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STRAIGHTENING OUT THE MORTGAGE MESS: HOW CAN WE PROTECT HOME OWNERSHIP AND PROVIDE RELIEF TO CONSUMERS IN FINANCIAL DISTRESS? (PART I)

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

SEPTEMBER 25, 2007

Serial No. 110–159

Printed for the use of the Committee on the Judiciary

Available via the World Wide Web: http://judiciary.house.gov

U.S. GOVERNMENT PRINTING OFFICE

37–978 PDF WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

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STRAIGHTENING OUT THE MORTGAGE MESS: HOW CAN WE PROTECT HOME OWNERSHIP AND PROVIDE RELIEF TO CONSUMERS IN FINANCIAL DISTRESS?

TUESDAY, SEPTEMBER 25, 2007

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCIAL
AND ADMINISTRATIVE LAW,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 3:53 p.m., in room 2237, Rayburn House Office Building, the Honorable Linda Sánchez (Chairwoman of the Subcommittee) presiding.

Present: Representatives Sánchez, Johnson, Lofgren, Watt, Cannon, Feeney, and Franks.

Staff present: Susan Jensen, Majority Counsel; Zachary Somers, Minority Counsel; and Adam Russell, Majority Professional Staff Member.

Ms. SÁNCHEZ. Okay. This hearing of the Committee on the Judiciary, Subcommittee on Commercial and Administrative Law will now come to order. And I will recognize myself for a short statement.

The skyrocketing foreclosure numbers are a sobering reminder of this Nation's growing mortgage crisis. What was once a small problem attributed to economically struggling areas is quickly becoming a national phenomenon.

In 2006, there were 1.2 million foreclosures in the United States, representing an increase of 42 percent over the prior year. And this year's numbers are looking even worse. Last month's foreclosures were 115 percent greater than those reported for August in 2006.

It is estimated that, between this year and next year, there will be a whopping $400 billion worth of mortgage defaults. As many as 2 million households may be at risk of losing their homes to foreclosure, a rate approaching that of the Great Depression. And economic conditions will worsen, given the fact that a substantial portion of subprime mortgages will reset their interest rates in the coming months.

We are in the middle of a mortgage meltdown. Falling real estate prices and a substantial change in the ease of obtaining loans are making it more difficult for overstressed homeowners to either refinance their way out of trouble or simply sell their homes. We need

to act quickly to shift the balance of power between borrowers and lenders. The question is how?

I was very pleased to join my colleague from North Carolina, Brad Miller, last week as an original co-sponsor of the Emergency Home Ownership and Mortgage Equity Protection Act of 2007. This measure goes to the very heart of the problem—protecting homeowners so desperate that they must file bankruptcy. H.R. 3609 allows, for the first time in nearly 30 years, a debtor in a chapter 13 case to reorganized his or her home mortgage obligations, just like any other debt. And unlike some proposals, it provides guidance to the courts in terms of how this restructuring may be done.

This legislation provides an important exception to the mandatory requirement that consumers receive credit counseling before they file for bankruptcy relief. The bill excuses a chapter 13 debtor from this requirement, if he or she submits to the court a certification that a foreclosure action has been commenced against the debtor's home. And this legislation provides important protections against lenders assessing excessive fees and hidden charges against chapter 13 debtors, who are trying to save their homes from foreclosure.

The Emergency Home Ownership and Mortgage Equity Protection Act is a measured response to the mortgage crisis, and one that I strongly support. I look forward to working with my colleagues on this Subcommittee, as well as the full Committee, to move this bill and explore other necessary reform.

It is my hope that today's hearing will provide an opportunity for us to gain a better understanding of the causes and possible solutions to the mortgage mess facing consumers and our economy. Accordingly, I look very much forward to today's hearing and to receiving the testimony from all of our witnesses.

At this time, I would now like to recognize my colleague, Mr. Cannon, the distinguished Ranking Member of the Subcommittee, for his opening remarks.

Mr. CANNON. Thank you, Madame Chair.

Home ownership has been one of the primary ways that American families have built wealth. Even during the rapid growth of the stock market in the 1990's, real estate continued to eclipse stocks as a share of most households' portfolios. In recent years, subprime lending has increasingly become a part of the mortgage industry, allowing even more families to build wealth through home ownership.

Subprime lending has greatly expanded the pool of credit available to borrowers who, for a number of reasons, would otherwise be denied credit. Subprime lending has benefited a great number of borrowers—borrowers who otherwise would not have been able to achieve the dream of home ownership.

The benefits of subprime lending have not come without their negatives, of course, which is why we are here today. It appears that we are currently facing two problems. One, how to help homeowners avoid foreclosure and stay in their homes; and two, how to store liquidity and stability to the full mortgage market and other credit markets.

Several legislative proposals have been made that claim to fix the first problem through amendments to the bankruptcy code. Ini-

tial analysis suggests, however, that these proposals will not only serve to exacerbate the second problem. Significantly changing chapter 13 as it applies to home mortgages has the potential to restrain the flow of capital in the home lending market.

Reducing liquidity will not only have a broad influence on the housing market in general, but it will reduce the availability of credit to Americans that desperately need it. In other words, it appears that the proposals being floated to help consumers may actually have the opposite effect. This is because allowing mortgages to be modified or rendered unsecured through bankruptcy will make it far more difficult to originate or sell mortgages in the secondary market.

The proposed changes to the code introduce substantial risks that the terms of loans will be changed in unpredictable ways. Accordingly, lenders will be forced to increase the costs of mortgages to reflect the additional risk.

As groups such as the U.S. Chamber of Commerce and the National Association of Homebuilders have pointed out, these problems would reduce liquidity and make it harder for Americans to obtain a new mortgage or refinance their existing mortgage—the exact opposite of what the mortgage market needs now.

While it makes common sense to help families save their homes, these proposals may have the exact opposite effect. And they may make it difficult for families to purchase homes in the future. The proposals that have been circulated thus far have little to do with helping families facing default on their mortgages because of subprime loans. The proposals have not targeted the problem. For example, seven of 11 provisions of Senator Durbin's Helping Families Save their Homes Act have nothing to do with mortgage finance. And those provisions that do deal with mortgage finance applied to all mortgages, not just true subprime loans made to marginal borrowers.

We are committed to working to make sure that American families are able to weather the current downturn and the problems associated with subprime mortgages. Members of the minority are working in a bipartisan fashion on Committees on both sides of the Capitol to craft solutions to the mortgage crisis.

But whatever solutions we come up with, we must remember that broad legislation aimed at the primary residence exception in chapter 13 affects not only those borrowers facing default from rising interest rates on subprime loans, but future prime and subprime borrowers as well. Reform of the primary residence exception does not occur in a vacuum. We must resist the urge to place the cost of the downturn on the backs of the lenders, simply because they are easy targets. No one questions that they share the blame. However, saddling lenders with the cost will merely cause lenders to shift that cost to future borrowers in the form of higher risk premiums.

I look forward to the testimony today and hope that the witnesses will keep in mind that this issue, like other issues in bankruptcy, involves the balancing of many competing interests. I hope the witnesses can help shed light on where we should strike the balance regarding the primary residence exception, or whether the proper balance has already been struck.

Thank you, Madame Chair. And I yield back.

Ms. SÁNCHEZ. Thank you. I thank the gentleman for his statement. But now, at this time, I would like to recognize Mr. Johnson for his opening statement.

Mr. JOHNSON. Thank you, Madame Chairwoman. Madame Chair, the cornerstone of the American dream has always been to own a home. Some versions of the dream feature a white picket fence and two-car garage. Some may have a large yard with a swing set and toys scattered around. But whatever the dream entails, and sometimes it can be a condominium or a town home, but whatever that dream entails, it always features home ownership.

And that dream now is quickly vanishing and becoming a nightmare for many people who have turned to subprime loans to obtain that goal. And many people have not just turned to them, they have been steered into them. What was once a niche product, subprime loans have taken a significant share now of the mortgage market. Combined with lax practices, lack of monitoring, aggressive marketing and disproportionate targeting, these loans have mushroomed into a mortgage crisis that has not only reverberated in this country, but also in the international markets.

This hearing comes at a time, Madame Chair, when the State of Georgia, where I hail from, has experienced the second highest rate of home mortgage foreclosures in the country, with one out of every 299 homes being reclaimed by the lender. The ripple effect of Georgia's foreclosure rate has not only affected home and resale values, but even school enrollment, which threatens the budgets of school systems.

In a recent article in the *Atlanta Journal-Constitution*, about 10,000 fewer students than expected enrolled in Atlanta's school system this year. When there are maybe up to 2 million households in our Nation on the verge of losing their homes this year, it is imperative that Congress steps in. I plan to offer legislation that would eliminate some of these onerous provisions of the bankruptcy law that only act as another hurdle to receiving relief.

But I thank the Chairwoman for holding this hearing to find some relief for those under the weight of subprime mortgages—those families who are being crushed under the weight of these subprime mortgages. The Administration has taken credit for putting more families in homes. But if Congress doesn't step in right away, many will soon face the streets.

Thank you, Madame Chair. And I yield back.

Ms. SÁNCHEZ. I thank the gentleman for his opening statement.

And the gentleman from Florida, Mr. Feeney, is recognized for his opening statement.

Mr. FEENEY. I thank the Chairwoman. And I don't think there is anybody that doesn't have sympathy for a homeowner that has been devastated, either by the subprime loans and teaser rates, or because their home has lost value, or because they lost their job, perhaps through no fault of their own—maybe a health reason. And in America, the way we do it is to give people a second chance. And so I support bankruptcy opportunities for relief.

But I also want to make sure the law of unintended consequences doesn't hurt a lot more people than we are trying to help. The primary cause of the housing bubble is excess liquidity

and the fact that there were very little checks at the table for a lot of closings going on.

Virtually everybody at a closing table makes money, whether a good loan is made or not. The attorney that closes the loan—the surveyor gets paid. The appraiser gets paid. The real estate agent gets paid. The mortgage broker gets paid. Lots of other people get paid. And ultimately the two people affected are the people that hold the loan when it's—by the way, typically the bank and the original lender gets paid, because they have repackaged the loan into the secondary market.

So it is whoever ends up with the loan that is affected. And I don't feel bad for any of those people particularly. They, in return for high returns on capital investments, took risks. I feel terribly bad for homeowners that, in some cases, were sucked into loans that they simply could not afford. I think we all share a lot of those sentiments.

But let me warn you where we are in the housing market today. I used to close a lot of real estate loans. I used to represent some real estate developers, builders, homeowners, buyers, purchasers. Liquidity has dried up. It is making it very difficult to sell a home, unless you happen to be fortunate to have huge amounts of equity in your home. When liquidity dries up, it means that there are fewer home purchasers available, because there are fewer dollars available to make loans.

The market has over-corrected. What used to be too loose with capital now is too tight in many places. And you are going to see the market, in and of itself, require higher down payments, tougher credit checks, more restrictions on the people that they tend to loan to, and higher interest rates—certainly a lot fewer teaser rates.

If you add, at a time of tough, tight liquidity in the housing market, another risk to the lender—that is that a bankruptcy judge is going to come in and to take away some of their secured equity, which is what some of these proposals do—you are going to affect not just the homeowners that are worried about foreclosure today. You are going to affect every homeowner out there that would like to one day sell their home, or a second home, or an investment property. And you are going to affect every potential buyer out there by making it more difficult for them to get credit.

The market is correcting itself. In fact, it is probably over-corrected. And when you add a huge risk to a lender on top of the burdens that the lending community is already suffering, you potentially will elongate the period of time before the housing market becomes stable again. You may throw states like Florida, and perhaps the country, into a recession. And you may infect other parts of the American market with a depression.

So let us be careful that the horses slow down. The free money ride in the mortgage loan market has stopped. And it is over-corrected. The horse is barely walking or moving now. If you are going to shoot it, just be aware of what you are doing is the only advice I have to my colleagues.

And with that, I will yield back the balance of my time.

Ms. SÁNCHEZ. Thank the gentleman.

In the interest of time, I am going to say that, without objection, other Members' opening statements will be included in the record.

Without objection, the Chair will be authorized to declare a recess of the hearing at any point.

[The prepared statement of Mr. Conyers follows:]

PREPARED STATEMENT OF THE HONORABLE JOHN CONYERS, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN, CHAIRMAN, COMMITTEE ON THE JUDICIARY, AND MEMBER, SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

I don't think there is any doubt that we are in the middle of a major economic crisis that will undoubtedly worsen over the next year or longer. This mortgage mess, as the title of today's hearing aptly notes, is jeopardizing the financial stability of American families across our Nation.

Just last week the Administration, which initially tried to downplay this crisis, finally acknowledged that *500,000 homeowners*—one-quarter of the two million Americans who have subprime mortgages scheduled to reset to higher interest rates over the next 18 months—were likely to lose their houses.

Sadly, there's another statistic we must acknowledge. According to the Congressional Research Service, subprime loans are disproportionately used by the elderly and members of minority groups. And, even more disturbing, there is evidence that "minorities who could qualify for cheaper prime loans are sometimes borrowing in the more expensive subprime market." If there is any doubt about that, you are more than welcome to visit Wayne County, Michigan, which earlier this year had the highest rate of home foreclosures among all other major metropolitan areas in the United States. In fact, the state of Michigan ranked fourth highest in the Nation in the number of foreclosure filings last month.

Today's hearing will undoubtedly shed some light on such important issues as to how did we got into this mess and who is to blame. But, I really hope this hearing will yield real and immediate solutions to this crisis. I will suggest at least three.

First, a homeowner in financial distress should be able to use bankruptcy to reorganize *all* of his or her debts. There is absolutely no reason to retain the current prohibition that prevents Chapter 13 debtors from modifying their home mortgages as part of a repayment plan.

Second, we should establish a homestead exemption floor for debtors over 55. Without this protection, many elderly debtors cannot use bankruptcy to save their homes if the equity in their homes—often representing their entire life savings—exceeds the low homestead exemptions allowed in some states.

Third, we should eliminate the various pitfalls and onerous requirements created as a result of the 2005 Amendments to the Bankruptcy Code. As we have heard at hearings held earlier this year, many of these new requirements simply serve as "gotchas" to catch the unwary and ill-advised consumer debtor.

Home ownership is one of the most important goals that all Americans should be able to aspire to in this Nation. That goal, however, is under siege right now and we need to act immediately.

Ms. SÁNCHEZ. I now would like to recognize the gentle lady from California, Ms. Lofgren, who wanted the honor of introducing our first witness.

Ms. LOFGREN. Thank you, Madame Chairwoman. It is indeed an honor to introduce our first witness, the Honorable Marilyn Morgan. Judge Morgan was appointed on June 16, 1988, to the United States Bankruptcy Court in the Northern District of California. She is a frequent participant in programs sponsored by the Bankruptcy and Commercial Law Section of the Santa Clara County Bar Association, the Bay Area Bankruptcy Forum, the California Bankruptcy Forum and the National Association of Bankruptcy Trustees.

Judge Morgan is a member of the National Conference of Bankruptcy Judges. And on a personal note, I have known Judge Morgan since the mid-1970's, before either one of us held a public office. We volunteered together on many county bar association committees. And she was known at that time as one of the most skilled lawyers in our bar association—known as really a scholar, someone

with integrity and a hard worker. And that reputation has carried forward to the bench.

She is respected nationwide for her expertise in bankruptcy. And it is just a delight to see Marilyn Morgan here today. And I thank the gentle lady for allowing me to introduce my friend.

