to be repaid, then even more financial difficulties may lie down the road when the credit must be repaid. Though the repayment is over a period of fifteen years, equaling out to $500 per year if the full $7500 is claimed, the credit nonetheless represents another risky loan given to families already at risk of foreclosure. Further methods of risky lending such as this tax credit are the types of lending that paved the way for the current housing market, and should not be encouraged by the government.

Given that many lenders have been too loose in their dealings with borrowers, and conversely buyers have been taking on loans they cannot afford, then why should another loan labeled as a "credit" be given to such homeowners? These irresponsible practices have caused the subprime mortgage crisis.[64] Taking another chance on borrowers who were irresponsible in the first place by assuming debts they could not relieve themselves of is just another risky bet. Unfortunately, if taxpayers who claim the credit ultimately end up not being able to pay it back, then the remaining taxpayers end up footing the bill.[65]

Even if homeowners who utilize the credit do indeed pay it back in full, the credit is hardly a solution to the crisis, and is merely a temporary fix.[66] One of the reasons that this tax credit is only a temporary fix is that plummeting home prices will block any impact that the credit may have; the market is too soft right now for a modest tax credit to make any real difference.[67] Another challenge to the effectiveness of this credit is that of

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[62] CCH Inc., *supra* note 36 at 2.

[63] Christie, *supra* note 10.

[64] Krugman, *supra* note 30.

[65] Herszenhorn, *supra* note 9. ("The bill raises the national debt ceiling to $10.6 trillion, an increase of $800 billion...and the Federal Housing Administration's authority, granted in the new legislation, to insure up to $300 billion in refinanced mortgages to help stem a tide of foreclosures.").

[66] Christie, *supra* note 10. ("Given the economy, it will only push a precious few first-time home buyers over the edge right now.")

[67] *Id.*

willingness to buy in the housing market.[68] Specifically, the current market has a psychological barrier because consumer believe prices will be lower tomorrow, a barrier the credit may not be able to overcome.[69] Last, even some leaders in the government do not feel confident about both the effectiveness of this bill and that there will be no loss to the taxpayer.[70]

Granted, homeowners at risk of foreclosure need help from the government. Lawmakers claim that these tax measures in the HERA are targeted, practical measures that are what's right for the economy and working American families.[71] This may be true to an extent, but the modest tax measures are not enough to make a difference in this ailing housing market. Furthermore, the tax credit that is recaptured is not large enough to make a difference when housing prices are plummeting.[72]

A solution to this crisis is expanding financial regulation to cover a much wider range of institutions.[73] Fortunately, Congress recognized this need for expanded regulation and placed Fannie Mae and Freddie Mac under conservatorship, with the goal of restructuring the companies.[74] There is, however, another method of preventing foreclosure that was not passed by Congress: court-supervised loan modifications, which will be discussed below.

IV. COURT-SUPERVISED LOAN MODIFICATIONS

A. The Call for Change in Current Law

Efforts to encourage voluntary loan modification in the housing market have failed to keep up with the increase in foreclosures.[75] Even with the addition of the HOPE for Homeowners Act in the HERA, court-supervised loan modifications are a much-needed complement to industry initiated voluntary efforts.[76] Sometimes such loan-modifications

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[68] *Id.*

[69] *Id.*

[70] Runnigen, *supra* note 16. (HUD Secretary Preston stating, "Roughly a third of the people who get this assistance will end up in foreclosure...and many more, we believe, will be chronic delinquencies.").

[71] Baucus, *supra* note 8 at 2.

[72] Christie, *supra* note 10.

[73] Krugman, *supra* note 30.

[74] *How the Rescue Plan Will Work*, *supra* note 6.

[75] Fishbein, *supra* note 23.

