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Power to Modify Mortgages Sits Well With Judges

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By AMIR EFRATI and JENNIFER S. FORSYTH

Federal bankruptcy judges say they are eager to have the power to restructure mortgages for struggling debtors because it could save hundreds of thousands of homeowners from foreclosure.

Top Senate Democrats are advancing legislation to let bankruptcy-court judges approve new repayment terms on first mortgages for primary residences for homeowners who have sought protection in a Chapter 13 filing. The proposal allowing so-called mortgage cramdowns, in which the principal amount of the loan is reduced, is one of several efforts Democrats are pushing to give homeowners relief as they wrestle with increasing debt levels and plummeting home values.

Reuters

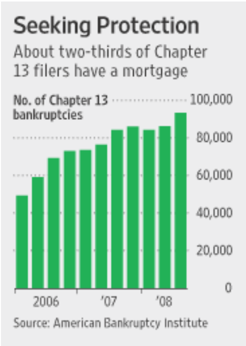
Proposed changes to bankruptcy laws could save thousands of homeowners from foreclosure.

Judges overseeing bankruptcy cases already can approve modifications for credit-card debt and most other kinds of loans, including second-home mortgages. But they haven't been able to modify primary-home mortgages since 1979, when the U.S. bankruptcy code went into effect, said Samuel L. Bufford, a U.S. bankruptcy judge in Los Angeles. Before then, many states allowed judges to do some form of modification, he said.

Allowing a judge to modify loans gets around the problem that many mortgages have been turned into securities and sold to multiple investors. "The bankruptcy system depends on people making deals, but the deal-making piece of it has disappeared when it comes to mortgages because of the way mortgages were sold and packaged," Judge Bufford said. "There's nobody on the lender side to do the deal unless you [get permission] from investors, and that's impossible."

The measure is "a good idea," said Laurel Isicoff, a federal bankruptcy judge in Miami. Financial institutions have gotten help from the government, but the only way to fix the economy is through "a holistic approach" that also "solves the problem of people losing their homes."

Until last week, when Citigroup Inc., one of the nation's largest mortgage lenders, dropped its opposition, the banking industry had long fought modification of first mortgages in bankruptcy, fearing it would encourage more homeowners to file for Chapter 13 and that it would further destabilize the housing market. Representatives of the Mortgage Bankers Association said last week that they were still opposed to cramdowns. But Citigroup's support increases the chances of passing legislation that would allow judges to lower the interest rate, reduce the principal or alter the length of primary mortgages.



Opponents of the proposed law change, including the Securities Industry and Financial Markets Association, say it would have "serious and negative consequences," including increasing mortgage rates for consumers overall because investors who typically buy the loans might deem new mortgage contracts too risky.

A Chapter 13 filing is a plan in which debtors can retain assets and pay back their debt over three to five years. About two-thirds of Chapter 13 filers have a mortgage, but half of them aren't able to keep paying the mortgage as part of their reorganization, judges and lawyers say.

A. Jay Cristol, a federal bankruptcy judge in Miami, said that changing the bankruptcy law would be beneficial because "after foreclosure, families get broken up and lenders hold on to nonperforming assets that they sell at a loss."

Samuel Schwartz, a Las Vegas bankruptcy lawyer, has a client who is facing foreclosure on her primary residence even though she has been able to modify the loans on her two investment houses. Under the current bankruptcy rules, she was able to "strip away" the second mortgage on one of the investment homes and she "crammed

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