Ms. SÁNCHEZ. Thank you.

And welcome Judge Morgan.

Our second witness is former Congressman Steve Bartlett. Mr. Bartlett is the president of Financial Services Roundtable. He served as a Member of Congress for the Third District of Texas from 1983 to 1991, and as mayor of Dallas, Texas from 1991 to 1995. I will admit that this is the second time that Congressman Bartlett has testified before this Subcommittee during this congressional session. So we welcome you back. The first was during the bankruptcy oversight hearing. It is good to have you again with us. And we appreciate your time in coming.

Our third witness is Mr. Eric Stein. Mr. Stein is president of the Center for Community Self-Help, a non-profit community development lender. And he serves as chief operating officer for Self-Help and its affiliates. He was formerly the executive director of CASA, a non-profit organization that develops housing for primarily homeless persons with disabilities. Prior to CASA, Mr. Stein worked for Congressman David Price.

Welcome.

And our final witness is Mr. John Rao. Mr. Rao is an attorney with the National Consumer Law Center, Incorporated. He focuses on consumer credit and bankruptcy issues and has served as a panelist and instructor at numerous bankruptcy and consumer law trainings and conferences. Before coming to NCLC, Mr. Rao served as a managing attorney of Rhode Island Legal Services and headed the program's consumer unit.

And I want to welcome you all today to the Subcommittee. Without objection, your written statements in their entirety will be placed into the record. And we are going to ask that you limit your oral remarks to 5 minutes.

For those of you who have not testified before Congress before, there is a lighting system. It will turn green when you are to begin your testimony. Four minutes into your testimony, you will get the yellow warning light. At the end of the 5 minutes, you will get the red light, letting you know that your time has expired. If you are mid-sentence, we would just ask you to complete your thought, so that we could move on to our next witness.

After each witness has presented his or her testimony, Subcommittee Members will be permitted to ask questions subject to the 5-minute rule. At this time, I would invite Judge Morgan to please proceed with her testimony.

TESTIMONY OF THE HONORABLE MARILYN MORGAN, UNITED STATES BANKRUPTCY COURT, NORTHERN DISTRICT OF CALIFORNIA, SAN JOSE, CA

Judge MORGAN. Chairwoman, Zoe Lofgren, and Members of the Subcommittee, I very much appreciate the opportunity to appear before you today on this most important subject. And I also appre-

ciate the significant thought that clearly all of you have put into the subject.

My jurisdiction covers Silicon Valley. This economic engine and its high housing costs is very different from the other end of my jurisdiction, Salinas, which is the salad bowl of the United States. It has a large population of farm workers.

In the nearly 30 years that I have worked with the Bankruptcy Code, I have seen many different industries go through economic downturns that have resulted in the filing of bankruptcies by large numbers of consumers. This is the first time in my memory, however, where the framework of the Bankruptcy Code provides no remedy for those in the most critical economic distress—those facing the imminent foreclosure of their homes.

In preparation for my testimony, I was able to meet with about a dozen lawyers from Salinas and San Jose, who are on the front lines, grappling with the issues you are considering. I asked them about the willingness of home lenders to modify loan terms to enable their clients, the distressed homeowners, to save their homes from foreclosure.

They told me that, in contrast to the talk about voluntary forbearance, the reality is that lenders have been unwilling to offer workouts to these debtors. They tell me that homeowners don't return phone calls. Or they keep debtors and attorneys hanging around for an answer, while a foreclosure sale date approaches. Among the attorneys that I spoke with, not one could report a single meaningful workout with a home lender.

I heard many heartbreaking stories, though, when I talked with these attorneys. I heard about hard-working Americans with real emotional investments in their homes and in the American way of life. I heard that these people have lost hope. Worse, because of the strong family culture in many of these ethnic communities, whole families—the aunts, the uncles, the grandparents—are being financially tapped out in an effort to save a home from foreclosure. I heard about grown men crying in their attorneys' offices.

Every week, I hold a court calendar where lenders seek authority to proceed with foreclosures. This calendar historically has been actively contested with lawyers and their clients going through the emotional experience of fighting to save a family home, and trying to come up with a plan to cure the defaults. Now, however—and this has been true for the past 6 months—90 percent of these motions go unopposed by debtors; because there is no remedy available in my court. And there is no hope for these homeowners.

Too many homeowners find that, even if they could cure the default, they can't afford the terms of the loan going forward because of the steep increase in the interest rate or other changes in the terms of the loan. Congress is in a unique position to alter this reality. And I believe you can do so with a very narrowly targeted change to the Bankruptcy Code that will help families avoid foreclosure.

As others have pointed out, under the Bankruptcy Code, a mortgage on the debtor's residence is the only debt that the bankruptcy courts cannot modify. And the home is the only asset that can't be protected. The Bankruptcy Code already provides relief for those whose loans on investment properties or on second homes have got-

ten them into financial trouble. But this relief doesn't extend to the working and middle-class families who are seeking to protect their residences.

The mortgage market today is very different than it was in 1978, when this provision was included in the Bankruptcy Code. Through the 1970's and the early 1980's—and you all probably remember this—fixed interest rate loans, with relatively low loan-to-value ratios, were the rule. Today's mortgage market is dominated by these so-called exploding ARMs, where monthly payment increases and double within a year or two, even as interest rates and the overall economy remain constant. These loans have left many borrowers with payments they cannot afford and mortgages that exceed the value of their homes.

One question I have to ask myself is what the impact of the proposed changes will be on the courts. Clearly there are a lot of abusive loans in my jurisdiction. And if Congress enacts this legislation, there will be a lot of work to be done. On the other hand, bankruptcy judges are trained to value property. And we are trained to determine appropriate interest rates. This is what we do.

I don't like to think that we are unpredictable. I think that, if you implement this proposed legislation in a way that allows us—if you give us clear standards in the legislation, our job is easier. And the process will be more efficient. The results will be more predictable for both lenders and borrowers. I think that your legislation can be consistent with the types of roles that we fulfill and will help improve the system.

Let me say that, speaking for myself, it bothers me to see a wrong without a remedy, and to work within a legal system that is not responding to the needs of the community. As judges, all we have is time. It is just a question of understanding our priorities. And we look to you to help establish those priorities.

Ms. SÁNCHEZ. Judge Morgan——

Judge MORGAN. Thank you.

Ms. SÁNCHEZ. Regrettably, your time has expired.

Judge MORGAN. Thank you. I am sorry.

[The prepared statement of Judge Morgan follows:]

PREPARED STATEMENT OF THE HONORABLE MARILYN MORGAN

Chairwoman Sánchez, Ranking Member Cannon, and Members of the Subcommittee, I am honored to have the opportunity to address you on this most important subject.

My name is Marilyn Morgan. I have served as a bankruptcy judge seated in San Jose, California for the past 19 years. My jurisdiction covers Silicon Valley, with its economic engine and high housing costs, and Salinas, the salad bowl for the nation, with its large population of migrant farm workers.

In the nearly thirty years that I have worked with the Bankruptcy Code, I have seen many different industries go through economic downturns that have resulted in the filing of bankruptcies by large numbers of consumers. This is the first time in my memory, however, where the framework of the Bankruptcy Code provides no remedy for those in the most critical economic distress—those facing the imminent foreclosure of their homes.

Nationwide, the home foreclosure rate doubled in the last year. And, according to statistics reported by RealtyTrac (an Irvine, CA real estate company), California's foreclosure rate is now second only to Nevada's. California's foreclosure filing rate in August 2007 reached one in every 224 households—twice the national average. This is a 363 percent increase from the same month a year before. In the semi-rural counties where I sit (San Benito, Monterey, and Santa Cruz), there are currently more than 1,350 homes in the process of foreclosure, and close to 800 that were re-

cently sold in foreclosure. In Santa Clara County, where San Jose is situated, nearly 4,000 homes are currently in foreclosure, and nearly 1,000 recently were sold in foreclosure. This is only the tip of the iceberg. As others have documented, the foreclosure problem is likely to get worse very soon.

A look at the bankruptcy filings for the same community shows a significant increase. In August 2007, there were 413 bankruptcy filings in the San Jose Division—the highest number of bankruptcy filings since the Bankruptcy Abuse Protection and Consumer Protection Act went into effect in October 2005. But clearly, the thousands of homeowners facing foreclosure are not filing for bankruptcy protection because the Bankruptcy Code provides no remedy.

In preparation for my testimony before you, I met with a dozen lawyers from Salinas who are on the front lines grappling with the issues you are considering today. I asked them about the willingness of home lenders to modify loan terms to enable distressed homeowners to save their homes from foreclosure. They told me that, in contrast to the "talk" about voluntary forbearance, the reality is that lenders have been unwilling to offer workouts to debtors who are losing their homes. Home lenders either don't return phone calls at all, or they keep debtors and their attorneys hanging without an answer as the foreclosure sale date fast approaches. Among the attorneys I spoke with, not one could report a single meaningful workout with a home lender.

I heard many heartbreaking stories when I talked with the attorneys. Hard-working Americans with a real emotional investment in their homes and the "American way of life" have lost hope. Because of the strong family culture in many ethnic communities, whole families are being financially tapped out in an effort to save a home from foreclosure. I heard of grown men crying in their attorneys' offices.

And, while some home foreclosures are due to purchases with 100 percent+ financing, many others are losing homes they have owned for years. Some of these debtors refinanced their homes in order to pay off credit cards or make home repairs. The fine-print and confusing mortgage loan provisions are beyond the comprehension of many borrowers. The attorneys I met with described many instances in which loan brokers had "explained away" homeowners' questions about how the payments on a new loan would work with reassuring but misleading statements that any payment or interest rate increases noted on the paperwork would be avoided in the future.

Every week, I hold a court calendar where lenders seek authority to proceed with foreclosures. This calendar historically has been actively contested, with lawyers and their clients going through the emotional experience of fighting to save the family home and come up with a plan to cure a default. Now, however, ninety percent of the motions to foreclose go unopposed by the debtors, because there is no remedy available in my court and no hope for the homeowners. Too many homeowners find that even if they could cure the default, they can't afford the terms of the loan going forward because of the steep increase in the interest rate or other changes in the terms of the loan.

One such case involved an elderly couple who were persuaded to refinance the residence they had owned for many years in order to replace all their windows—a not uncommon situation affecting older homeowners who have been subjected to aggressive marketing pitches. The thousands of dollars for windows and high origination fees significantly increased their mortgage. To the homeowners, it looked like a very good deal because their monthly payments even went down a little bit. What they didn't understand was that the decreased payments were based on negative amortization, resulting in the mortgage actually increasing rather than being paid down over time. In order to just keep even with the interest, the monthly payment was almost twice the negatively amortized payment—and well beyond their financial capability. With falling home values, they cannot refinance their home. Because of the current bar in Chapter 13 to the restructuring of home mortgages, this couple has no remedy to prevent the loss of their home.

Congress is in the position to alter this reality. You can do so with a narrowly targeted change to the Bankruptcy Code that will help families avoid foreclosure.

As others have previously pointed out to this Subcommittee, under the Bankruptcy Code a mortgage on the debtor's residence is the *only* debt that the bankruptcy courts cannot modify, and the home is the only asset that cannot be protected in this way. The Bankruptcy Code does provide relief for those whose loans on investment properties or second homes have gotten them into financial trouble, but this relief does not extend to the working and middle-class families who are seeking to protect their residences.

The mortgage market today is very different than it was in 1978, when this provision was inserted in the Bankruptcy Code. Throughout the 1970s and early 1980s, fixed interest rate loans with relatively low loan-to-value ratios were the rule. Sub-

prime lending has increased significantly in recent years, and today's mortgage market is dominated by so-called "exploding" ARMs, where monthly payment increases can double within a year or two, even as interest rates in the overall economy remain constant. These loans have left many borrowers with payments they cannot afford and mortgages that exceed the value of their homes.

Without being able to restructure these debts, borrowers cannot save their homes and get back on their feet financially. If Congress addresses this serious problem by enacting legislation to permit Chapter 13 debtors to modify mortgages on their primary residence, many thousands of homeowners throughout the nation may be able to avoid the loss of their homes. It is my experience that a home is the largest and most important asset a family has, and the mortgage loan is the family's largest single debt. The exclusion of the principal residence from modification prevents bankruptcy protection from reaching where it is needed most.

One question I have to ask myself is what the impact of the proposed changes will be on the courts. Clearly, there are a lot of abusive loans in my community and if Congress enacts this legislation, there will be a lot of work to be done. On the other hand, bankruptcy judges are trained to value property and to determine appropriate interest rates. This is what we do. Implementing the proposed legislation will be consistent with the scope of our current duties. And, if clear standards are provided in the legislation, our job will be easier, the process more efficient, and the results more predictable for both lenders and borrowers.

Speaking for myself, it bothers me to see a wrong without a remedy and to work within a legal system that is not responding to the needs of the community. As judges, all we have is time. It's just a question of understanding our priorities, and we look to you to establish those.

In closing, let me say that I appreciate the opportunity to testify before you today. I am happy to answer any questions you may have.

Ms. SÁNCHEZ. It goes very quickly. Thank you for your testimony.

At this time, I would like to invite Mr. Bartlett to present his testimony.

TESTIMONY OF THE HONORABLE STEVE BARTLETT, THE FINANCIAL SERVICES ROUNDTABLE, WASHINGTON, DC

Mr. BARTLETT. Madame Chair, and Ranking Member Cannon, and Members of the Subcommittee, my name is Steve Bartlett. I am president of Financial Services Roundtable, which represents about 100 companies that have 65 percent of the residential mortgages that are made in this country.

The topic of the hearing today, it seems to me, is not about mere technical points of bankruptcy law. In reality, I think that this hearing is about whether Congress would consider converting secured debt into unsecured debt through well-intentioned changes, but I think disruptive changes, in the bankruptcy process.

Such an action would not only not help homeowners, but would in fact make things much worse for today's homeowners and, more importantly, for millions of future borrowers, who could be frozen out of the opportunity to buy homes themselves. Those with less than perfect credit would be priced out of home ownership. And even those with perfect credit would pay higher rates.

Let me hasten to say that I do appreciate the good intentions of the Chair and Members of the Subcommittee. I realize that this is a difficult time we are experiencing. And there is a tendency to want to do something. But unfortunately, opening the bankruptcy law to convert secured debt to unsecured debt would do more harm than good.

Now, the good news is that there is some good news on the home mortgage front, although admittedly it doesn't always feel like it. Beginning in early summer of 2007, our lenders began con-

centrated efforts to call, to reach out, to call every single borrower in the subprime mortgage prior to a reset, and to help borrowers and to modify those loans on an unprecedented scale. Now, this is the end of September. And that began to be happening in an aggressive way in June.

Also, chapter 13 is working to save homes. It has been estimated that chapter 13 is successful in stopping foreclosures in some 97 percent of the cases. And that is with the current law.

So my testimony today will focus on five items. First, I wanted to share with you affirmative steps that lenders are taking at this time to contact borrowers and modify home mortgages. Second, I will describe an industry initiative called HOPE. I actually brought the chart that has provided the opportunity for free counseling to over 120,000 homeowners so far—about half of those with significant outcomes being able to keep their homes.

Third, I will discuss developments in the securitization industry that also brings some good news. Again, recent developments—and I have entered some of those into the record—to provide some needed flexibility to modify the home mortgages. Fourth, some evidence that indicates that chapter 13 is in its current form is a very successful law. And last, I will address some of the specific bankruptcy proposals in the recently introduced legislation.

