

Debunking the Mortgage Bankers Association's Cramdown Claim

The Mortgage Bankers Association (MBA) 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 (“principal residences”).¹ The MBA figure is the result of a cherry-picked comparison.

The MBA figure is derived from a comparison of the current interest rate spread between mortgages on single-family principal residences and on investor properties.² The MBA reasons that because single-family principal residence mortgages cannot be modified in bankruptcy while investor property mortgages can, that the *entire* difference in mortgage prices for these property types is attributable to bankruptcy modification risk for the investor properties.

The MBA's claim is demonstrably false. First, the MBA engages in questionable calculations of the price spread. It includes not only the current additional interest rate premium for investor properties of 37.5 basis points, but also amortizes the higher down payments and points generally required on investor properties in order to achieve the 200 basis point figure.³ Even accepting the MBA's inflated numbers, however, the idea that the entire spread in

¹ Statement of David G. Kittle, CMB, Chairman-Elect, Mortgage Bankers Association, Before the Subcommittee on Commercial and Administrative Law, Committee on Judiciary, United States House of Representatives, Oct. 30, 2007, Hearing on “Straightening Out the Mortgage Mess: How Can We Protect Home Ownership and Provide Relief to Consumers in Financial Distress? – Part II,” at <http://judiciary.house.gov/media/pdfs/Kittle071030.pdf>, at 3.

The MBA has vacillated in the size of its claim. More recent MBA press releases have claimed only an increase of 150 basis points, without explaining the 50 basis point decline from the 200 basis point figure featured in Congressional testimony. Mortgage Bankers Association, Press Release, MBA's “Stop the Cram Down Resource Center” Puts a Price Tag on Bankruptcy Reform, Jan. 15, 2008, at <http://www.mortgagebankers.org/NewsandMedia/PressCenter/59343.htm>.

Notably, in response to a request from U.S. Representative Brad Miller (D-N.C.), for clarification of its in later communications with members of Congress, the MBA changed its explanation of the 150 basis point increased cost of mortgages claim arguing (without providing any evidence or methodology for the derivation of its numbers) that 70-85 basis points would be due to higher default incidence rates, 20-25 basis points would be due to higher loss severity rates, 10 basis points would be due to the administrative costs imposed by bankruptcy, and 50-60 basis points would be due to market uncertainty and increased political risk. Stephen A. O'Connor, Senior Vice President of Government Affairs, Mortgage Bankers Association, Letter to Rep. Brad Miller, dated April 18, 2008 (on file with the Authors.)

² Statement of David G. Kittle, CMB, Chairman-Elect, Mortgage Bankers Association, Before the Subcommittee on Commercial and Administrative Law, Committee on Judiciary, United States House of Representatives, Oct. 30, 2007, Hearing on “Straightening Out the Mortgage Mess: How Can We Protect Home Ownership and Provide Relief to Consumers in Financial Distress? – Part II,” at <http://judiciary.house.gov/media/pdfs/Kittle071030.pdf>, at 3.

³ *Id.* the MBA's amortization of the higher down payments typically required on investor properties is debatable. Lenders bear no risk on down payments, unlike on interest payments. Down payments receive different tax treatment than interest payments for borrowers. And down payments create equity in a house, unlike interest. By amortizing down payments—turning them into interest dollar for dollar adjusted for present value—the MBA is wrongly equating two very different types of payments that should not be treated as dollar for dollar equivalents.

Regardless, even if the MBA were correct is correct that higher down payments and/or points will be required and that it will be harder to make high LTV loans, this is not necessarily a bad thing, as it might compel more prudent lending practices and would inherently protect lenders from ending up with undersecured loans that could be stripped down by creating an instant equity cushion.

mortgage rates between single-family owner occupied properties and investor properties being due to bankruptcy modification risk is preposterous.⁴

The MBA then cherry-picks its evidence to support its lobbying position. The MBA could have also compared interest rates spreads between mortgages on single-family owner occupied properties and mortgages on other property types that can currently be modified in bankruptcy—mortgages on multifamily properties or vacation homes. As it turns out, there is *no rate spread*; conforming mortgages on vacation homes and multifamily properties are currently priced the same as single-family principal residences. Only investor property mortgages are priced higher. The same holds true for private mortgage insurance premiums; there is no additional premium for multifamily properties at any of the seven major private mortgage insurers, even though multifamily property mortgages can be modified in bankruptcy. The pattern also holds true for Fannie Mae and Freddie Mac delivery fees—Fannie and Freddie do not demand discounts that track the difference in bankruptcy modification risk. This means higher interest rates on investor properties must be attributed to non-bankruptcy risk factors entailed in lending against an investor property.

There are many non-bankruptcy risk factors that explain the pricing spread on mortgages between investment properties and single-family owner occupied properties. The higher interest rates and points required on investor properties are explained by higher default rates on investor properties, the greater likelihood of investor properties being non-recourse, and the more limited secondary market for investor property mortgages. Investor properties have inherently greater default risk in part because an investor has the additional rent or mortgage expense that an owner-occupier does not. Investor properties also carry a variety of tenant risks—vacancy, non-payment, and damage. Because investor properties mortgages are often financed through rental payments, tenant risk adds to the default risk. There are myriad risk factors for investor properties that single-family owner occupied properties do not have. The MBA of all organizations should recognize that most, if not all, of the price spread between investor property mortgages and single-family owner occupied mortgages is due to factors other than bankruptcy modification risk. If the MBA revealed a non-cherry-picked comparison in its lobbying materials, its spurious 200 basis point claim would fall apart.

Based on my empirical analysis of a wide variety of mortgage market data,⁵ there is statistically a zero percent chance that the MBA's 150 basis point claim is correct. All empirical and market observational data indicates that that MBA's claim of an effective 150-200 basis point increase from allowing strip-down is groundless. The empirical evidence indicates that there is unlikely to be anything more than a *de minimis* effect on interest rates as a result of permitting bankruptcy modification.

⁴ At the January 29, 2007 Hearing on the Growing Mortgage Foreclosure Crisis: Identifying Solutions and Dispelling Myths, Before the Subcommittee on Commercial and Administrative Law, Committee on the Judiciary, United States House of Representative, David Kittle, the president-elect of the MBA claimed that prior to the enactment of the Bankruptcy Code there was no difference in interest rates for single-family owner-occupied principal residences and investor properties. The MBA has produced no data or other source to support this assertion, including in response to inquiries from major media outlets, and we know of no data source on interest rates that both goes back to 1978 and has rates broken down by property type. Indeed, the idea that investor properties and owner-occupied properties would ever be priced the same, even if there were no bankruptcy system whatsoever, ignores the significant default risk entailed in lending against investor properties caused by various tenancy risks.

⁵ See Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WISC. L. REV. (forthcoming).