Bond Case Briefs

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NYT: When Lenders Are Not Paid Back.

Much of the lending done in the United States relies on having both collateral and contractual obligations (loan covenants) that together provide the lender with assurance that the funds lent out will be repaid. Drivers falling behind on an auto loan, for example, will eventually find themselves without wheels — the car is the collateral. The house is likewise the collateral for a mortgage; lenders can foreclose on borrowers in default, though with rules that differ across states.

In financial markets, borrowers might pledge instruments like mortgage-backed securities as collateral for cash loans, whether for a term of years or just overnight. Rather than putting up physical assets as collateral, governments often instead promise to repay bondholders out of a dedicated stream of income like the tolls on a bridge or out of unspecified revenue from future taxes. The attraction of such collateralized borrowing is obvious for both sides, since the borrower generally can obtain funds at a lower interest rate than with an unsecured loan, in which lenders would typically find themselves back in the line for recovery in a bankruptcy proceeding if the borrower defaulted.

It is not surprising that a financial crisis involving trillions of dollars of bad loans led to legal conflicts and policy debates about the role of collateral and the sanctity of contracts. In several prominent cases, there have been disputes over the ability of lenders to enforce the terms set when the loan was made, including the ability to seize collateral. These include the 2009 automaker bankruptcies, Detroit's municipal troubles and, most recently, efforts to use the process regarding eminent domain to force mortgage write-downs.

These issues involve sometimes difficult trade-offs between the treatment of borrowers facing distress and the potential harm to future borrowers who will find their access to credit constrained if lenders cannot rely on the security of collateral or the sanctity of contracts. The varied resolutions of these debates over collateral and contracts thus have important economic implications for borrowers of all kinds, including businesses, governments and families, and for the overall economy.

It seems likely that people owed money by the city of Detroit will get less than promised. One of the many interesting elements in the city's bankruptcy proceedings is the treatment of the holders of general obligation bonds, which are $530 million out of the city's $18 billion in total debt. In the past, this type of municipal bond was considered relatively safe in that the borrowing authority was seen as having an implicit commitment to raise taxes as necessary to pay off the obligation. The proposal from Kevyn Orr, Detroit's emergency manager, however, would have these bonds paid back at only 20 cents on the dollar.

With Detroit city services already threadbare, and with Mr. Orr's bankruptcy proposal foisting losses on retired city workers and current employees through reductions in pensions and other benefits, it seems only fair for bondholders to share in the pain. This might seem especially the case when much of the loss would fall not even on bondholders, but instead on specialized companies that have collected premiums to provide insurance against just the possibility of such a municipal default.

Bond insurers are likely to file suit, but success by Mr. Orr in upending the heretofore accepted view of general obligation bonds could inflict considerable pain on other municipal borrowers, who might well expect to pay higher interest rates to investors nervous that one day other cities might follow Detroit's example. Indeed, several other cities in Michigan are reported to have delayed their bond sales out of concern over interest rates demanded by investors after Detroit's July 18 bankruptcy filing.

Even before the city's ordeal, the bankruptcy cases of Chrysler and General Motors likewise challenged notions of the sanctity of contracts and the security of collateral, with unintended negative consequences for other borrowers. Along the lines of the proposal by Mitt Romney on Nov. 19, 2008, the Obama administration put the two car companies through a managed bankruptcy with "post-bankruptcy financing" and assurance to "car buyers that their warranties are not at risk." (The quotes are from Mr. Romney's commentary on the Op-Ed page of The New York Times but apply precisely to the Obama bankruptcy plan.)

In carrying out the bankruptcies, the administration gained court approval for proposals that reversed the order of priority of the creditors' claims by giving better financial outcomes to junior creditors like funds controlled by some unions than to more senior creditors like banks that had lent to G.M. and Chrysler and investors who owned the two companies' bonds. Academic research has found that unionized companies faced higher borrowing costs relative to non-unionized companies for a year after the Chrysler bankruptcy filing, presumably reflecting the compensation demanded by lenders to put money at risk of being rearranged to favor the administration's political allies.