Madame Chair, let me state that I have 5 minutes to do all that. So most of that will be in my written testimony, which is submitted for the record.

Ms. SÁNCHEZ. Certainly.

Mr. BARTLETT. Let me start with Roundtable member companies. I will tell you today that every single company that I represent—there are some 65 percent of the market—are actively working to contact their borrowers, particularly with those facing adjustable rate mortgages, resets.

We are calling every single subprime borrower, every single one, writing them letters. Some of our companies are actually going to their—door to door, if they can't reach them, to try to reach those borrowers before the reset. Some of our companies are starting 6 months before the reset. And they all start 60 days before the reset.

And they are offering forbearance. They are offering loan modification. And they are offering to work with the borrower in some way to try to modify to meet the current income. It doesn't always work, because foreclosures and inability to make your payment is due to a lot of factors. But it is working in about half of the cases of the people that we can reach. One of my messages today is to everyone that you talk with, please invite them to contact their lender or contact our independent counselors; because the worse solution is a foreclosure. And it can be prevented in virtually every single case.

I do take note of Judge Morgan's testimony, meeting with a group of attorneys. And let me state that some of that is perhaps dated information. Some of it is because of the nature of people that have then stopped talking with their lenders or never did. And they reached their attorneys. But I do offer, to any of those attorneys or others, to call me directly, to call our organization, to call this number. And we will work with them.

For those borrowers who are unable to make their mortgage payments, and where refinancing is not an option, lenders have adopted loss mitigation efforts to help them avoid foreclosure in every single case, to include forbearance agreements, loan modifications, enhanced counseling programs, reduced payment amounts, lowering interest rates, and extending the terms of the loans to subprime borrowers.

Madame Chair, I will submit the balance of my testimony for the record and be prepared for questions on any of the testimony. Thank you.

[The prepared statement of Mr. Bartlett follows:]

PREPARED STATEMENT OF THE HONORABLE STEVE BARTLETT

Good morning Madam Chair, Congressman Cannon and Members of the Subcommittee. I am Steve Bartlett, President and CEO of The Financial Services Roundtable. I appreciate the opportunity to testify before the Subcommittee today.

The topic of this hearing is not about mere technical points of bankruptcy law. In reality, this hearing is about whether Congress will consider converting secured debt into unsecured debt through changes in the bankruptcy process. Such an action would not only NOT help homeowners, but would in fact make things much worse both for today's homeowners, but, more importantly, for future borrowers. Those with less than perfect credit would be priced out of homeownership, and even those with perfect credit would pay higher rates.

Let me hasten to say I do appreciate the good intentions of the Chair and members of the Subcommittee. I realize that with the difficult time we are experiencing, there is a tendency to want to do something. Unfortunately, opening the bankruptcy law to convert secured debt to unsecured does a lot more harm than good.

The good news is there is good news on the home mortgage front. Companies are reaching out to help borrowers in trouble on an unprecedented scale. And Chapter 13 is working to save homes. According to one prominent bankruptcy practitioner who represents homeowners, Chapter 13 is successful in stopping foreclosures in 97% of cases. This means Chapter 13 is highly successful. I am reminded of the old adage, "if it isn't broken, don't fix it."

My testimony today will focus on five items. First, I will discuss affirmative steps lenders are taking at this time to contact borrowers facing interest rate resets. Next, I will describe an industry initiative called HOPE that has provided the opportunity for free counseling to over 120,000 homeowners, often with significant successful outcomes. Third, I will discuss developments in the securitization industry that will create much-needed flexibility to modify mortgage loans. Fourth, I will simply cite some evidence that indicate Chapter 13 in its current form is a very successful program which should be continued. And finally, I will address some of the specific bankruptcy proposals in the recently-introduced legislation, HR 3609.

The Roundtable, through our Housing Policy Council which represents over 65 percent of originated mortgages in the United States, has not been sitting idly by as some borrowers have begun to face difficulties. We have been working to develop proactive strategies to prevent foreclosures. We believe that no one wins from a foreclosure.

There is not much positive in the press about subprime mortgages and foreclosures. Hopefully, the Fed's recent decision to cut interest rates may eventually lessen the credit crunch and help homeowners facing interest rate resets later this year. But I would like to share some more immediate good news.

Because Roundtable member companies, and all responsible lenders, want customers to be successful, major national lenders and servicers are actively working to contact their borrowers, particularly those facing adjustable rate mortgage resets. In addition, we are helping our customers through a national partnership with NeighborWorks(r) America and the Homeownership Preservation Foundation. It is estimated that about 50 percent of homeowners facing foreclosure never contact their lender. Our members are trying to overcome that challenge through active efforts to reach out to their borrowers. Our members are aggressively adopting new programs and products to address the specific difficulties subprime borrowers may have, with a particular focus on those with adjustable rate mortgages in this challenging interest rate environment and the slowing housing market.

Our members are taking action to offer options before a borrower is in default that are designed to ensure that borrowers are in the best possible position to an-

ticipate and manage the challenges they may face with upcoming payment adjustments.

These actions include proactively contacting borrowers through a variety of channels—direct mail, email, interactive websites, inbound and outbound calling up to six months in advance of rate adjustments—to let them know of affordable refinance opportunities or of mutually agreeable payment plans that will keep borrowers in their homes.

For those borrowers who are unable to make their mortgage payments and where refinancing is not an option, lenders have adopted loss mitigation efforts to help them avoid foreclosure. These efforts include forbearance agreements of varying lengths (up to 12 months in some cases), loan modifications, enhanced counseling programs and increased staffing to assist customers. With regard to loan modifications, lenders are reducing payment amounts, lowering interest rates and/or extending the terms of the loans held by subprime borrowers.

For those borrowers who are reluctant to contact their lender or are just not aware of the options open to them, industry participants, led by the member companies of the Roundtable's Housing Policy Council, have formed a national foreclosure prevention partnership with NeighborWorks(r) America and the Homeownership Preservation Foundation, to reach out to these homeowners in trouble and offering them help.

This national partnership is based on the successful Chicago Homeownership Preservation Initiative (HOPI), an innovative partnership between the City of Chicago, the Federal Reserve Bank of Chicago, the Neighborhood Housing Services of Chicago, the Homeownership Preservation Foundation and several lenders who worked together to tackle the city's foreclosures. By all measurements, this program has been a success. In the year of the program, over homeowners 4,000 in the Chicago test market received counseling, over 1,300 families avoided foreclosure, and the program resulted in $267 million in collective savings for the City of Chicago, its homeowners and HOPI lender partners. We have expanded these successes on a national scale.

Building on the successful Chicago HOPI program, the Housing Policy Council and fifteen of its member companies have partnered with Fannie Mae, Freddie Mac, the Mortgage Bankers Association, other lenders, and respected national non-profits, NeighborWorks® America and the Homeownership Preservation Foundation, in a national foreclosure prevention campaign.[1] All participants are united in the goal of helping homeowners avoid foreclosure whenever possible. Through this new and innovative program, our member companies are taking exceptional measures to help any homeowner who is experiencing a financial crisis and potential foreclosure.

Free phone counseling is available, which can be reached by dialing the Homeownership Preservation Foundation's hotline, 888-995-HOPE. Every counselor is an independent specialist in foreclosure prevention, certified by the Department of Housing and Urban Development. When it is appropriate, the counselor acts as an intermediary on behalf of the homeowner, contacting their lender and discussing options available. Free in-person counseling is also available through local NeighborWorks® affiliates. The hotline is now available in all 50 states and Puerto Rico and bilingual services are available. In June 2007, the Ad Council introduced a new campaign promoting the Homeowners' Hope hotline in television, radio and print advertisements. The tag line of the campaign is a message I cannot emphasize enough: if you are in financial difficulty, call the hotline for help because "nothing is worse than doing nothing."

In 2006, over 48,000 homeowners called the HOPE Hotline while in 2007, counselors have already fielded over 80,000 calls from at-risk homeowners, with almost 40,000 of those completing counseling. The average daily call volume in August was 1600. Nearly half of those counseled have avoided foreclosure either through a loan modification or pre-foreclosure home sale. That is, over 120,000 Americans have had the opportunity for free counseling and about 60,000 borrowers have been able to stop a foreclosure. The Homeownership Preservation Foundation is seeing some significant trends in callers from July and August that I would like to share with you:

- More callers are reaching out earlier. 23% are less than 30 days late at the time of contact (up from 14% in Q1 and 21% in Q2). The earlier the borrower

[1] As of September 2007, the national partners of this program are: American General Financial Services, a member of AIG, Inc.; Bank of America; Barrett Burke LLP; Citigroup; Countrywide Home Loans; EMC Mortgage; Fannie Mae; Freddie Mac; GE Money; GMAC ResCap; Housing Policy Council; HSBC—North America; JPMorgan Chase; LaSalle Bank; Mortgage Bankers Association; National City Mortgage Co.; Ocwen Loan Servicing, LLC; Option One Mortgage; State Farm Insurance; SunTrust Banks, Inc.; Washington Mutual; and Wells Fargo Home Mortgage.

reaches out, the more options available. This is a positive trend potentially attributable to the national Ad Council campaign.

- More homeowners with ARM products are calling. Those with an ARM product is up to 44%, (up from 34% in Q1 and 40% in Q2). Of all the homeowners counseled in July and August, 31% had ARMs at 8% or higher interest rate (up from 24% in Q1 and 30% in Q2). 34% of those counseled have fixed rate products.
- California is the state with the highest call volume, accounting for 15% of calls. In August, 8600 Californian homeowners called the hotline. Other states with high call volume include Ohio (11% of calls), Georgia (9.5% of calls), Florida (7.3% of calls), and New York (5.9% of calls).

Now I want to share with you some good news in the securitization area. One of the most exciting developments in the field of mortgage lending has been the growth of mortgage-backed securities. Mortgages are now routinely pooled and sold to buyers who rely on the income stream from borrowers. This has provided for the regeneration of capital to permit lenders to make additional mortgage loans to even more aspiring homeowners. Because of the secondary markets, the capital markets have been making a much larger pool of capital for home mortgages. But if enacted, HR 3609 could have a de-stabilizing effect on the mortgage markets, which are now begging to stabilize.

But there was a problem. Market actors in the securitization process were not as well-equipped as we should have been to handle a downturn. Earlier this year, the Roundtable worked with the holders of mortgage-backed securities to allow for loan modifications for distressed customers in a way that is best for everyone. By June, 2007, the American Securitization Forum created guidance to encourage companies that service mortgages which have been sold into the secondary market to modify loans to prevent foreclosure. Now servicers can speak for investors and permit loan modification. Under this guidance, servicers are permitted to reduce principal in some cases. I would ask consent that a June, 2007 Statement of Principles related to loan modifications be entered into the record. The lesson here is that mortgage servicers and the holders of mortgage-backed securities see the problems facing some American homeowners and have responded by offering flexibility and demonstrating a willingness to work with borrowers. As this Statement of Principles becomes more widely adopted in the marketplace, we should expect more and more homeowners with subprime mortgages to get needed relief.

I hope all that I have described dispels the misperception that lenders actually want to foreclose. The exact opposite is true; responsible lenders wish to avoid foreclosure. Foreclosure is a losing proposition for all parties: the borrower, the neighborhood, and the lender. Lenders lose money in a foreclosure and they also lose a customer; responsible lenders want customers for life who can benefit from other services and products they offer.

Chapter 13 as it currently stands is an effective government program. One prominent Chicago bankruptcy lawyer argues on his website that Chapter 13 is effective at staving off foreclosure for 97% of all cases. And since the 2005 reform law, the percentage of Chapter 13 cases has jumped to around 35–40% of all consumer cases. Another prominent bankruptcy attorney described Chapter 13 as a "lifeline" and is "the best way to save a home." And a February, 2007 study financially supported by the Federal Reserve Bank of Philadelphia notes that 80% of Chapter 13 filers have a plan confirmed by a judge, even though some portion of these debtors will not complete the plan for one reason or another.

Finally, I want to address proposals to change bankruptcy law as it relates to mortgages. Radical, risky reforms to bankruptcy will have the devastating effect of increasing risk for lenders to an unacceptably high level. HR 3609 contains a provision that could have this detrimental impact. Section 3 of the bill would authorize bankruptcy judges to unilaterally reduce the loan amount of any mortgage and convert part of the mortgage to an unsecured status. It is important to note that this applies to all mortgages, even prime, fixed-rate loans that are fully current. This will force mortgage lenders to charge much higher interest rates for all types of mortgage loans. This will dry up credit for many Americans who may not be able to afford these higher rates.

If courts can simply reduce the value of collateral, a mortgage loan can effectively become unsecured and lenders will offer interest rates that more closely resemble the much higher interest rates for unsecured loans. Such greatly increased costs will fall hardest on lower income borrowers seeking to purchase a home. And these increased costs will make it hard for young families to afford a first home.

Allowing for wholesale, involuntary revisions to mortgage loans by bankruptcy judges will likely also harm the secondary market for mortgage loans. As I men-

tioned earlier, the industry is working hard to create flexibility for borrowers. As we all know, the secondary market is a crucial source of liquidity, permitting mortgage lenders access to funds to make new loans to more Americans pursuing the dream of homeownership. Bankruptcy law revisions must not have the effect, even if unintended, of reducing liquidity that flows from the secondary market.

Similarly, it would be highly unwise for Congress to give bankruptcy judges unlimited discretion to effectively re-amortize loans. Section 4 of HR 3609 could do just that by stretching payments to mortgage lenders over an even longer period of time. As with converting secured debt to unsecured debt, this proposal would increase risks, chill the secondary market and result in fewer mortgages and higher interest rates. Again, low and middle income Americans would be the big losers in this scenario.

In the short term, there is a real possibility that the voluntary work-out programs currently being used and expanded could be disrupted if Chapter 13 were modified to give bankruptcy judges unlimited discretion to modify loans. After all, if a borrower—any borrower, even a solvent borrower who is current on a prime and fixed-rate loan—can simply file for bankruptcy and a judge could re-write almost all aspects of the loan—as HR 3609 proposes to do—there is a greatly reduced incentive to work things out with a lender.

Finally, I am truly mystified by the idea that Congress would exempt homeowners from counseling as a pre-condition for filing bankruptcy. As our HOPE projects shows, counseling can help save homes. It us therefore counterintuitive to remove the counseling requirement for homeowners as Section 5 of HR 3609 would do. I urge the Subcommittee not to deprive homeowners of the financial training and education that comes with high quality counseling.

Madam Chair, Chapter 13 has worked well at saving homes while preserving access to mortgage credit and paying unsecured lenders after satisfying secured debt. I recognize that you have the best of intentions. But converting secured debt into unsecured debt will make things worse. With due respect, HR 3609 is a step toward higher interest rates and higher fees and lower rates of homeownership. We stand ready to discuss how Congress might help in the face of the credit crunch, but we are compelled to oppose changes in bankruptcy law that undermine the very foundation of low-cost secured lending. As I have stated earlier, mortgage lenders and servicers are working hard to help borrowers. We have a hotline with free counseling that is working. The financial services industry is looking to avoid foreclosures and create positive outcomes for both borrowers and lenders. Thank you for inviting me to testify. I look forward to your questions.

