Congress of the United States
Washington, DC 20515

February 23, 2009

BY FACSIMILE AND POST

The Honorable Timothy F. Geithner
Secretary of the Treasury
Washington, D.C. 20220

Dear Mr. Secretary,

Last Tuesday, February 18, 2009, the President and your department unveiled the "Homeowner Affordability and Stability Plan." One aspect of that plan is to allow judicial modifications of home mortgages during bankruptcy. While we have several reservations regarding bankruptcy modifications, we write regarding the particularly troubling effect such modifications will have on taxpayers, the federal government and the other elements of the Administration's plan.

Under the proposed revisions to the Bankruptcy Code, bankruptcy courts would be able to force reductions in mortgage principal (commonly called "cramdown"); prohibit, delay or reduce interest rate adjustments; reduce interest rates generally; and extend maturity dates up to 40 years from the date of mortgage origination. Although allowing for this type of modification in bankruptcy may have the short-term effect of lowering bankruptcy petitioners' monthly payments, it is certain to yield negative long-term consequences for taxpayers and the federal government that will dwarf any benefit to the economy that cramdowns might create.

First, the federal government and taxpayers will have significant exposure to the losses that will result from bankruptcy modifications, especially from cramdowns. Outstanding mortgage and debt guarantees from Freddie Mac and Fannie Mae amount to more than *$5 trillion*. The government and the taxpayers have enormous exposure for federal guarantees of mortgages made by troubled or failed lenders such as Citigroup, Bank of America, Indy Mac, and Washington Mutual, as well as for mortgage guarantees issued by the Federal Housing Administration (FHA), the Veterans Administration, and the Rural Housing Service. What is more, federal and taxpayer exposure to risks created by bankruptcy modifications are set to increase under the Administration's plan to subsidize private investors' purchases of troubled mortgage-backed assets.

In light of these federal guarantee obligations and other exposures, bankruptcy modifications will not, as advertised, simply redistribute losses from borrows to lenders. They will to a very great extent redistribute those losses in turn *from lenders to taxpayers*. This approach will produce a massive redistribution of wealth, and it will be a redistribution from responsible, accountable taxpayers to borrowers and irresponsible lenders who will not be held

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accountable. Making matters worse, this approach will overwhelm the taxpayer-protection features of the Homeowner Affordability and Stability Plan and produce an unfair competitive advantage for institutions, like Citigroup and Bank of America, which are disproportionately backed by federal mortgage guarantees. Frankly, the proposal appears to be moral hazard run amok.

Additionally, we are concerned that allowing bankruptcy modifications will severely undercut the federal government's efforts to restore the flows of credit necessary to support the nation's financial recovery. Principally, this is because widespread cramdowns of mortgages in bankruptcy will force downgrades of senior-tranche mortgage-backed securities held by banks and insurance companies. These downgrades will force financial institutions holding the securities to boost their capital reserves significantly. For example, a bank holding a AAA-rated security that has been downgraded to a BB rating will have to increase its associated capital reserves *tenfold.*

Standard & Poor's, Barclays, J.P. Morgan Securities, and others have all pointed to these effects,[1] which could cause financial institutions collectively to hoard *hundreds of billions of dollars* in additional capital reserves. This effect will freeze lending, jeopardize the solvency of many struggling banks, and negate the effects of the hundreds of billions of dollars that we committed to stabilize the financial system last October. As you recently stressed, efforts to stabilize the credit market and the housing market are intimately connected.[2] They cannot be successful if they work at cross-purposes.

The above are but two of the foremost problems that passage of the proposed bankruptcy legislation could create. Others include, for example, risk-related domino effects that will push up future mortgage interest rates and increase down payment requirements. These additional effects would make it harder and more expensive for borrowers to obtain new mortgages or refinance existing ones, including under programs that are part of the Administration's housing plan. As you have observed, homeowners who are already "underwater" have trouble refinancing.[3] We must be vigilant that efforts to help these homeowners do not at one and the same time pull refinancing out of the reach of other homeowners due to rising interest rates and down payment requirements.

We believe that these pitfalls can and should be avoided. As you have written, the Administration's plan must be crafted, at most, "to *carefully* change the bankruptcy law" for "hard-working families who have *run out of options*."[4] It should not mistakenly change the bankruptcy law in a way that can only fast-track troubled borrowers past the other loan modification options available to them and undermine other elements of the Administration's

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1 *See, e.g.,* Standard & Poor's, *The Potential Effect of Proposed Bankruptcy "Cram-Down" Legislation on U.S. RMBS*, *Ratings Direct* at 4, 9 (Jan. 30, 2009); Barclays Capital Research, *US Securitized Products Strategy* at 1-2 (Jan. 9, 2009); J.P. Morgan, *Securitized Products Weekly* at 11 (Jan. 23, 2009); Jody Shenn, *Bankruptcy Bill May Hurt Banks on Mortgage-Bond Quirk*, Bloomberg (Jan. 21, 2009) (available online at http://www.bloomberg.com/apps/news?pid=20601009&sid=abIxZqXis96s).

2 Timothy Geithner and Shaun Donovan, *Housing plan's aim: Help people help themselves*, USAToday (Feb. 19, 2009).

3 *Id.*

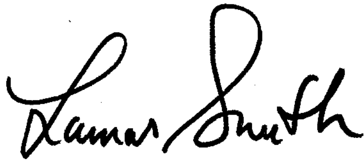
4 *Id.* (emphasis added).

housing plan and our collective efforts to resuscitate the credit markets. At the very least, this means that bankruptcy modifications should not apply to the roughly two-thirds of outstanding mortgages controlled or guaranteed by Freddie Mac, Fannie Mae, the FHA, and other federal entities. The federal government, by virtue of its strong position over these loans, should be able to effectuate or facilitate modifications without resort to judicial modification in bankruptcy. There is no reason to subject government-controlled and government-backed loans to judicial modification – and risk the enormous collateral effects on taxpayers and the lending market – when the federal government can force the modification of these loans outside of bankruptcy.

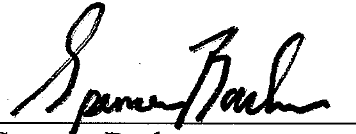
It is our hope that the Obama Administration will work with us in a bipartisan effort to narrow the proposed changes to the Bankruptcy Code. If it does, it can help to avoid the serious costs that bankruptcy modification will impose on taxpayers, the federal government and the broader economy. Because of the congressional schedule, we request you reply to this letter within 48 hours providing your thoughts on the issues we have raised.

We appreciate your prompt and timely consideration and responses.

Sincerely,



Lamar Smith
Ranking Member
Committee on the Judiciary



Spencer Bachus
Ranking Member
Committee on Financial Services

Trent Franks
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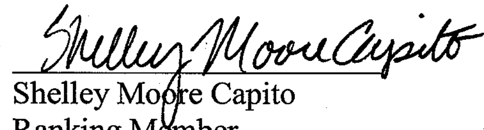

Shelley Moore Capito
Ranking Member
Subcommittee on Housing and Community Opportunity