[76] *Id.*

are the only available option to some of the challenges lenders face, such as when second liens exist.[77]

Under current law, homeowners at risk of foreclosure are denied equal access to court-supervised loan modifications.[78] A primary residence is often the most important asset to families, yet under current law judicial modification of loans under a chapter 13 payment plan is allowed for owners of commercial real estate and even yachts.[79] Surprisingly, mortgages on primary residences are the only types of debts not subject to judicial modification.[80] Such mortgage loans must be paid off according to their original terms or else the bankruptcy automatic stay will be lifted, permitting the mortgagee to foreclose on the property.[81] At the same time, lenders who could modify loans to make them affordable to borrowers are simply not doing so.[82]

In response to the subprime mortgage foreclosure crisis, H.R. 3609: The Emergency Home Ownership and Mortgage Equity Protection Act of 2007, was reported out of the House Judiciary Committee on December 12, 2007.[83] Though the bill has yet to be enacted, it is nonetheless an effective bill that allows for judicial modification loans in order to allow borrowers to avoid foreclosure. The passing of this bill, or one similar in nature to it, would help families stuck in bad loans keep their homes.[84]

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[77] *Id.*

[78] Ctr. for Responsible Lending, *HR 3609 – Compromise Bill Permitting Court-Supervised Loan Modifications Would Save 600,000 Homes*, Jan. 18, 2008, *at* http://www.responsiblelending.org/pdfs/hr-3609-support-brief.pdf [hereinafter Ctr. for Responsible Lending].

[79] 11 U.S.C. § 1322(b)(2).

[80] Ctr. for Responsible Lending, *supra* note 78.

[81] InsuranceNewsNet, *Georgetown Law Center Study Finds Zero Percent' Likelihood of MBA-Claimed Interest Rate Spike Under Mortgage Foreclosure Crisis Bills Before Congress*, Feb. 7, 2008, *at* http://insurancenewsnet.com/article.asp?n=1&neID=200802071680.2_e50b008f37cbff62 [hereinafter Georgetown Law Center Study] ("As a result, if a debtor's financial distress stems from a home mortgage, bankruptcy is unable to help the debtor retain her home, and foreclosure will occur.").

[82] Ctr. for Responsible Lending, *supra* note 78. ("A report by Moody's found that loan servicers had only modified 3.5 percent of mortgages that increased to higher rates, compared with industry estimates that up to half of subprime borrowers facing reset will lose their homes to foreclosure.").

[83] *Id.*; *See* H.R. 3609, 110th Cong. (2007).

[84] Ctr. for Responsible Lending, *supra* note 78.

B. Qualifications for Relief

First and foremost, judicial modification would only be available when a homeowner lacks the sufficient income to pay their mortgage, and foreclosure is imminent.[85] This would be determined by deducting modest living expenses allowed by the IRS, to see if their income is insufficient to cover their mortgage obligations; also, they must have received notice from their lender that foreclosure is imminent.[86] This strict test allows for a tapered targeting of families who would otherwise lose their homes. Accordingly, the court-supervised loan modification would not be granted to homeowners who do not need such assistance. As an additional incentive to lenders, lenders could not recover any more than the market value of the home when foreclosure happens, and typically recovers far less than that, whereas with a judicial modification more would be recovered by lenders.[87]

Next, courts would be required to set interest rates at a reasonable market rate, calculated by the current 30-year conventional fixed rate plus a reasonable risk premium.[88] Judicial discretion would be further limited in that the principal balance of the loan cannot be reduced below the fair market value of the property, and that the 30-year term would remain unchanged.[89] Another key limitation on judicial discretion is that courts could modify existing loans only, and new loans would not be subject to modification.[90]

Conventional fixed-rate and adjustable rate loans would not be eligible for modification.[91] The two categories of loans that regulators have determined to be potentially dangerous in light of poor underwriting by lenders that would be subject to modification are subprime and non-traditional loans.[92] Last, the bill would apply only to loans originated on or after January 1, 2000, and would be subject to a seven-year sunset.[93]

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[85] *Id.*
[86] *Id.*
[87] *Id.*
[88] *Id.*
[89] Ctr. for Responsible Lending, *supra* note 78.
[90] *Id.*
[91] *Id.*
[92] *Id.* (Non-traditional loans in this sense means interest-only loans and payment option adjustable-rate mortgages.).
[93] *Id.*

C. Benefits, Response to Objections

It is possible for a law such as H.R. 3609 to save over 570,000 families from losing their homes due to foreclosure.[94] This calculation is based on the number of homeowners who face an interest rate reset through the end of the decade that would meet the means test required in a Chapter 13 and are still current on their mortgage loans.[95] The number of homes that could avoid foreclosure through this method may be even higher in light of the updated projections indicating that almost 2.2 million subprime foreclosures will occur primarily late in 2008 through the end of 2009.[96]

In addition to helping those who are at risk of foreclosure, court-supervised loan modification would stabilize property values for families who live near homes at risk of foreclosure, saving Americans an estimated $72.5 billion in home values.[97] This is because foreclosures have a significant impact on neighborhood property values, whereby each foreclosure of a conventional mortgage within an eighth of a mile results in a decline between 0.9 and 1.136 percent.[98] For example, if a house goes into foreclosure, then a residence with a fair market value of $100,000 would decline somewhere between $900 and $1136 in value.