ATTACHMENT

Attachment A

HOMEOWNER'S HOPE HOTLINE:

888-995-HOPE

The Homeowner's HOPE™ Hotline is available:

- To any homeowner in America having trouble paying their mortgage
- Any time – 24 hours a day, 7 days a week

888-995-HOPE offers:

- Absolutely free foreclosure prevention counseling by expert counselors at HUD-approved agencies.

When a constituent calls 888-995-HOPE:

- Service begins immediately—the counselors themselves answer the phone
- Homeowners can get budgeting help, a written financial plan, and assistance contacting their lender when appropriate
- If they'd like face-to-face counseling, they are referred to their local NeighborWorks® agency or other local resources
- If they need additional services, homeowners may be referred to agencies in their area

The details:

The Homeowner's HOPE Hotline (888-995-HOPE) is provided free of charge by the Homeownership Preservation Foundation, a nonprofit dedicated to preserving homeownership. The Foundation partners with local governments, nonprofits, borrowers, and mortgage lenders/servicers to deliver innovative homeownership preservation solutions.

In 2006, over 48,000 homeowners called the HOPE Hotline. In 2007, HPF has fielded over 60,000 calls from at-risk homeowners. Nearly half of those counseled have avoided foreclosure by working out new loan terms or by selling their home. Currently call volume is increasing by 25% every 6-8 weeks. Callers tend to be female, married, with children, mid to lower income.

In-person counseling is provided by over 230 NeighborWorks® organizations, located around the country in all 50 states, Puerto Rico and the District of Columbia. NeighborWorks® organizations are chartered by NeighborWorks® America, a national nonprofit created by Congress to provide financial support, technical assistance, and training for community-based revitalization efforts.

National Supporters of this effort include: American General Financial Services, a member of AIG, Inc., Bank of America, Barrett Burke, LLP, Citigroup, Countrywide Home Loans, EMC Mortgage, Fannie Mae, Freddie Mac, GE Money, GMAC ResCap, Housing Policy Council, HSBC– North America, JPMorgan Chase, LaSalle Bank, Mortgage Bankers Association,

National City Mortgage Co., Ocwen Loan Servicing, LLC, Option One Mortgage, State Farm Insurance, SunTrust Banks, Inc., Washington Mutual and Wells Fargo Home Mortgage.

If you need more information:

About 888-995-HOPE and HPF:	visit: www.995hope.org
About in-person counseling:	visit: www.nw.org/ForeclosureSolutions
Ad Council Campaign:	visit: www.ForeclosureHelpAndHope.org

888-995-HOPE

DC:531733.1

hpf homeownership preservation foundation

HPC HOUSING POLICY COUNCIL

NeighborWorks® AMERICA

Ms. SÁNCHEZ. I appreciate your testimony, Mr. Bartlett. And thank you very much for staying within the 5-minute rule.

At this time, I would invite Mr. Stein to present his testimony.

TESTIMONY OF ERIC STEIN, ESQUIRE, PRESIDENT, CENTER FOR COMMUNITY SELF-HELP, DURHAM, NC, ON BEHALF OF THE CENTER FOR RESPONSIBLE LENDING

Mr. STEIN. Madame Chairwoman Sánchez, Ranking Member Cannon, Members of the Subcommittee, thank you for inviting me and holding this hearing.

My day job is as a lender. I am chief operating officer of Self-Help, which has done $5 billion worth of financing to 55,000 families across the country—primarily home ownership. Our losses have been less than 1 percent. I am also affiliated with Center for Responsible Lending, which is an affiliate of Self-Help, which is a non-profit research and policy organization.

Clearly, subprime foreclosures have triggered a national crisis. We believe it is primarily through reckless lending that 2.2 million families, without a healthy intervention, lose their home to foreclosure. The decreases in property values are the greatest since the Great Depression.

One hundred lenders have gone out of business. Entire neighborhoods have lost value. These 2.2 million who are going to lose their home, that affects everybody around them. And their wealth will be reduced by $265 billion. So it is not just the people affected by losing their home. It is all their neighbors as well.

As a lender, our strong experience has been that people will do practically anything to save their home. And that is why our loan loss rates are so low, if the loan is a reasonable one. However, in today's environment, there are simply few options for borrowers.

Four million borrowers are in subprime exploding ARMs—as Judge Morgan was talking about—that are scheduled to reset. And what are they going to do? They are not going to be able to afford the payments, which are going to jump up by 40 percent. Interest rates are going to go from 8 percent to 12 percent. No one can afford that.

So what are their options? They were sold these loans, because the lenders said oh, don't worry about the interest rate, we will refinance you. But that option is rapidly disappearing. As property values fall, prepayment penalties keep them from doing it. And lenders go away.

The second option would be to sell the house, which is frequently an option. But oftentimes it doesn't provide enough money to pay back the loan. So you are left with two choices, and only two. One is loan modification, that Congressman Bartlett was talking about; and the second is foreclosure.

Bankruptcy, one would think, would be the option of last resort for people, but it really is practically useless for these situations. While it is true that it stops foreclosure, that is only for a month or so, because the judge can't modify the home debt. And that is the thing that is causing the financial problem. The lender can come in and object. And within a month, generally speaking, the foreclosure will proceed. So it stops it, but not for long.

And the data shows that servicers, in fact, are not modifying loans in substantial numbers. Moody's had a report that was just issued last week where they surveyed servicers representing 80 percent of the market and found that most of those services, only 1 percent of the loans were modified that reset in January, April and July of this past year—only 1 percent.

So if modifications aren't happening, and there are a lot of reasons why that doesn't happen, that leaves foreclosure. And that is why First American CoreLogic said that up to half of the 450,000 families scheduled to have resets in the next 3 months will lose their home to foreclosure.

There is only one solution. And that is this tweak to the Bankruptcy Code. That is the only solution. As a lender, it is not like the first thing that came to mind was oh, let us go change the Bankruptcy Code. But we went through all the alternatives through a process of elimination. There is nothing else. This is it.

I think it is important to mention that we are not going back to the 2005 act. This goes back to 1978. 2005 was trying to move people into payment plans in chapter 13. And all we are saying is let us make those payment plans have some effect, because right now they are not effective. Investors and speculators can use this provision to have their—can have their loans modified in bankruptcy. Let us let middle-class homeowners have that same right.

Bankruptcy law is like a life preserver. We are reserving it for the strongest swimmers, while hundreds of thousands of families drown. We believe that 600,000 families will have their homes saved if this provision is implemented. It won't happen all at once.

And the beauty of it is that most of them won't even have to file bankruptcy, because one reason that lenders aren't modifying is they are scared of being sued by different classes of investors who are affected differentially. And if bankruptcy is a fallback, then that is a good defense against the lawsuit. That will save $72.5 billion for neighbors. It is a win-win for lenders.

What I would say—and borrowers and the economy, is that this is already unsecured debt we are talking about. It is unsecured now, because it is over the value of the house. If the lender were to foreclosure, they would not get the full value of the loan. They would only get—in fact, they get less than what we are talking about. We are talking about the fair market value. We should look at whether liquidation value is the more appropriate standard.

But they are going to get less in foreclosure. Neighbors aren't going to see their houses decline. Taxpayers won't have to pay a dime. Neighbors will be helped, and the economy will be helped. It is a much greater risk to the economy with all these foreclosures than this little change that would affect only about 1 percent of mortgages outstanding.

For 15 years until 1993, in four circuits, this strip-down provision was adopted. And there was no problem with the housing market at that time. All other assets classes can be modified now from 1978 until today. And the markets work fine. And I think it will in this case too.

Thank you.

[The prepared statement of Mr. Stein follows:]

PREPARED STATEMENT OF ERIC STEIN

Testimony of Eric Stein
Center for Responsible Lending

Before the U.S. House Judiciary Committee
Subcommittee on Commercial and Administrative Law

"Straightening Out the Mortgage Mess: How Can We Protect Home Ownership and Provide Relief to Consumers in Financial Distress"

September 25, 2007

Chairman Sánchez, Ranking Member Cannon, and members of the Subcommittee, thank you for holding this hearing on how we can protect homeownership and provide relief to consumers in financial distress. In the past few months, we've seen the adverse effects of abusive subprime loans spread across the nation, from California to the Midwest to Florida, and the ripple effects are now evident worldwide. We commend you for focusing on the problem and seeking positive solutions.

Executive summary

I. Without policy intervention, subprime foreclosures will cause a widespread national crisis.

We estimate that 2.2 million families will lose or have lost their homes to foreclosure due to reckless subprime lending, including one out of every five subprime mortgages made in 2005 and 2006. The foreclosures today are the worst they've been in at least 25 years, and the problem is growing. The cost of the subprime problem extends far beyond the families who lose their homes. Millions of other families—who faithfully paid their mortgages—will be hurt by declines in property values spurred by nearby foreclosures and a weaker housing market. *In fact, the losses associated with the 2.2 million completed foreclosures, if not averted, will total $265 billion in wealth lost by American families* ***not*** *facing foreclosure*. In addition, our national economy has been severely affected already by the subprime meltdown. Over 100 mortgage lenders already have gone out of business. The stock market is increasingly volatile and the housing market is facing its first national decline since the Great Depression.

II. The only policy change that can forestall this crisis is tweaking chapter 13 to provided equal access to homeowners.

A. The only current option is loan modifications, and they are rarely provided.

The risk is highest for a family facing an exploding ARM reset -- whose rates rise sharply two years after origination, resulting in massive and unaffordable payment increases. For

these four to five million families, none of their options are good ones. First, they can try to continue to make the payments, which is not realistic given the 40% payment increase. Second, they can try to refinance into another loan, but property declines, inflated appraisals, prepayment penalties, mortgage delinquencies, and the drying up of the subprime market make this frequently impossible. Third, they often cannot sell for enough to pay off the mortgage.

Under current law, only two options remain: loan modification or foreclosure. The most favorable is for the family to negotiate with the lender to modify the loan to make it affordable. Unfortunately, *lenders are not modifying loans in significant numbers*. Housing counselors and attorneys in the field concur with recent Moody's findings to this effect: "most servicers had only modified approximately 1% of their serviced loans that experienced a reset in the months of January, April and July 2007."

Obtaining a loan modification can be difficult because it is often impossible to locate the holders of the mortgage to negotiate with; servicers fear being sued by investors if they modify, even when in the interest of investors as a whole; servicers are overwhelmed; and the most intractable, subprime borrowers with piggyback second mortgages create a prisoner's dilemma that neither holder has an interest in agreeing to a modification.

This leaves foreclosure. No wonder that *researchers at First American CoreLogic report that up to **half** of the 450,000 families who are holding subprime mortgages whose payments will reset shortly will lose their home to foreclosure.*

B. The solution: tweak the bankruptcy code to permit mortgage loan modifications.

Congress can ameliorate the worst of the crisis yet to come, but only through allowing mortgages to be modified through chapter 13. *Currently, federal law makes the mortgage on the primary residence the only debt that bankruptcy courts **cannot** modify even though courts can modify mortgages on investment properties and vacation homes.* This makes no sense. Because the home mortgage exception applies only to primary residences, borrowers wealthy enough to own two homes or speculators whose investments have gone bad can obtain relief from the mortgage on their vacation or investment home, thereby retaining at least one shelter for their family. Judges have the ability to modify loans securing their home for family farmers, whose bankruptcies are governed by chapter 12, and owners of commercial real estate and all businesses, who are subject to chapter 11. Thus, the current bankruptcy law deprives mostly low-wealth and middle class families of protections available to all other debtors and grants lenders on home mortgages a special protection not available to any other type of lender.

III. The proposed amendment provides significant benefits.

The most immediate beneficiaries would be families who otherwise would lose their house, and perhaps their life savings, to foreclosure. We estimate that *600,000 families facing subprime exploding ARMs would be able to save their homes. By opening up*

bankruptcy protection to homeowners, the most important result will be for those who will no longer need to file chapter 13 because they will receive a voluntary modification instead. The change will remove the fear that servicers have of getting sued by investors, as well as establish standards that servicers will adopt for sustainable loan modifications.

Our proposal guarantees lenders the value of the property that they took as collateral; the secured portion of the loan would not be reduced below this amount. In fact, this is a *better deal than the lender would get at foreclosure*, which causes significant delays of one to two years, the lender receives liquidation value, and incurs substantial expenses. Loan modification in bankruptcy does not increase the loss that will be taken by a lender/investor in foreclosure; it just allows the process to reach a resolution without a homeless family and boarded-up home as the unnecessary by-products. The loan modification would also ensure a continued stream of interest income to the lender, and would prop up property values by avoiding massive foreclosures, which would reduce the value of their other loans.

This proposal saves American families not facing foreclosure $72.5 billion in wealth by avoiding 600,000 foreclosures by their neighbors, and the associated property value declines. Encouraging vacant, boarded-up homes by a policy of favoring foreclosure over loan modification in chapter 13 bankruptcy has the terrible likelihood of trapping distressed borrowers in homes where the mortgage is higher than the property value. This change imposes no cost on taxpayers, and does not create a moral hazard by bailing out investors with public money. By preventing so many foreclosures, it will improve the finances of local municipalities, who save $30,000 for each foreclosure averted.

It will not hurt the economy or housing market. The bankruptcy remedy is a very targeted response. Bankruptcy involving one's home is a last resort for almost all families, given the stigma and five years of intrusive financing management under supervision of a bankruptcy judge. *While this is a significant impact on the current foreclosure epidemic, this result is still just 0.6% of all households and 1.4% of all homeowner households with outstanding mortgages.*

The spillover effects of concentrated foreclosures pose a much more real risk to freezing up local housing markets in states like California, Florida, Ohio, Nevada, Arizona, and the 41 other states where foreclosures are up significantly over the past year *than this change to the bankruptcy code.*

Lending experience during the fifteen years in which bankruptcy courts were modifying mortgage loans on primary residences belies some lenders' claim that allowing such modifications would negatively impact the cost or availability of credit. The claim is similarly belied by the past thirty years, continuing to the present, in courts have been modifying mortgage loans on family farms, investment properties, vacation homes and commercial real estate with no ill effects on those submarkets.

Self-Help and Center for Responsible Lending

My day job is as a lender; I serve as Chief Operating Officer of Self-Help (www.self-help.org), which consists of a credit union and a non-profit loan fund. I also serve as Senior Vice President of Self-Help's affiliate, the Center for Responsible Lending (CRL) (www.responsiblelending.org), which is a not-for-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices.

For the past 26 years, Self-Help has focused on creating ownership opportunities for low-wealth families, primarily through financing home loans to low-income and minority families who otherwise might not have been able to get home loans. In other words, we work to provide fair and sensible loans to the people most frequently targeted for predatory and abusive subprime mortgages. Self-Help has provided over $5 billion of financing to 55,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across the country. Our loan losses have been less than one percent per year.

In addition to making direct loans, Self-Help encourages sustainable loans to borrowers with blemished credit through a secondary market operation. We buy these loans from banks, hold on to the credit risk, and resell them to Fannie Mae. We have used the secondary market to provide $4.5 billion of financing to 50,000 families across the country, loans that have performed well and significantly increased these families' wealth.

Through this lending experience, I understand the importance of promoting sustainable homeownership and maintaining access to affordable home loans, and I have an appreciation of how responsible use of the secondary market can contribute to such a result.

