Viewpoint

One of a series of opinion columns by bankruptcy professionals

Mortgage Modification: The Pendulum Swings Away From Lenders

By Scott Y. Stuart

Remember the subprime market and its collapse in 2007? The panic it sent through the economy and the shock waves it sent through major financial institutions? That was the beginning of a long and complicated recession. And as we venture forward towards recovery, or at least some form of tentative stability, it is time to revisit the housing market to see what progress has been made on stabilization, mortgage reformation and growth.

Turnaround professionals who work in the consumer sector have much to be concerned about on this front. While programs exist to assist struggling homeowners, few have taken advantage of them for various reasons. Congress has been toying with passing legislation which would allow bankruptcy judges to modify mortgages, but this too has problems. The result at the moment is the continued escalation of foreclosures, financial institutions unwilling (or incapable) of mortgage modifications and homeowners facing a dearth of reasonable options to get relief while the housing market remains relatively flat.

Enter H.R. 1106, the bill that would allow mortgage modification. This bill passed the House of Representatives earlier this year and is currently awaiting debate and vote by the Senate. It is unclear when the Senate will get to this piece of legislation, which carries with it some significant and powerful changes to the law. What the Senate will ultimately pass, if anything, will largely depend on a combination of the state of the housing market as well as public opinion on the issue, which varies widely.

Some of the highlights of the bill the Senate will consider are noteworthy. It is also important to point out that H.R. 1106 is likely to be modified from its current form. That being said, the intent of the legislation is clear. Bankruptcy judges will potentially have extraordinary powers to modify mortgages, albeit within certain guidelines. The question becomes, how will this change the lending practices of financial institutions given the possible uncertainties this legislation poses?

The proposed law starts with what constitutes a "qualified loan modification" and includes loans that reduce payments to a percentage of a debtorís income without negative amortization, mandates no fees associated with modification and permits post bankruptcy payments. Thus, lenders will be much more limited to deem a loan "modified" as a result of these latitudes.

Under the proposed new law, Chapter 13 debt limits may be eliminated. In other words, mortgage debt in excess of $1,010,000, which would make an individual ineligible from filing for Chapter 13 protection, would now be able to do so. The ease of available relief from mortgage debt beyond the subprime market is sure to create a public outcry. Opponents of such a liberal filing provision argue that economic instability lurks if no segment of the mortgage sector is shielded from this bill.

One of the more controversial portions of the proposed legislation deals with interest rate modification on principal residence mortgages. Under current law, debtors do not have the right to modify principal residence mortgages in a Chapter 13 bankruptcy. The legislation as proposed, however, allows judges to change interest rates, terminate adjustable rates and limit what is deemed and collectable as secured debt. The ramifications here are very important given how they go to the very core of contractual relationships that, while not deemed illegal, change the economic landscape for lenders. Of course on a going forward basis, should this legislation pass and be signed into law, a new level of risk not previously assumed by lenders will now have to be built into lending formulas. In the meantime, lenders are effectively being told they may be subject to an unraveling of their deals.

Is this a fair result retrospectively as opposed to prospectively? Even if it becomes law on a prospective basis, what protections will lenders be afforded so they can be enticed to assume the risk associated with those who may use bankruptcy to force modifications as stated? Finally, what level of risk will lenders be willing to take and how much credit will no longer be available, if modifications such as this will be rather easy to come by? Arguably, it would seem that measures such as this could have the opposite of the intended effect, causing lenders to lend only in the least risky situations and at higher interest rates to protect themselves against potential modification losses. This would not solve the problems facing the housing market but would exacerbate them further.

As for protections for lenders, while some have been proposed, there is a question as to whether they go far enough or are real enough to create protections and confidences in the mortgage lending sector. For example, if a homeowner sells a home before a bankruptcy is completed but after loan modification has been approved, the lender will receive a percentage of the profit above the reduced loan principal. As currently proposed the profit percentage to be turned over to the lender would be 90% in year one reduced by 20% each year following through year five. The current bill is silent on what role, if any, a lender can play in evaluating or participating in the sale process even though it will be subject to its outcome.

continued on next page

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continued from page 7

One last provision that is seemingly a lender protection, but arguably is not, is the requirement that a debtor seek a voluntary mortgage modification at least 30 days prior to filing for bankruptcy. That being said, if bankruptcy is filed without the request, the borrower must still seek a modification from the lender before requesting a court modification.

While this provision seems to gives lenders an opportunity to do a workout with a borrower, the debtor still has most of the leverage. Despite this requirement, the law as currently drafted does not have any thresholds under which an offer by a lender to modify can be deemed more reasonable then a subsequent request by a borrower to seek deeper modification following a filing. Thus, while the lender may have the ability to object to a post-filing modification, it has no legal right to assert reasonableness of the pre-filing modification offer, which a borrower may reject for any reason.

It is unlikely that the Senate will adopt H.R.1106 as currently written for a host of reasons. Central to this is the risk of an unstable credit market and higher interest rates on loans as a result of new risks being placed on lenders. In addition, this bill does not make bankruptcy an option of last resort, but a rather an attractive option if the goal is primarily debt relief through mortgage modification. These are just a few concerns to be considered. While the subprime meltdown may have started this mess, H.R. 1106 may do nothing more for mortgage reformation then "Cash for Clunkers" did for auto sales.

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Scott Y. Stuart is a partner with Donlin, Recano & Company, Inc. He can be reached at 212-481-1411 or sstuart@donlinrecano.com.

Firm Retention Summary

FirstPlus Financial Group Inc.

This is a summary of a request from the Chapter 11 trustee of FirstPlus Financial Group Inc. to hire Robbins Tapp Cobb & Associates PLLC as accountant, filed Sept. 9 with the U.S. Bankruptcy Court in Dallas.

COMPANY: FirstPlus Financial Group Inc.

FIRM TO BE HIRED: Robbins Tapp Cobb & Associates PLLC

PRINCIPAL ASSIGNED TO THE CASE: J. James Jenkins

DUTIES: The firm will provide the following services:

Forensic accounting services:

– developing litigation strategy and accounting data that can assist the trustee and his professionals to determine and to analyze whether potential claims or causes of action exist for, among other things, preferences and fraudulent transfers; and

– providing such other forensic accounting services as required and as requested by the trustee.

General accounting services:

– assisting the trustee and his professionals to determine the estates' assets and their fair and/or market value;

– assisting the trustee and his professionals to determine the estates' liabilities;

– assisting the trustee and his professionals to prepare any tax returns due from the estates;

– consulting with the trustee and his professionals, the debtors, the estates' creditors, other stakeholders, their respective attorneys (if any), and others regarding accounting, tax, and financing matters; and

– providing such other professional services as required and as requested by the trustee.

HOURLY COMPENSATION: Members of the firm will be compensated at the following hourly rates:

Members, directors, professionals, accountants and paraprofessionals	\$80 - \$300

BONUS POTENTIAL: Not applicable.

CASE BACKGROUND: FirstPlus Financial, a financial services provider, filed for Chapter 11 protection on June 24.

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