Another great benefit would be that the court-supervised loan modifications would come at no cost to the U.S. Treasury.[99] The modifications would avoid any potential abuses by narrowly targeting only those borrowers who would otherwise lose their homes, and would not assist families not at risk of foreclosure as defined by the law.[100] Last, in terms of helping lenders as well as borrowers in this crisis, lenders would be guaranteed the value they would obtain through foreclosure, given that foreclosure

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[94] *The Looming Foreclosure Crisis: How To Help Families Save Their Homes: Hearing Before the S. Comm. on the Judiciary*, 110th Cong. (2007) (written statement of Mark Zandi, Chief Economist and Co-Founder, Moody's Economy.com) [hereinafter Zandi].

[95] *Id.*

[96] Updated Projections, *supra* note 3.

[97] Ctr. for Responsible Lending, *supra* note 78.

[98] Dan Immergluck & Geoff Smith, *There Goes the Neighborhood: The Effect of Single-Family Mortgage Foreclosures on Property Values*, Woodstock Institution, June 2005, http://www.woodstockinst.org/content/view/104/47/ (last visited Nov. 13, 2008).

[99] Ctr. for Responsible Lending, *supra* note 78.

[100] Zandi, *supra* note 94.

sales can only recover the fair market value of the home; lenders would also avoid the high costs and significant delays involved in the foreclosure process.[101]

This type of loan modification is also preferable to the HOPE for Homeowners Act in certain aspects. The main argument for loan modifications is that there is no cost to the U.S. Treasury in such a system of court-supervised loan modifications.[102] On the other hand, with the HOPE for Homeowners Act, the federal government is authorized to assume up to $300 billion in mortgages.[103] Additionally, borrowers must also share their newly-created equity and future appreciation equally with FHA, until the borrower sells the home or refinances the mortgage, whereas no such requirement exists with court-supervised loan modifications.[104] Moreover, in terms of the sheer estimates as to how many homes will avoid foreclosure, 400,000 will be saved through the HOPE for Homeowners Act, compared to 600,000 by court-supervised loan modifications.[105]

The main argument made against court-supervised loan modifications is that such modifications would make credit less available and consequently have a negative impact on interest rates.[106] This claim is compellingly refuted by three points of data. First, courts have been modifying mortgage loans on farms, commercial real estate, vacation homes and investor properties for decades with no negative effects on credit in these markets.[107] They may even make credit more available, since debt secured by all of these asset types, such as farms, commercial real estate, etc., is more readily able to be secured, despite the fact that they can

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[101] Ctr. for Responsible Lending, *supra* note 78.

[102] *Id.*

[103] Summary of the "Housing and Economic Recovery Act of 2008", *supra* note 11.

[104] *Id.*

[105] Runnigen, *supra* note 16.

[106] Ctr. for Responsible Lending, *Objections to HR 3609 – Myth v. Reality*, (Mar. 10, 2008), *at* http://www.responsiblelending.org/pdfs/bankruptcy-myth-v-reality-hr3609-final-3-8-08.pdf [hereinafter Objections to HR 3609].

[107] *Id.* (While interest rates are generally higher on investment properties than primary residences, this is due to the increased credit risk associated with lending to investors, whereas an owner of a primary residence must live somewhere, and the amount that otherwise would have gone to rent can be applied to the mortgage; in contrast, an investor who cannot find a tenant and lacks sufficient resources to cover the mortgage payments...is at greater risk of default.).

be modified in bankruptcy.[108]

Second, from 1978 to 1993 when many courts across the country were granted authority to modify loans by treating them as secured up to the value of the property, those jurisdictions experienced no adverse effects on the cost or availability of credit.[109]