As a lender, I can promise you that proposing a change to the nation's bankruptcy laws was not the first thought that leapt to mind; it was a process of elimination where we thoroughly considered every other option we could think of, pursued them as far as they would go, and found each wanting to meet the goal of having a large scale impact. We have been involved in most every major effort to figure out what to do to assist current borrowers – summits convened by FDIC and Senator Dodd; efforts led by a group of attorneys general; efforts led by officials in numerous states; and extensive discussions with major lenders, secondary market players, and members of Congress. Changing the bankruptcy code is simply the only thing that any party can do that will keep hundreds of thousands of families in their homes. There is no other option.

The bottom line

Because of the dangerous subprime loan products offered over the last five years, particularly the exploding ARMs, plus the weak underwriting fostered by unquestioning investor demand, there will be substantial losses that somebody will bear. The question facing Congress is who shall bear these losses. There are only three possibilities:

- Taxpayers. A savings and loan type bailout of many hundreds of billions of dollars is possible to pay off unaffordable mortgages. Beyond the cost to a country already in substantial deficit, this strategy would have the result of saving investors from loss, creating a moral hazard that would likely cause a repeat.

- Investors. So long as there isn't a taxpayer bailout, then investors, who signed up to take the rewards and bear the risk, will necessarily reap what they have sown. The losses will come and holders of subprime securities will feel the effects.

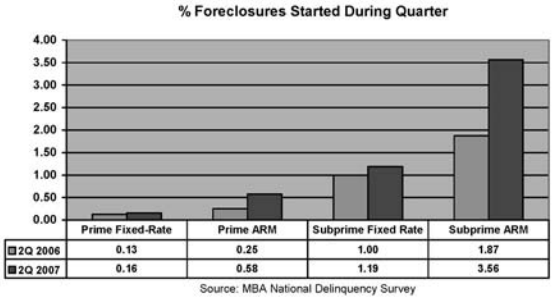
- Homeowners, neighbors and the economy. Congress will decide whether the investors will bear the risk alone, or whether they will also cause 600,000 families to needlessly lose their homes, neighbors who were paying their mortgages to needlessly lose $72.5 billion in wealth, and the wider economy to needlessly bear the ripple effects of these economic losses and vacant homes. The bankruptcy tweak suggested here today will keep losses from filtering down to the parties least able to sustain them, and who never signed up to take them.

I. Without policy intervention, subprime foreclosures will cause a widespread national crisis.

Today, because of reckless lending practices in the subprime market and voracious investor demand for the resulting loans,[1] we estimate that 2.2 million families have lost or will lose their homes to foreclosure. These foreclosures already are occurring in record numbers, and the worst is still ahead. This is a true national crisis; in fact, this epidemic of foreclosures has been called the "Fifty-State Katrina." The difference is that this disaster, unlike a hurricane, was entirely man-made and avoidable.

Subprime mortgages are no longer a niche market; they have become a significant share of all new mortgages made in America, making up well over 20 percent of all home loans originated in 2006 and currently representing $1.2 trillion of mortgages currently outstanding.[2] Six million of these loans are outstanding. Eighty percent of 2006 subprime loans were so-called 2/28 mortgages,[3] otherwise known as "exploding ARMs", whose interest rates are set to increase from 8% - 9% to 12% - 13% immediately after the second year, even with interest rates in the economy remaining constant. Even with the recent modest cut in interest rates, subprime borrowers will face 40 percent or greater increases in their monthly mortgage payments once their initial "teaser" rates expire and their fixed interest rates reset into higher-rate variable rates.

We estimate that one out of every five subprime mortgages made in 2005 and 2006 will end in families losing their homes to foreclosure.[4] The foreclosures occurring today are the worst they've been in at least 25 years, and the problem is growing. The 2nd Quarter National Delinquency Survey, recently released by the Mortgage Bankers Association (MBA), shows that new foreclosures on subprime adjustable-rate loans in the second quarter 2007 are **90%** higher than the same time last year, compared with a 23% increase on prime fixed-rate loans.[5]



The MBA data show that mortgage loans entering foreclosure have increased in 47 states since this time last year; on average, 50% higher. Only four states, together totaling less than two percent of the American population, did not experience increases in new foreclosures.

- These losses represent a personal catastrophe for each of families involved. For most, their only "wealth" is their home equity, which will now have been stripped by these loans even if the family avoids foreclosure. Many of these households will be displaced and pushed backwards financially, some into homelessness. Some will take years to recover, and many never will. It takes an average of ten years for a family to return to homeownership after a foreclosure.[6]

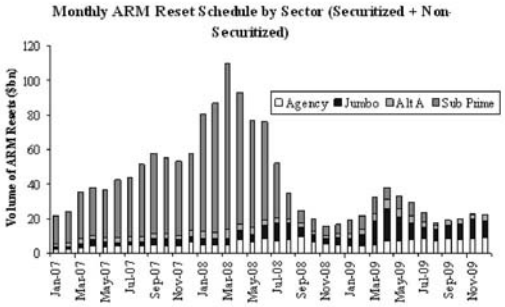
The cost of the subprime problem extends far beyond the families who have lost or will lose their homes, however.

- Millions of other families—those who have faithfully paid their mortgages on time—will be hurt by declines in property values spurred by nearby foreclosures and a weaker housing market. In fact, the losses associated with the 2.2 million completed foreclosures, if not averted, will total $265 billion in wealth lost by American families *not* facing foreclosure.[7]

- Our national economy has been severely affected already by the subprime meltdown. Over 100 mortgage lenders already have gone out of business and tens of thousands of workers have lost their jobs. It's harder for mortgage lenders and firms in other business lines to get credit from once-burned, twice shy investors. The stock market is increasingly volatile and the housing market is facing its first national decline since the Great Depression. All these factors spell slower (or even negative) economic growth in the U.S and—with German banks worried

about subprime loans made in Chicago—bleak prospects for help from players in other global financial markets.[8]

It is important to recognize that while the rate of subprime foreclosures is alarming today, the worst is still ahead. As the chart below shows, a large majority of these rate resets will occur later this year and in early 2008.[9]



II. The only policy change that can forestall this crisis is tweaking chapter 13 to provided equal access to homeowners.

A. The sole current option to avoid foreclosure for many is loan modifications, and they are rarely provided.

It is very difficult for homeowners in unsustainable loans to avoid foreclosure. Many subprime borrowers in fixed-rate mortgages are in trouble due to risky elements of their loans, including the lack of appropriate underwriting, appraisal fraud, prepayment penalties, lack of property tax and hazard insurance escrows, and other equity-stripping measures. Alt A borrowers, one step up from subprime, are increasingly facing payment difficulties, as are those in so-called non-traditional loans such as payment option ARMs and interest-only loans provided by lenders not schooled in this type of lending.[10] Finally, in the face of property declines, even prime borrowers are feeling stress and delinquency.

The risk is highest at the moment though for a family facing an exploding ARM reset -- that is, 2/28 hybrid adjustable rate mortgages, whose rates rise sharply two years after origination, resulting in massive and frequently unaffordable payment increases.[11] For these four to five million families, none of their options are good ones.

- Stay in the loan. First, they can try to continue to make the payments. While many borrowers drain retirement funds or forgo essentials such as medicine or food in an effort to make their mortgage payments, the fact is that few will be able to sustain their payments at this level. In these loans, the debt-to-income ratios were often unsustainably high even at the introductory "teaser" rates – often 50% to 55% of gross monthly income – and now, for many borrowers, the increased payment will approach or exceed their total net monthly income after the interest rate adjustment. This option is simply not realistic for the vast majority of borrowers.

- Refinance. Second, they can try to refinance into another loan. Some borrowers who still have some equity and who have a regular income may be able to refinance into another loan. But borrowers caught unaware by a reset who are now delinquent on their mortgages or borrowers who lack sufficient equity either due to housing depreciation, appraisal fraud, and/or equity-stripping may not be able to refinance. Moreover, many of the lenders that extended these loans are themselves filing for bankruptcy,[12] and the subprime market has largely dried up.

- Sell. Third, they can try to sell their house. However, the same obstacles that keep them from refinancing face them again. Because these loans were underwritten with such high loan-to-value ratios, the slow-down or reversal of home price appreciation along with the appraisal fraud and equity-stripping common to these loans, means that a sale would not net sufficient proceeds to cover the outstanding debt. Further, the equity they recoup must cover applicable prepayment penalties (which are included in over two-thirds of subprime loans). In some real estate markets, especially in neighborhoods hard hit by multiple foreclosures, it may not be possible to sell at all. Selling the house and paying off an unaffordable mortgage is increasingly difficult to do.

Under current law, only two options remain: loan modification or foreclosure.

- Servicer modifications. The most favorable option is for the family to negotiate with the lender to modify the loan to make it affordable. Such modifications can include interest rate and principal reductions, forgiveness of loan payments, or loan period extensions.[13]

  The centrality of the modification option was recognized by President Bush on August 31, when he said, "I've made this a top priority to help our homeowners navigate these financial challenges, so that many families as possible can stay in their homes. …I strongly urge lenders to work with homeowners to adjust their mortgages. I believe lenders have a responsibility to help these good people to renegotiate so they can stay in their home."[14]

  Unfortunately, despite the President's call to action and much public discussion of how lenders stand ready to help borrowers avoid foreclosure, in practice, lenders are not modifying loans in significant numbers. While it is very difficult

to get information about modifications from lenders, the experience of housing counselors and attorneys in the field is that meaningful modifications are rare.[15] Just last week, Moody's surveyed the modification practices of subprime servicers constituting 80% of the total market regarding borrowers whose mortgages reset in 2007 or 2008. Moody's concluded that subprime losses will continue to increase, and it will have to continue to downgrade subprime securities, because "most servicers had only modified approximately 1% of their serviced loans that experienced a reset in the months of January, April and July 2007."[16]

Obtaining a loan modification can be difficult for four reasons.

- Who owns the loan? It is important to realize that most borrowers will be negotiating with a servicer of their loan rather than with their original lender. People facing foreclosure in previous mortgage crises had the advantage of being able to go to their local bank or savings and loan to negotiate directly with the entity that made the loan, serviced it, and held the economic interest; since the lender faced significant losses from foreclosure, a win-win modification could often be worked out. The world has changed, however. Many borrowers and even their servicers simply cannot locate the holders of the mortgage to negotiate with; the loans have been sliced and diced so many times that the owners cannot be found.

- Fear of investor lawsuits. The servicer has obligations to the investors who have purchased the mortgage-backed securities through pooling and servicing contracts, and the interests of these investors conflict. Servicers are hesitant to modify the loans because they are concerned that it will impact different tranches of the security differently, and thereby raise the risk of investor lawsuits when one or more tranche inevitably loses income. This phenomenon is known as "tranche warfare". For example, a modification that defers loss will favor the residual holder if the excess yield account is released, but will hurt senior bondholders. The legally safest course for the servicer is clearly foreclosure.

- Servicers are overwhelmed. The magnitude of the crisis has simply been too much for many servicing operations to effectively respond. Hundreds of thousands of borrowers are asking for relief from organizations that have traditionally had a collections mentality, been increasingly automated, and whose workers are simply not equipped to handle case-by-case negotiations. Further, many of these servicers are affiliated with lenders who are going bankrupt or are facing severe financial stress, and therefore are cutting back just as the demands are increasing significantly.

- Piggyback seconds. The most intractable problem is the fact that a third to a half of 2006 subprime borrowers took out piggyback second mortgages on their home at the same time as they took out their first mortgage.[17] In these cases, the holder of the first mortgage has no incentive to provide modifications that would free up

borrower resources to make payments on the second mortgage. At the same time, the holder of the second mortgage has no incentive to support an effective modification, which would likely cause it to face a 100% loss. The holder of the second is better off waiting to see if a borrower can make a few payments before foreclosure. Beyond the inherent economic conflict, dealing with two servicers is a negotiating challenge that most borrowers cannot surmount.

Since bankruptcy isn't an option to save their home under current law, foreclosure is the only option for these families. *No wonder that researchers at First American CoreLogic reported last week that up to **half** of the 450,000 families who are holding subprime mortgages whose payments will increase in the next three months will lose their home to foreclosure.*[18]

B. The solution: tweak the bankruptcy code to permit mortgage loan modifications.

With as many as 1.7 million foreclosures predicted to occur in the next two to three years,[19] it is imperative that Congress take action to assist homeowners struggling today, not just protect future subprime borrowers. Congress can ameliorate the worst of the crisis yet to come, but only through implementing a single policy change, the one the Judiciary Committee is considering now. Currently, federal law makes the mortgage on the primary residence the only debt that bankruptcy courts *cannot* modify – even though courts can modify mortgages on investment properties and vacation homes. This makes no sense. This simple tool – providing homeowners equal access to chapter 13 bankruptcy relief – will reduce devastation and benefit the entire economy, without expenditure of taxpayer dollars

The 2005 bankruptcy law had the intended effect of shifting debtors from chapter 7, where their debts are liquidated, to chapter 13, where they paid their debts back to the best of their ability through a three to five year payment plan. Chapter 13 has a preexisting problem, however, that renders it useless for addressing the current subprime foreclosure crisis. The issue is that a 30-year-old clause in chapter 13 of the Bankruptcy Code makes the home mortgage virtually the only debt that the court cannot modify and therefore the home the only asset it cannot protect.[20] This special protection applies only to the mortgage on the primary residence; bankruptcy courts are free to modify loans for investors or speculators having trouble making payments on second homes, vacation homes, boats, family farms, and commercial real estate. Since a home is typically the largest and most important asset a family has, and the home mortgage loan is the family's largest single debt, the exclusion of the principal residence from modification prevents bankruptcy protection from reaching where it is needed most.

We propose simply eliminating this anomaly.

Our proposal does not revisit the 2005 amendments to the Bankruptcy Code, but rather addresses the provision from the 1978 Code. Our proposal follows the roadmap laid out

by the successful Family Farmer Bankruptcy Act of 1986, which has enabled courts to modify loans on a borrower's principal residence that is located on their farms.

We suggest that Congress amend the provision found at 11 USC §1322(b)(2), which empowers the court to "modify the rights of holders of secured claims, *other than a claim secured only by a security interest in real property that is the debtor's principal residence*, or of unsecured claims…" (emphasis supplied). All that is required to make this change is to strike the italicized language, and make several other modest conforming changes, most importantly to enable the mortgage to repaid over a period longer than the three to five year plan – namely, 30 years less the number of years the borrower has been in their home. (See Appendix B for full list of recommendations.)

The result of this change would be to permit a bankruptcy judge in chapter 13 to do two things. First, if the borrower were "upside down", with the mortgage value higher than the value of the property, the judge would bifurcate the mortgage into two classes. The first class would be secured to the value of the property. The second would be the remainder of the mortgage, which would be placed on par, and paid pro rata with, other unsecured debt. Second, the judge could modify the interest rate, for example, by making the introductory rate in an exploding ARM permanent, and reamortizing the loan over the remaining life. As a result of this change, a loan a family would have no prospect of paying could now become affordable.

The language we seek to change was enacted in 1978, a time when virtually all home mortgages were fixed-interest rate instruments with low loan-to-value ratios. The loans were rarely the source of a family's financial distress. As originally introduced, the House legislation permitted a plan to modify any secured indebtedness, including that represented by a home mortgage.[21] During Senate hearings on the proposed legislation, advocates for secured lenders suggested that home-mortgage lenders were "performing a valuable social service through their loans," and "needed special protection against modification." At their urging, the original proposal was subsequently amended to insert the exception for mortgages on primary residences.[22] This claim likely succeeded through effective lobbying since, as described below in section III, the merits of the argument are groundless. Whatever the merits of this claim in 1978, however, when home mortgage loans were responsibly underwritten thirty-year fixed rate loans, it plainly does not apply to the practices of subprime mortgage lenders during the last decade.

