PRINCIPAL PAYDOWN PLAN FOR UNDERSECURED MORTGAGES

A proposal of the National Association of Consumer Bankruptcy Attorneys

Summary

The Principal Paydown Plan calls for a restructuring in Chapter 13 bankruptcy of certain underwater mortgages. Under this approach, homeowners will be able to eliminate negative equity, acquire modest equity and then re-amortize the mortgage into a market rate loan. The reduction of principal is not achieved by a cramdown, but rather by temporarily reducing the interest rate to 0% so that all payments made by the homeowner are applied to pay down the principal. In exchange for this benefit, the homeowner would have to agree to a general settlement of claims against the servicer, trustee and investor. This Plan will achieve a significant improvement in the over-encumbered status of the home; provide needed and justifiable hope for the homeowner, many of whom have a legitimate claim against the servicer; and stabilize individual communities across the country, as well as the overall housing market.

The Continuing Foreclosure Crisis

While there is some debate as to whether the economy is starting to rebound, the number of foreclosures continues to increase and jeopardize the fragile recovery. An estimated 6.7 million homes already have been lost to foreclosure and that number is expected to reach 13 million by the end of 2014, resulting in about $1 trillion in direct financial losses to borrowers, local governments and financial institutions.

Some analysts argue that all of these foreclosures will help the market reach its bottom, at which point recovery can ensue. This viewpoint, however, does not consider that many foreclosures are unnecessary and should not occur under a system where mortgage servicers are obligated to make changes to the mortgage if the changes would return a greater value to the investor.

Unfortunately, foreclosures still outpace the negotiation of affordable and sustainable loan modifications. This is true despite the Administration's Home Affordable Modification Program (HAMP), which offers monetary incentives to servicers and borrowers in an effort to encourage such modifications. The shortcomings of HAMP, which have been well documented, are that it does not include mandated principal reduction and the modified loan capitalizes arrears into the new principal, thereby stopping the foreclosure but resulting in a loan that is even more undersecured.

We are facing historic levels of homes lost through foreclosures. Not every individual foreclosure can or should be stopped, but there is an urgent need to stop the epidemic by closing the growing chasm between prevention and losses. Without stronger policy intervention, not only will millions of families lose their homes unnecessarily, but massive foreclosures will continue to destroy communities, drag down the housing market, and keep a full economic recovery out of reach.

A Solution – A Principal Paydown Plan for Undersecured Mortgages

There is no "silver bullet" strategy to fix every mortgage or repair every foreclosure-ravaged neighborhood. Moreover, the toxic combination of negative equity and a weak economy means that many homeowners with fixed-rate, prime mortgages are experiencing much higher default numbers as well. The breadth and depth of the housing crisis means that we must address it through multiple approaches and solutions. Recent research has shown a strong correlation between negative equity and mortgage delinquency. Homeowners who are underwater have no cushion to absorb financial difficulties. Furthermore, in some cases, homeowners who are unlikely to move into a positive equity position have fewer incentives to stay in the home or make the necessary ongoing investments in maintenance. For these homeowners, even the reduction of monthly payments to an affordable level does not fully solve the problem. As a result, a homeowner's equity position has emerged as a key predictor of loan modification redefault, more so than unemployment or other factors.

Bankruptcy courts are an attractive venue for addressing foreclosure problems in many cases. In particular, a Chapter 13 bankruptcy case provides the benefits of:

- Supervision by a federal bankruptcy judge and trustee over the term of the Chapter 13 plan (usually three to five years).
- A discharge of some or all general unsecured debt, leaving the homeowner in a much better financial position to make future mortgage payments.
- A process for dealing with wholly unsecured junior mortgage or liens on real property – where no home value exists beyond the balances owed on senior mortgages. Voiding these liens also improves the homeowner's ability to pay the senior mortgage in the future.
- Legal authority to essentially "quiet title" to real property, providing a process that can clarify legal rights to the property so that all parties are on notice of the results.

The stigma of filing bankruptcy and the imposition of stingy expense allowances for those in a Chapter 13 bankruptcy are more than enough to dissuade homeowners with the ability to pay from filing bankruptcy for the purpose of "gaming" the system. Furthermore, the bankruptcy court's detailed budget review of the Chapter 13 debtor prevents the moral hazard of misuse of bankruptcy protection.

There currently are about 1.6 million active and pending Chapter 13 bankruptcy cases, of which approximately 880,000 include mortgages. An additional 22,000 new Chapter 13 cases that include mortgages are filed each month. The Principal Paydown Plan, as outlined below could apply to all of these cases. In summary, the Plan:

- Applies only to Chapter 13 bankruptcy cases.
- Applies only to principal residences.
- Does not involve a "cramdown" of first mortgages or principal reduction down to fair market value.
- Enables the homeowner to quickly accumulate equity (or diminish negative equity) by reducing the interest to 0% for five years so that all payments made by the homeowner are credited directly to principal. At the end of the five year period, the remaining principal balance is amortized over 25 years at market rate.
- Utilizes current bankruptcy law regarding wholly unsecured junior mortgages to void those liens.
- Would require the borrower to settle claims against mortgage stakeholders. Most homeowners do not want to go through the expensive, time-consuming, painful and uncertain process of litigating their rights and would welcome the opportunity to keep their homes in exchange for a settlement of claims.
- Would include a short-form "quiet title" action that would settle the rights of the mortgage-related stakeholders and ensure that the homeowner is making future payments to the proper party and that property title is marketable.

A more detailed discussion of the proposal is available by contacting Maureen Thompson, NACBA's legislative director, at mthompson@hastingsgroup.com or (703) 276-3251.