Third, and most important here, is that the cost of credit has the risk that some loans will end in loss of the home to foreclosure already incorporated.[110] In turn, law that provides for modifications only in cases of homes that will be lost to foreclosure without such loan modifications, will impose no additional risk and cost because modification which allows lenders to recover at least as much through modification as in foreclosure is preferable to the cost associated with foreclosure.[111] To further eliminate any concern that loan modifications would negatively impact the cost or availability of new loans, loan modifications would be allowed for existing loans only.[112]

Not surprisingly, the claim that court-supervised loan modifications would make credit less available and/or more expensive is advocated by the financing industry, namely the Mortgage Bankers Association.[113] However, there is no empirical evidence that court-supervised loan modifications would have more than a minor impact on mortgage interest rates or home ownership rates.[114]

A similar argument against court-supervised loan modifications is that modifying the interest rates and/or principal

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[108] *Id.*

[109] *See* Adam J. Levitin & Joshua Goodman, *The Effect of Bankruptcy Strip-Down on Mortgage Markets* (Georgetown Univ. Law Ctr. Bus., Econ. and Regulatory Policy Working Paper Series, Research Paper No. 1087816), *available at* http://works.bepress.com/adam_levitin/11 (last visited Oct. 5, 2008).

[110] Objections to HR 3609, *supra* note 106.

[111] *Id.*

[112] *Id.*

[113] Georgetown Law Center Study, *supra* note 81. ("The Mortgage Bankers Association has claimed that permitting modification of mortgages in bankruptcy will result in an effective 200 basis point increase in interest rates on single-family owner-occupied properties.").

[114] *Id.* ("As there is significant evidence that mortgage interest rate markets are indifferent to bankruptcy modification risk, we conclude that permitting unlimited strip-down would have no or little effect overall on mortgage interest rates... lenders' losses in strip-down would be extremely limited both in scope and magnitude and often total less than those they would incur in foreclosure").

balances of outstanding loans is unfair to lenders.[115] The opposite here is true; modifications would be designed so that lenders actually recover more than they would under foreclosure.[116] Under foreclosure, lenders typically recover approximately 40% of the principal balance.[117] This recovery is guaranteed because the only borrowers eligible for modification would otherwise go into foreclosure, and the law would permit the write-down of loan balances to the fair market value of the home.[118] In the case of foreclosure, any portion of the loan that exceeds the proceeds of the foreclosure sale cannot be recovered by the lender. Whereas any excess under a court-supervised loan modification would be treated as unsecured debt which would be paid back to the lender.[119]

An additional argument made by opponents of court-supervised loan modifications is that such modifications are inappropriate because they shield borrowers from any impact of their poor decision to take on a loan that they could not afford.[120] Granted, a moral hazard may be created by assisting these borrowers at risk of foreclosure, but this hazard is greatly outweighed by the need to subdue the subprime mortgage crisis that would harm not only the borrowers but innocent consumers, since widespread foreclosures hurt not only the defaulting borrowers, but neighbors as well.[121]

V. CONCLUSION

The HERA, considered to be the most significant housing legislation in decades, implements a number of programs to curb the alarming rate of foreclosures in America, namely the Federal Housing Finance Regulatory Reform Act and the HOPE for Homeowners Act. Of particular interest to the HERA is the first-

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[115] Objections to HR 3609, *supra* note 106.

[116] *Id.*

[117] Business Wire, *Fitch Smartview: 170 U.S. Subprime RMBS Transactions Placed Under Analysis*, Jul. 12, 2007, *available at* http://www.businesswire.com/portal/site/google/index.jsp?ndmViewId=news_view&newsId=20070712006007&newsLang=en (last visited Nov. 13, 2008) ("First lien loss severity assumptions reflect the performance to-date, resulting in projected lifetime loss severity averaging approximately 40%.").

[118] Objections to HR 3609, *supra* note 106.

[119] *Id.*

[120] *Id.*

[121] *Id.*

time homebuyers tax credit. Though the tax credit may help some homebuyers avoid foreclosure in the short run, the credit must be repaid and will unlikely give the housing market the jump start necessary to bounce back from its recent contraction. Many of the existing foreclosures result from risky lending to individuals who could not afford the adjustable-rate-mortgage payment increases, or made unwise use of their home equity. Consequently, the tax credit which is another risky loan, is not the best way to get the market moving again. A better way to do so is through court-supervised restructuring of mortgages on family's homes. This method would save more homes than would the first-time homebuyers tax credit, and would come at no cost to the United States Treasury.