Even at that time, many bankruptcy courts avoided the provision's harsh result by finding exceptions to the blanket prohibition on modifying home mortgage loans, e.g., by finding that the exemption applies only to the extent that the outstanding loan balance did not exceed of the value of the home, or by finding that it only applies to purchase money lending and not refinances.[23]

But in 1993, in *Nobleman v. American Savings Bank*, 508 U.S. 324 (1993), the Supreme Court held that bankruptcy courts must apply section 1322(b) according to its express, literal terms. The practical effect of this decision is that borrowers stuck in unaffordable

home loans now must cure their defaults and, in addition, make monthly payments on the mortgage loans according to the often inflated and abusive terms or lose their homes.

This result is not only unwise; it is also unfair. Because the home mortgage exception applies only to primary residences, borrowers wealthy enough to own two homes or speculators whose investments have gone bad can obtain relief from the mortgage on their vacation or investment home, thereby retaining at least one shelter for their family. Judges have the ability to modify loans securing real estate for family farmers, whose bankruptcies are governed by chapter 12, and owners of commercial real estate and all businesses, who are subject to chapter 11.[24] Thus, the current bankruptcy law deprives mostly low-wealth and middle class families of protections available to all other debtors and grants lenders on home mortgages a special protection not available to any other type of lender.

III. The proposed amendment provides significant benefits.

A. Debtors.

The most immediate beneficiaries would be families who otherwise would lose their house, and perhaps their life savings, to foreclosure. As described in Appendix A, *we estimate that 600,000 families facing subprime exploding ARMs would be able to save their homes.* These savings would result from two different factors. First, those families that file chapter 13, have their mortgages modified, and successfully complete their plans, would benefit by keeping their homes. Chapter 13 bankruptcies for families in such loans would have a much greater chance of success than current plans, because of the ability to modify an abusive loan.

Second, perhaps counter-intuitively, by opening up bankruptcy protection to homeowners, the most important result will be for those who will no longer need to file. The change will remove the fear that servicers have of getting sued by investors, as well establish standards that servicers will adopt for sustainable loan modifications. In addition, the fact that a modification could be pursued in bankruptcy proceedings might provide an incentive for lenders and servicers to offer their own modification plans.

The vast majority of families would much prefer to avoid filing for bankruptcy, and would find a voluntary modification incomparably preferable to the necessity of entering bankruptcy. In fact, the change could actually reduce the number of bankruptcy cases filed overall, as families who receive voluntary modifications would not need to file to stay a foreclosure, as is common today as a holding pattern since bankruptcy can't modify the mortgage.

The proposed amendment will help typical borrowers such as one client whom a bankruptcy attorney recently told us about. This 77-year old, African-American widower on a fixed income from Social Security was financed into an unaffordable subprime hybrid ARM that has already seen two upward rate adjustments. He has been in a chapter 13 plan since October of 2005, but his plan payments keep rising due to the

mortgage adjustments. Since he has no place to move to, he is trying to stick with the chapter 13 for now, but if his monthly mortgage payments continue to increase, he will eventually end up losing his home.

Under our proposed change in the bankruptcy law, the debtor's mortgage could be reamortized for 30 years less the number of years he's been in the loan at a lower fixed rate that would be affordable. Not only would the payments be lower, but the debtor would not have to make additional payments toward arrears. In short, he would be able to be restored to approximately the same position he was in before the abusive loan, albeit having lost some equity in his house.

B. Creditors.

Our proposal guarantees lenders at least the value of the property that they took as collateral; the secured portion of the loan would not be reduced below this amount. In fact, this is a better deal than the lender would get at foreclosure, which would be the result absent the proposed change. When foreclosing, a lender faces significant delays of commonly one to two years before getting some of its money back through selling the house (see Appendix C). In addition, at foreclosure auction the lender receives what is called liquidation value, because it is a distressed sale. Finally, the lender incurs substantial expenses in keeping up the property, fixing it up if necessary, and paying for legal costs. As a result, lenders generally lose 30 to 40 cents on the dollar, and more in declining property value regions, when foreclosing. In other words, loan modification in bankruptcy does not increase the loss that will be taken by a lender/investor in foreclosure; it just allows the process to reach a resolution without a homeless family and boarded-up home as the unnecessary by-products.

This discrepancy between the appraised value used in our proposal and liquidation value actually received by the lender is why many observers have made the strong argument that the mortgage shouldn't be crammed down to the appraised value of the house, but rather to its liquidation value less expected transaction costs.

The lender would benefit by our proposal because a loan modification would ensure a continued stream of interest income. The modifications that judges would order, or that would be voluntarily agreed upon outside of bankruptcy, are no different than what lenders agreed to in the summit convened by Senator Dodd, what bank regulators have urged lenders to do, and what industry best practice is.[25] The presence of the bankruptcy option would enable the lender to act in the most economically beneficial way, without fear of investor lawsuit.

In addition, the lender would benefit from the propping up of property values by avoiding massive foreclosures, which would serve to decrease the value of property underlying existing loans, increase both the incidence and severity of default on those loans, and therefore decrease the loans' value.

C. Neighbors.

Foreclosures depress values of nearby houses. The Woodstock Institute determined that each foreclosure on a city block reduces property values on each house by 1.14%. Thus, our proposal saves American families not facing foreclosure $72.5 billion in wealth by avoiding 600,000 foreclosures by their neighbors.[26] Encouraging vacant, boarded-up homes by a policy of favoring foreclosure over loan modification in chapter 13 bankruptcy has the terrible likelihood of trapping distressed borrowers in homes where the mortgage is higher than the property value, due to these property declines.

A recent *USA Today* cover story described the plight of an upper middle class suburb of Atlanta, which has suffered from numerous foreclosures:

> "If you're like most homeowners, you've probably never given much thought to whether your neighbors pay their mortgages on time. You've got enough to worry about.
>
> Dannice Clark was like that. She'd skip newspaper articles about the trouble with "subprime" loans for people with risky credit. While fixing dinner, she'd tune out TV reports on how subprime defaults are accelerating the nationwide pace of foreclosures. Why should she care? She had a fixed-rate loan on a 5,000-square-foot home with two kitchens in Waters Edge, an upscale subdivision in Stone Mountain, just outside Atlanta.
>
> Here's why: Clark has been trying to sell her home for nearly five months and hasn't had one offer — even after cutting the price to $334,900 from $359,000. The problem is that her street is dotted with four foreclosed homes that lenders are trying to unload for less money.
>
> 'It's truly affecting the sale of my house,' says Clark, 45, who works for the U.S. Postal Service. 'Why pay full price for my house when you can pick up a foreclosure for $30,000 or $40,000 less?'
>
> And as thousands of homeowners across the nation are learning, it's not only home values that are being affected by the foreclosure crisis. When foreclosures rise, as they have in Waters Edge and other middle-class areas amid the meltdown of the subprime mortgage market, they can unravel the social fabric and reshape neighborhoods.
>
> The crime rate can rise while the quality of the schools goes down. Homeowner associations can see their treasuries drained. Nearby businesses close their doors, and local tax revenue suffers."[27]

D. Wider economy.

This change imposes no cost on taxpayers, and does not create a moral hazard by bailing out investors with public money.

By preventing so many foreclosures, it will improve the finances of local municipalities, the entities that lose property tax revenue and bear expenses associated with vacant properties and blight. One study in the Chicago metro area found that each foreclosure costs the municipal governments in police, fire and code enforcement expenses more than $30,000, according to the Homeownership Preservation Foundation.[28]

Some will argue that allowing loan write-downs in bankruptcy might hurt the already fragile home mortgage market. There are two possible effects to analyze: whether lenders will be less willing to extend credit, particularly for high LTV loans, and whether the conventional mortgage market might be more prone to liquidity freeze-ups.

The first response is that the bankruptcy remedy is a very targeted response. Bankruptcy involving one's home is a last resort for almost all families. The family's credit is damaged, though arguably less than it would be from foreclosure. Chapter 13 is not an "in and out" procedure, but rather, a three to five year ordeal. Bankruptcy for three to five years is "major surgery" for a family, not a cosmetic procedure. We hope that this chapter 13 remedy will salvage homeownership for 600,000 families. While this is a significant impact on the current foreclosure epidemic, this result is still just 0.6% of all households and 1.4% of all homeowner households with outstanding mortgages, and we believe that most of these households will not in the end need to go through bankruptcy, but will instead receive a voluntary modification that will serve the lender better economically than a foreclosure.

While the after-inflation value of homes is projected to fall over the next two years, mortgage lenders focus primarily on nominal house prices when deciding whether to make a loan. 2007 will likely be the first year in the last 60 years that the country has seen an actual decline in home prices nationwide, and is projected to fall by approximately 3%. The Federal Reserve, with its recent aggressive rate cut, has shown its determination to prevent actual house deflation as occurred during the early 1930s. Chairman Bernanke's professional interest in and writings about the Great Depression, predating his tenure as Federal Reserve Chairman, argue that home deflation will be a focus of the Federal Reserve. For safety and soundness reasons, and for the protection of homeowners, lenders *should* be very cautious and prudent when making high LTV mortgage loans during periods of stable or slightly declining home prices. This result is a good one and will occur regardless of whether loans are able to be modified in bankruptcy.

Lenders will pull back more than necessary for prudent lending practices only if borrowers are able to "game" the system. This result could hypothetically occur by a borrower who takes a 100% loan against a home in an area where the borrower expects a price decline. This would enable a calculating borrower to plan to file a year later for a five-year chapter 13 bankruptcy, and thereby gain a 3% modification in the loan amount. Just stating the hypothetical demonstrates how far-fetched this scenario is. Presuming that tens of thousands of borrowers will have better ability than bankers/lenders to predict future real estate price declines is implausible. And even then, those borrowers would

have five years of intrusive financing management under supervision of a bankruptcy judge.

The spillover effects of concentrated foreclosures pose a much more real risk to freezing up local housing markets in states like California, Florida, Ohio, Nevada, Arizona, and the 42 other states where foreclosures are up significantly over the past year, than this change to the bankruptcy code.

Lending experience during the fifteen years in which bankruptcy courts were modifying mortgage loans on primary residences belies some lenders' claim that allowing such modifications would negatively impact the cost or availability of credit. For the first fifteen years after the enactment of the 1978 Bankruptcy Code, numerous bankruptcy courts around the country believed that they had the authority even as to mortgages on primary residences to "strip down" under-secured mortgage liens to the value of the mortgaged property, and during this period, such mortgages were thus repeatedly written down to the value of the mortgaged home. This practice ended with *Nobleman* in 1993.

During this fifteen year period, there was no suggestion that the cost or availability of credit for mortgages on primary residences was negatively impacted in those jurisdictions whose courts allowed strip-downs, either as compared with other jurisdictions, or as compared with lending experience before strip-downs were permitted or after *Nobleman* brought the practice to an end.[29]

This provision's Supreme Court formalization in 1993 led to the introduction of abusive 125% LTV loans, as formerly unsecured lenders recognized that if they attached these loans to the house, they would be favored against other unsecured lenders in chapter 13. This was not a good outcome, since these were loans that families could not escape.[30]

The claim that allowing modifications of home mortgages will adversely impact the cost or availability of credit is similarly belied by the past thirty years of experience, in which bankruptcy courts have been modifying mortgage loans on family farms, investment properties, vacation homes and commercial real estate, with no ill effects on credit in those submarkets. That we have robust financing markets for rental property, vacation homes, land lots, family farms, RVs and boats, all of which permit loan modifications in bankruptcy, is strong evidence that the proposed change will not have negative consequences.[31]

Conclusion

Deleting the provision that exempts, alone, the mortgage on a principal residence from being modified in chapter 13 bankruptcy is the only thing that Congress can do to materially reduce the coming wave of foreclosures. Doing so will benefit 600,000 families who will not lose their houses because of chapter 13 modifications, or more likely, voluntary modifications; neighbors will save $72.5 billion of wealth by foreclosures avoided; lenders will receive no less than they would have received through foreclosure; and the national economy will be stronger.

Appendix A – Homeowner savings

US Estimates

Row	Measurement	Year 2004	2005	2006	1Q-2Q 2007
a	Projected Foreclosures	16%	19%	19%	19%
b	Probability of ARM	87%	93%	92%	80%
c	Probability of FRM	13%	7%	8%	20%
d	Probability of Foreclosure Given ARM	16%	20%	20%	20%
e	Probability of ARM Given Foreclosure	91%	95%	94%	85%
f	Probability of Shock	98%	97%	97%	97%
g	Probability of Outstanding	21%	57%	72%	99%
h	Proportion that could be helped (% Original Cohort)	3%	10%	13%	15%
i	Original cohort	2,219,547	3,259,908	3,219,749	1,093,105
j	Estimate of eligible homeowners	64,960	335,260	413,237	169,041
k	Total eligible	982,498			
l	% of outstanding borrowers	14%	18%	18%	16%
m	Total % of outstanding borrowers	17%			
n	Less expected modifications (10%)	6,496	33,526	41,324	16,904
o	Less economically unviable (25%)	16,240	83,815	103,309	42,260
p	Net potential help	42,224	217,919	268,604	109,877
q	**Net total potential help**	**638,624**			
r	Net potential help as % outstanding borrowers	9%	12%	12%	10%
s	Net total potential help as % of outstanding borrowers	11%			
	Chart Data	All	All Count	FC only	FC Count
	Loans not projected to foreclose	81.5%	7,979,097		
	Projected foreclosures completed or fixed rate	8.5%	830,714	45.8%	830,714
	Projected foreclosures that cannot be helped	3.5%	343,874	19.0%	343,874
	Population that could be helped	6.5%	638,624	35.2%	638,624

Row	Measurement	Source
a	Projected Foreclosures	CRL, Losing Ground report, 2007 assumed
b	Probability of ARM	Fannie Mae, Bloomberg
c	Probability of FRM	Fannie Mae, Bloomberg
d	Probability of Foreclosure Given ARM	UNC research, calculation
e	Probability of ARM Given Foreclosure	Calculation
f	Probability of Shock	HMDA, Federal Reserve H.15
g	Probability of Outstanding	Bloomberg
h	Proportion that could be helped (% Original Cohort)	Product of rows a, e, f, g
i	Original cohort	CRL, Losing Ground, Net Drain reports, Inside B&C Lending
j	Estimate of eligible homeowners	Calculation
k	Total eligible	Calculation
l	% of outstanding borrowers	Calculation
m	Total % of outstanding borrowers	Calculation
n	Less expected modifications (10%)	10% estimate from Moody's 7/12/07 conference call
o	Less economically unviable (25%)	25% assumption

We estimate that the proposed changes potentially could help 638,000 homeowners stave off foreclosure arising solely from a subprime adjustable-rate mortgage with a large payment shock. This estimate is net of borrowers who are expected to receive loan modifications (10%) and those who are expected to fail in any event (25%). This document details the logic, assumptions, and calculations made to arrive at this estimate.

We begin with our estimate of total projected foreclosures for each subprime loan vintage (i.e., annual cohort) in row a. The projections from 2004-2006 are based on our "Losing Ground" report, issued in December 2006. The 2007 figures reflect an assumption that the projected foreclosure rate for this vintage will follow that for 2006. This assumption is based on (1) observations of securitized loan deals brought to market in 2007 showing that loan origination quality has not improved markedly and (2) continued concerns about the strength of the housing market.