This research focused particularly on the financial market impact of government pronouncements and court decisions that were especially relevant to creditors' rights, like the announcement on April 26, 2009, that the government had agreed to give the United Automobile Workers a key stake in Chrysler even before striking a bargain with the more senior lenders, and the May 5, 2009, court decision that challengers to the bankruptcy proposal could not remain anonymous.

Other research has looked instead at the impact of announcements that revealed that the two companies would be bailed out and finds no evidence of an impact on borrowing costs. This differing result makes sense: lenders to G.M. and Chrysler might well have been heartened by the possibility that TARP funds would be used to prop up the two companies, since this could make it more rather than less likely that their loans would be repaid. Only the specific events that threatened the collateral or contracts would be expected to indicate concerns on the part of creditors.

The negative effects from the bankruptcy travails of the two auto companies and the home of their headquarters are relevant for the city of Richmond, Calif., which has sent letters to lenders offering to buy the loans on 624 homes at discount, with a looming threat to use eminent domain powers if the financial companies controlling the mortgages do not go along. Working with the firm Mortgage Resolution Partners, Richmond seeks to reduce the principal balance of the mortgages it acquires and allow homeowners to refinance into loans with lower payments with the aim of helping some families avoid foreclosure.

The idea behind the eminent domain proposal is that the mortgages involved are at considerable risk of default and are properly valued at a discount reflecting the costs involved with the foreclosure process; the threat of eminent domain is thus meant to prod a lender into accepting reality by writing down the loan to its fair value. The difficulty, of course, is determining this fair value. Many borrowers whose loans are involved in the Richmond proposal are actually still current on their mortgages. A lender might hesitate to take a write-down on a loan that so far is paying off.

Richmond faces a number of lawsuits seeking to stop its use of eminent domain, while the Federal Housing Finance Administration put out a statement indicating that it could order Fannie Mae and

Freddie Mac to cease doing business in areas “employing eminent domain to restructure mortgage loan contracts.” The Obama administration has stated that it is not clear that mortgages seized through eminent domain would qualify for refinancing through the Federal Housing Administration. With Fannie, Freddie and the F.H.A. together covering around 90 percent of new mortgages, a lack of access to these sources would greatly reduce the availability of mortgages for homeowners in Richmond.

Without government-supported financing, people seeking a mortgage in Richmond would need to find a bank willing to make them a loan and hold it on the bank’s balance sheet. It could be quite difficult to get a mortgage in a locale that uses the eminent domain power, since lenders will naturally hesitate to hold housing credit risk when there is uncertainty about the ability to collect on the collateral by foreclosing on a delinquent borrower rather than writing down the mortgage.

An important reason that mortgage rates are lower than interest rates on auto loans and credit cards is that a home provides reasonably good collateral for the lender (even when it can take years in some states to foreclose on residents who stop making mortgage payments). Use of eminent domain to seize mortgages could change this, just as other developments that weakened the value of collateral in the auto industry or the understanding of loan provisions in municipal finance have had unintended negative consequences for other potential borrowers.

If the effort in Richmond succeeds, the 624 homeowners involved and more in other cities that use the eminent domain approach will benefit from lower payments (and the investors in Mortgage Resolution Partners will see a payoff), but potential home buyers nationwide will be examined with a more jaundiced eye from their lenders than is now the case. Indeed, the reaction of financial markets to the Chrysler bankruptcy suggests that favorable court rulings or other such tidings could lead to higher mortgage interest rates nationwide even before the final outcome is known on the legality of this use of eminent domain.

Just as other municipalities in Michigan are finding it more difficult to borrow in the wake of Detroit’s proposal to change the historical understanding of its bond obligations, so too might American families face a steeper challenge as they look to become homeowners if lenders cannot count on homes’ standing as collateral behind mortgage loans.

By PHILLIP SWAGEL

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