Next, in row e, we calculate the proportion of all projected foreclosures that are expected to be adjustable-rate mortgages (ARMs) based on (1) ARM market share (row b) and (2) elevated risk that ARMs will experience foreclosure, based on published research from the University of North Carolina.

Next, in row f, we analyze Home Mortgage Disclosure Act (HMDA) data to arrive at an expectation for the proportion of ARM loans that will experience significant payment shocks at reset. Here, the test for significant payment shocks are that the new payment will be greater than 50% of the original reported borrower income and will be 10% above the original payment burden. Since HMDA data does not contain key information, to arrive at an "average" expectation, we assume all loans are ARMs with 30 year terms,

carry a typical start rate, and a typical margin. Using HMDA-reported borrower incomes and loan amounts, we then reach the reported figures. For 2007, we assume the figure will follow 2006.

Next, in row g, we observe the proportion of securitized loans from each year that are still outstanding through market data on subprime mortgage backed securities on Bloomberg.

We then multiply rows a, e, f, g (foreclose % * % ARM given foreclosure * % outstanding * % with expected payment shock) to arrive at our estimate of borrowers who are "eligible" for help: that is, current borrowers with a subprime ARM projected to end in foreclosure and carrying a large built-in payment shock.

From here, we discount the estimate to take into account expectations for borrowers who will receive loan modifications from lenders (row n) and borrowers who are likely to fail in any event (row o).

Appendix B – Evaluation of HR 3609

Rep. Miller has introduced the Emergency Home Ownership and Mortgage Equity Protection Act of 2007, which is co-sponsored by two members of this Subcommittee, Chairman Sánchez and Rep. Watt, as well as Reps. Frank and Maloney. CRL is strongly supportive of HR 3609; it directly addresses the lack of ability for judges to modify mortgages on a principal residence and will provide substantial help to struggling homeowners, neighbors, and the economy as a whole.

In addition to the chapter 13 modification provision that is the subject of this testimony, CRL strongly supports these provisions from Rep. Miller's bill:

1. Amortization after the plan. Without enabling the mortgage to be amortized beyond the end of the plan, the proposal would not be effective. We propose that the period of amortization be 30 years, less the number of years that the borrower has been in the house.

2. Protection against abusive fees. This provision would require lenders to give notice of fees levied, provide debtors a chance to object, and, if required, give the court the ability to determine the fee's reasonableness. Abusive fees are so significant a problem that they have seriously undermined chapter 13 mortgage relief, even for debtors who complete their plans. Lenders often add unauthorized or excessive fees to accounts, without telling the debtor or the court. Examples include attorney's fees, even for litigation the lender lost, often far in excess of reasonable amounts for standard form motions; fees for numerous "property inspections"; late fees that are improper because chapter 13 payments are misapplied by lender software, and other junk fees. Many debtors find out about the fees only after the bankruptcy case is over. In many cases they thought they had resolved their mortgage problem, only to find themselves two or three months behind again because payments were applied to the fees. Otherwise, they often do not find out until they go to refinance or sell, and the fees are demanded at closing, when debtors are under tremendous pressure to pay them so the closing goes through.

3. Waiver of credit counseling. Credit counseling is a useful tool for a family having financial difficulties, but a debt management plan will not help a family facing imminent foreclosure; it is far too late for that. It can only waste money and time, both of which are in scarce supply in such a situation. The GAO questioned the utility of credit counseling in any event.

CRL also supports the addition of three other provisions.

1. Homestead exemption for people over 55 for purposes of bankruptcy. Many older Americans have more equity in their home than a state's low homestead exemption permits, but have a mortgage loan with an unaffordable or exploding interest rate. This provision would enable a judge to recast the interest rate in a bad loan so the older borrower can keep his or her house in a state with a low homestead exemption.

Without a homestead floor, older Americans with just a bit more equity in their house than the state homestead exemption ($20,000 in North Carolina for a single person, for example) must pay the amount of this "nonexempt equity" to pay off unsecured creditors in chapter 13, which generally requires selling their house because they don't have liquid assets of this amount. So someone with $30,000 in equity in NC could not utilize the chapter 13 modification provision and save their house without this change.

The provision is consistent with the 2005 amendment adding section 522(b)(3)(C) and (d)(12) that protect pension rights for all debtors, no matter which set of exemptions they utilize. That is because, for many older homeowners, their life savings are in their home equity. The $75,000 amount protected is, in fact, very modest compared to the pension benefits that can be protected.

2. Resolution of disputes. The majority of circuits hold that bankruptcy judges have the discretion to hear all "core proceedings" that are integral to the bankruptcy case, such as claims and defenses raised as objections by the debtor. This is because bankruptcy is a collective proceeding, and the bankruptcy court can consider all interests better than an arbitrator with only two parties before him; applicable mandatory arbitration would govern "non-core" claims. A minority of circuits have found otherwise, however, insisting that all disputes be arbitrated, even the question of whether a creditor violated a bankruptcy stay. This will delay the resolution of disputes and frustrate the ability of the court to treat all creditors equally. We recommend that Congress adopt the majority view.

3. Preservation of consumer protection claims in bankruptcy. It would appear to be common sense, and is the majority rule, that a consumer protection claim that a borrower has against their lender is available to be pursued until the statute of limitation runs, or for some claims, when the sale of the house occurs. However, a minority of courts have held that a foreclosure judgment wipes away these claims. That is so even if the claim is that a lender committed fraud to convince a borrower to take out an abusive mortgage, which caused the foreclosure. This provision would simply clarify that the debtor can still raise consumer protection claims in bankruptcy even if there has been a foreclosure judgment entered against him or her, which is common since families often only declare bankruptcy after this judgment has been obtained.

Appendix C – Foreclosure Timelines

State	Sale Held	Confirmation of Sale	Redemption Period	Minimum estimated time complete sale	Maximum estimated time complete sale
AL	49-74 (days)		365 days	414	439
AK	105-108		365 days *	105	473
AR	80		365 days*	80	445
AZ	102		30-180 days*	132	282
CA	117-120		365 days*	117	485
CO	91		75 days	166	166
CT	court decides	3-4 weeks	court decides	court decides	court decides
DC	75-90		None	75	90
DE	170-210	200-300	None	370	510
FL	135		None	135	135
GA	37		None	37	37
HI	160-220	195-260	None	355	480
IA	160		20-365 days	180	525
ID	150		365 days	515	515
IL	300		90 days	300	390
IN	251		None	251	251
KS	130		3-12 mos	220	495
KY	147	3 weeks	1 year	533	533
LA	180-240		None	180	240
MA	75		None	75	75
MD	46	30-60	court decides	court decides	court decides
ME	240		90 days	330	330
MI	60		30 days - 1 yr	90	425
MN	90-100		6-12 months	270	465
MO	50-60		20 days - 1 year	70	425
MS	90-115		None	90	115
MT	160-170		0-1 year	160	535
NC	110		10 days	120	120
ND	150		6 mos - 1 year	330	515
NE	120-180	0 or 2-3 weeks	None	120	201
NH	65		None	65	65
NJ	270		10 days	280	280
NM	180		1-9 mos	210	450
NV	116		None	116	116
NY	299-445		None	299	445
OH	217		depends on county	depends on county	depends on county
OK	156	30		186	186
OR	150		180 days *	150	330
PA	270	10	None	280	280
RI	75		120	195	195
SC	150		0-30	150	180
SD	150		60- 365 days	210	515
TN	60		0-730 days	60	790
TX	21		None	21	141

UT	138		court decides	138	138
VA	45-60		240 days*	45	300
VT	0-7 mos	10 days	180- 365 days	190	585
WA	135		365 days*	135	500
WI	290		60-365 days	350	655
WV	120		None	120	120
WY	60	0	90- 365 days	150	425
				Longest wait time	**790**
				Median maximum wait time	**360**

Source: www.stopforeclosure.com -click on United Stated Foreclosure Laws (View FC By State)
Source: http://www.realtytrac.com/foreclosure_laws_overview.asp (FC Chart at the bottom)

1 As Alan Greenspan recently told Newsweek, "[Y]ou had Wall Street's securitizers basically then talking to the mortgage brokers saying, 'We'll buy what you've got.' The big demand was not so much on the part of the borrowers as it was on the part of the suppliers who were giving loans which really most people couldn't afford. We created something which was unsustainable. And it eventually broke. If it weren't for securitization, the subprime-loan market would have been very significantly less than it is in size." From "The Oracle Reveals All," Newsweek, pp. 32, 33 (Sept. 24, 2007).

2 Inside B&C Lending (Sept. 1, 2006); see also Inside Mortgage Finance – MBS Database, 2006.

3 Credit Suisse, Mortgage Liquidity du Jour: Underestimated No More, March 12, 2007, p. 6.

4 Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest , Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners, (December 2006) at http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31214551. A recent study by the investment bank, Lehman Brothers, shows that the number of 2006-originated loans likely to face foreclosure is 30 percent. Mortgage Finance Industry Overview, Lehman Brothers Equity Research, p. 4 (December 22, 2006).

5 Foreclosure filings on subprime mortgages now account for over 60 percent of new conventional foreclosure filings reported in the MBA National Delinquency Survey. This fact is striking given that only 23 percent of recent originations were subprime, and subprime mortgages account for only 13 percent of all outstanding mortgages.

6 Donald R. Haurin and Stuart S. Rosenthal, The Sustainability of Homeownership: Factors Affecting the Duration of Homeownership and Rental Spells, p. 43 HUD
Office of Policy Development, (December, 2004), at http://www.huduser.org/Publications/pdf/homeownsustainability.pdf.

7 Families lose 1.14% of their own house's value for every foreclosure that occurs on their block. Woodstock Institute, "There Goes the Neighborhood: The Effect of Single-Family Mortgage Foreclosures on Property Values," June 2005, http://www.woodstockinst.org/content/view/104/47/. Median house value of $212,000 * 1.14% * 50 houses/block = $121,000 neighborhood cost/foreclosure * 2.2 million foreclosures = $265.8 billion in lost wealth. http://www.realtor.org/Research.nsf/files/MSAPRICESF.pdf?SHLE/MSAPRICESF.pdf

8 See, e.g., Nicola Clark, "Bank in Germany Posts Loss Because of Bad Stock Trades," New York Times (August 31, 2007); Jenny Anderson and Heather Timmons, "Why a U.S. Suprime Mortgage Crisis is Felt Across the World," New York Times (August 31, 2007). Indeed, the globalization of the consequences have left people on other continents asking for an international oversight role: "Why should the rules of lending in the U.S. be left to U.S. regulators when the consequences go everywhere?" Heather Timmons and Katrin Bennhold, "Calls Grow for Foreigners to Have a Say in U.S. Market Rules," New York Times C1, (August 29, 2007).

9 Source : Bank of America analyst, cited by Orange County Register
http://blogs.ocregister.com/mortgage/archives/2007/06/bofa_analyst_mortgage_correcti_1.html

10 "Rising Early Payment Defaults Threaten to Inflict Further Problems on Alt A Lending." Inside Mortgage Finance 7/6/07.

11 Through the second quarter of 2006, hybrid ARMs made up 81 percent of the subprime loans that were packaged as investment securities. That figure is up from 64 percent in 2002. (Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs, p. 2 Fitch Ratings Credit Policy (August 21, 2006)).

12 See e.g., Gretchen Morgenson, Crisis Looms in Market for Mortgages, The New York Times (March 11, 2007).

13 See the Interagency Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages. http://www.federalreserve.gov/newsevents/press/bcreg/20070904a.htm; Homeownership Preservation Summit Principles, Sen. Chris Dodd, http://dodd.senate.gov/index.php?q=node/3870; Fitch Ratings, "Residential Mortgage Loss Mitigation Strategies," Oct. 14, 2003.

14 White House press release, August 31, 2007. See also the Interagency Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages, which encourages servicers to use their authority to pursue loss mitigation strategies wherever possible, including loan modifications.

15 See generally "Modified Mortgages: Lenders Talking, Then Balking," San Francisco Chronicle, 9/13/07; Jim Wasserman, "Foreclosures stack up: Frustrated borrowers who lenders to try to work things out say it's a fruitless ordeal," Sacramento Bee, 9/2/07; "Tangle of Loans Feeds Foreclosure Crisis," The Boston Globe, 7/3107 http://www.boston.com/business/personalfinance/articles/2007/07/31/tangle_of_loans_feeds_foreclosure_crisis/.

16 Michael P. Drucker and William Frieke , Moody's Investors Service, Moody's Subprime Mortgage Servicer Survey on Loan Modifications. September 21, 2007 ("Based on the survey results, Moody's is concerned that the number of modifications that will be performed in the future by subprime servicers on loans facing reset may be lower than what will be needed to significantly mitigate losses in subprime pools backing rated securitizations.").

17 Credit Suisse, Mortgage Liquidity du Jour: Underestimated No More, March 12, 2007, p. 5.

18 Bob Ivry, "Subprime Borrowers to Lose Homes at Record Pace as Rates Rise," Bloomberg.com (September 19, 2007).

19 Moody's Economy.com, "Into the Woods: Mortgage Credit Quality, Its Prospects, and Implications," a study incorporating unique data from Equifax and Moody's Investors Service (2007).

20 In 2005, the bankruptcy law was amended to treat some recent purchase money loans for automobiles in a similar fashion, but the dollar figures for such loans pale in comparison to the amount of a home loan and, depending on fair market value, the amount of equity associated with the residence. Moreover, such loans can still be modified with respect to interest rate and payment amounts.

21 Grubbs v. Houston First American Sav. Ass'n, 730 F.2d 236, 242-43 (5th Cir. 1984).

22 See Grubbs, 730 F.2d at 246 (discussing the legislative history of the modification provision of the 1978 Bankruptcy Code).

23 Prior to 1992, when the Fifth Circuit rendered the decision that was affirmed by the Supreme Court in Nobleman, every circuit court of appeals that considered the issue -- there were four all together -- permitted mortgages on primary residences to be stripped down to the value of the mortgaged property, although district courts around the country were split on the issue. The four circuit court decisions were In re Bellamy, 962 F.2d 176 (2nd Cir. 1992); In re Hart, 923 F.2d 1410 (10th Cir. 1991); Wilson v.

Commonwealth Mortgage Corp., 895 F.2d 123 (3rd Cir. 1990); and In re Hougland, 886 F.2d 1182 (9th Cir. 1989). The basis for these decisions was the courts' view that § 1322(b)(2) permitted bankruptcy courts to bifurcate under-secured homestead mortgages between the portion that was secured and the portion that was not. See Nobleman, 508 U.S. at 327 n. 2.

24 The family farm chapter 12 corollary to section 1322(b)(2), found at 11 USC § 1222(b)(2), provides the bankruptcy court with power to "modify the rights of holders of secured claims, or of holders of unsecured claims…" Similarly, the corresponding provision of chapter 11, found at 11 U.S.C. § 1123(b)(5), contains language identical to that in section 1322(b)(2), reaffirming the exemption for loans secured by the debtor's primary residence, but imposes no corresponding exemption for a company's principal place of business or any other property.

25 See Homeownership Preservation Summit Principles, Sen. Chris Dodd, http://dodd.senate.gov/index.php?q=node/3870; the Interagency Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages, http://www.federalreserve.gov/newsevents/press/bcreg/20070904a.htm; Fitch Ratings, "Residential Mortgage Loss Mitigation Strategies," Oct. 14, 2003.

26 Families lose 1.14% of their own house's value for every foreclosure that occurs on their block. Woodstock Institute, "There Goes the Neighborhood. The Effect of Single-Family Mortgage Foreclosures on Property Values," June 2005, http://www.woodstockinst.org/content/view/104/47/. Median house value of $212,000 * 1.14% * 50 houses/block = $121,000 cost/foreclosure * 600,000 avoided = $72.5 billion saved. http://www.realtor.org/Research.nsf/files/MSAPRICESF.pdf?SHLE/MSAPRICESF.pdf

27 Noelle Knox. "Rising foreclosures reshaping communities," USA TODAY. 4/07, A1 http://www.usatoday.com/money/economy/housing/2007-04-12-foreclose-cover-usat_N.htm

28 Id.

29 We at CRL gathered data from the United States Census Bureau and the Federal Housing Finance Board to assess the impact of strip-downs on both home ownership rates and mortgage interest rates. Every year, the Census Bureau estimates population and home ownership rates for the fifty states and the District of Columbia. And each month the Federal Housing Finance Board conducts a survey known as the Monthly Interest Rate Survey, or MIRS. The MIRS tracks rates and terms on conventional mortgage loans. CRL gathered and reviewed the Census and MIRS data from 1984 to 2000. We assumed that fewer families could purchase and own homes if mortgages became scarce or prohibitively expensive. The data show that allowing strip-downs had no appreciable impact on the cost of credit or the rate of home ownership.

30 The high loan to value loan market grew from $1 billion in 1995 to $8 billion in 1997 and was expected to be around $12 billion in 1998. http://www.fdic.gov/bank/analytical/regional/ro19991q/na/infocus1.html.

31 While it is true that rates are higher on investment properties, this is entirely due to the increased credit risk associated with such a loan (an owner-occupier has to live somewhere, and the amount that otherwise would have gone to rent can contribute to their mortgage; if they cannot find a tenant for an investment property and have no additional resources, their chances of default are greater). For example, Genworth Mortgage Insurance's "A-Minus Rate Sheet" dated December 1, 2005 shows a 0.5% premium for investor loans added to a base rate of 1.66% annually for coverage on a 90% LTV A minus loan with a credit score of 600-619.

Ms. SÁNCHEZ. Thank you very much, Mr. Stein. I appreciate your testimony. And at this time, I would invite Mr. Rao to begin his testimony.

TESTIMONY OF JOHN RAO, ESQUIRE, NATIONAL CONSUMER LAW CENTER, INC., BOSTON, MA, ON BEHALF OF THE NATIONAL ASSOCIATION OF CONSUMER BANKRUPTCY ATTORNEYS

Mr. RAO. Madame Chair, Ranking Member Cannon and Members of the Subcommittee, thank you for inviting me to testify today regarding solutions to the foreclosure crisis. I testify here today on behalf of the low-income clients of the National Consumer Law Center, as well as on behalf of the National Association of Consumer Bankruptcy Attorneys.

A fundamental goal of chapter 13 bankruptcy has always been to provide an opportunity for consumers to repay their obligations. Unfortunately, this has become exceedingly difficult in recent years, for homeowners, because our bankruptcy laws have not kept pace with the enormous change in the mortgage marketplace that has occurred since those laws were first enacted over 30 years ago. New nontraditional loan products have challenged the ability of hard-working families who have fallen on difficult times to use chapter 13 to save their homes.

The most effective tool for saving homes from foreclosure, which Congress provided for consumers when chapter 13 was enacted, is the right to cure defaults. It has long played an important role, because consumers often need more than the 6 to 8 months repayment plans that many lenders have been willing to offer to get current on a default. I personally have helped many borrowers save their homes using the chapter 13 right to cure and have witnessed the incredible joy, pride and release these individuals experience when they are able to turn things around and to preserve their home ownership dream.

Widely discussed and well-documented changes in the mortgage marketplace over the past 20 years have eroded the viability of the chapter 13 safety net for homeowners in foreclosure. There has been great growing concern, from those on the front lines, including housing counselors, legal services office, bankruptcy attorneys and other attorneys, who assist homeowners in foreclosure, that options for curing a mortgage default, whether under chapter 13 or under voluntary repayment plans, have become increasingly inadequate for helping homeowners with high-cost loans, especially with those loans that did not give proper consideration to the homeowners' ability to pay.

Sadly, the problems have really become more acute in recent years, because of the widespread use in the subprime market of nontraditional loan products, such as hybrid ARMs. In my written testimony, I provide examples of the affects of rate adjustments under these loans. Even under the more conservative examples I use, it is evident that such rates and changing payment amounts can cause serious affordability problems for many homeowners who live paycheck to paycheck and do not have the flexibility to make adjustments to their household expenses.

For a consumer who is in chapter 13, there is even less flexibility, because the consumer's disposable income based on his or her expenses is fixed at the time the plan is confirmed and must be paid to the trustee to satisfy the creditors' claims. In effect, every dollar the family earns is accounted for. And whatever small cushion they family may have in their budget will cover only minimal additional expenses. A change in mortgage payment over $500 during the 3 to 5 years of a plan, or as much as $700 if there was a teaser rate in the loan, can be more than the average family spends on their entire food budget in a given month.

Simply put, the traditional tools of the bankruptcy system to help consumers in foreclosure are no longer adequate. The right to cure provision does not permit the homeowners to change the timing of installment payments or the amounts. And bankruptcy courts are currently powerless to prevent payment increases under ARMs during the 3 to 5 years of a plan.

There is a way to make chapter 13 as viable today in helping consumers as it was in comparative terms to when it was first enacted. It does not involve a major rewrite of our bankruptcy laws. In fact, the solution is already in the Bankruptcy Code for chapter 11, 12 and 13 provisions.

A targeted solution would involve two changes. First, permit mortgages on residences to be modified during a chapter 13. There is no longer any justification for the special protection afforded to home mortgage lenders added in 1978. This special protection should be eliminated, so working families have the same right to modify loans as corporate debtors have for commercial loans, and wealthy individuals for investment properties and family farmers for all kinds of loans.

Second, permit reamortization of the modified loan. Modification by itself does not fully address the problem based on the current structure of the Code. That is because the modified secured claim needs to be paid during the plan. And there really needs to be a way to address the long-term effect of the plan. Thank you, Madame Chair.

[The prepared statement of Mr. Rao follows:]

PREPARED STATEMENT OF JOHN RAO

TESTIMONY OF JOHN RAO

ATTORNEY,
NATIONAL CONSUMER LAW CENTER

DIRECTOR,
NATIONAL ASSOCIATION OF CONSUMER
BANKRUPTCY ATTORNEYS

BEFORE THE SUBCOMMITTEE ON ADMINISTRATIVE AND COMMERCIAL

LAW HOUSE OF REPRESENTATIVES JUDICIARY COMMITTEE

"Straightening Out the Mortgage Mess: How Can We Protect Home Ownership and

Provide Relief to Consumers in Financial Distress"

SEPTEMBER 25, 2007

Chairman Sanchez, Ranking Member Cannon, and members of the Subcommittee, we thank you for holding this hearing and for inviting us to testify today regarding ways in which Chapter 13 can be improved to help homeowners avoid foreclosure. I testify here today on behalf of the low income clients of the National Consumer Law Center,[1] as well as on behalf of the National Association of Consumer Bankruptcy Attorneys.[2] The clients and constituencies of these groups collectively encompass a broad range of families and households who have been affected by the current foreclosure crisis.

A fundamental goal of chapter 13 has always been to provide an opportunity for consumers to repay their obligations. Unfortunately this has become exceedingly

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[1] The National Consumer Law Center, Inc. (NCLC) is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of sixteen practice treatises and annual supplements on consumer credit laws and bankruptcy, including Consumer Bankruptcy Law and Practice (8th ed. 2006) Truth In Lending, (5th ed. 2003) and Cost of Credit: Regulation, Preemption, and Industry Abuses (3d ed. 2005) and Foreclosures (2d ed. 2007), as well as bimonthly newsletters on a range of topics related to consumer credit and bankruptcy issues. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low income people, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to deal predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of the all federal laws affecting consumer credit since the 1970s, and regularly provide extensive comments to the federal agencies on the regulations under these laws.

[2] The National Association of Consumer Bankruptcy Attorneys (NACBA) is the only national organization dedicated to serving the needs of consumer bankruptcy attorneys and protecting the rights of consumer debtors in bankruptcy. NACBA has more than 2,500 members located in all 50 states and Puerto Rico. NACBA has been actively involved in promoting reasonable and fair bankruptcy legislation since it was founded in 1992.

difficult in recent years because our bankruptcy laws have not kept pace with the enormous changes in the mortgage marketplace that have occurred since those laws were first enacted. New non-traditional loan products have challenged the ability of hard-working families who have fallen on difficult times to effectively use Chapter 13 to save their homes.

I. Saving Homes in Chapter 13.

Since the enactment of the Bankruptcy Code in 1978, homeowners facing foreclosure have often turned to Chapter 13 as a last resort for saving their homes. One of the most significant provisions in Chapter 13 is the right to cure defaults on loans, even if the lender has called the loan due ("accelerated") before the bankruptcy is filed and even if such right to cure does not exist under state law or the consumer's loan contract. For long-term loans a consumer has fallen behind on and is not able to pay-off in full within the three to five years of a Chapter 13 plan, such as a home mortgage, section 1322(b)(5) permits the homeowner to cure the default within a reasonable time by making payments on the arrears together with the ongoing payments during the plan.

The cure right in Chapter 13 currently serves an important role because of the limitations of voluntary workout options. Some mortgage servicers are not permitted by the investors of the mortgage loans to approve repayment or forbearance plans longer than six to twelve months, which is too short a period for many borrowers to affordably cure a default. Those that do offer longer plans often impose restrictions and paperwork burdens that homeowners may not be able to satisfy in the frenzy of the foreclosure process. Other servicers have simply been too aggressive in pursuing foreclosure without offering workout options or may be the cause of the homeowner's foreclosure problem

because of negligent servicing.[3] Chapter 13 makes long-term repayment plans available when mortgage lenders and their servicers have not been willing to negotiate reasonable similar plans.

The cure provisions in current law work best when homeowners have had a temporary loss of income (unemployment, illness, divorce, natural disaster, and so forth) which caused the default, and they now have sufficient income at the time the Chapter 13 case is filed to pay during the plan the arrears which have accumulated and the regular monthly payment. For this model to be successful, it goes without saying that the mortgage loan must have been affordable for the homeowner when the loan was made. Likewise the homeowner must be able to prospectively afford the regular monthly payments, taking into consideration any changes in terms permitted under the loan documents that would affect the monthly payment, during the three to five years of the plan.

The following example demonstrates how the current Chapter 13 cure provisions can help a homeowner avoid foreclosure in comparison to a typical workout plan.

Comparison between Workout and Current Chapter 13 Bankruptcy Plan

The borrowers have a fixed-rate mortgage they obtained five years ago ($185,000 principal). The interest rate is 7.50%, with monthly principal and interest payments of $1,292. Due to unemployment of one spouse last year for a period of six months, they fell behind on the mortgage and other bills. They now have mortgage arrears and foreclosure fees of $14,000. They are currently both employed, though at about 85% of their prior income. Their monthly gross income is $4,500. Despite efforts to negotiate a workout plan modifying the mortgage, their mortgage servicer has only agreed to a

[3] *See* Kurt Eggert, Limiting Abuse and Opportunism by Mortgage Servicers, 15 Housing Policy Debate 753, 756–58 (2004).

12-month forbearance agreement.

Status Under 12-month Workout Agreement

$	14,000	total arrears
$	1,517	ongoing monthly mortgage payment (including taxes and insurance)
$	1,167	payment on arrears (assuming cure over 12 mos.)
$	**2,684**	monthly to keep current and cure the arrears

The couple can scrape together enough to make the first monthly payment but know that they will soon default on the workout agreement as the monthly payment represents 57% of their gross monthly income.

Result After Addressing Problem in Chapter 13 Bankruptcy

$	1,517	ongoing monthly mortgage payment (including taxes and insurance)
$	389	payment on arrears (assuming cure over 36 mos.)
$	46	interest on arrears payment each month (assuming required by mortgage documents)
$	44	trustee's fee each month (assuming plan permits regular monthly payments to be made directly to servicer and not considering other administrative costs, such as attorney's fees, or other payments under plan)
$	**1,966**	monthly to keep current and cure the arrears for 36 month plan (TOTAL)

With this chapter 13 plan, the couple will pay approximately $718 less per month than a workout to cure the delinquency on the mortgage. This total housing payment during the plan will represent 44% of their gross income. The plan under current bankruptcy law will be difficult for them but is much more affordable than the workout.

II. Problems with Cure Provisions and High Cost Loans.

When Chapter 13 was enacted in 1978, a much different mortgage market existed than does today. The typical American pursuing the homeownership dream would have obtained a thirty-year mortgage with a fixed interest rate and monthly payment. This

loan would have been made by a bank using accepted underwriting guidelines which considered the homeowner's ability to repay the loan.[4] Risks to the lender and the homeowner were kept in check by ensuring that the loan amount did not exceed an appropriate loan-to-value ratio, typically no more than 80% LTV. The loan would likely have been kept in the bank's own portfolio of loans and not assigned to another entity, and it would have been serviced by that same bank.[5] Although a time of record-high interest rates, borrowers generally obtained loans within a small range of prevailing market rates and a subprime market for home borrowers was virtually nonexistent.

The 1990s saw the enormous growth in the use of asset-based securities to fund an ever increasing supply of mortgage credit.[6] Creating capital flow in this way,

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[4] In considering potential borrower's ability to repay, lenders have traditionally considered the borrower's housing expense ratio and debt-to-income ratio. In the conventional mortgage market, lenders generally require that the borrower's housing expense ratio, which considers the principal, interest, taxes and insurance (PITI) on the loan in comparison to income, be less than 28%. Such lenders also require that the debt-to-income ratio, which is the PITI plus the sum of other recurring debt such as auto loans and credit card obligations in comparison to income, be less than 36%. In the case of government insured loan programs intended to promote home ownership by low and moderate income borrowers, different ratios may apply. For instance, lenders originating FHA loans generally have used qualifying benchmarks of 29% as a monthly housing expense ratio and 41% for a debt-to-income ratio. A similar 41% debt-to-income ratio has been used for VA mortgages.

[5] In 1990, Congress imposed new requirements on servicers of federally related mortgage loans through amendments to RESPA. *See* Cranston-Gonzalez National Affordable Housing Act, Pub. L. No. 101-625, 104 Stat. 4079 (1999) (codified at 12 U.S.C. § 2605). These amendments followed reports of a substantial number of consumer complaints about mortgage servicing problems particularly related to changes in the industry involving the transfer of sevicing. *See* U.S. Gen. Accounting Office, Report, Home Ownership--Mortgage Servicing Transfers Are Increasing and Causing Borrower Concern (1989).

[6] The Asset-Back Securities Market: The Effects of Weakened Consumer Loan Quality, FDIC Regional Outlook, Second Quarter, 1997.

subprime mortgage lending took off during this period. In 1994, approximately $10 billion worth of home equity loans were securitized.[7] By the end of 1997, the volume had leaped to about $90 billion, and by 2002, more than $134 billion in subprime mortgage-backed securities were issued.[8] Homeowners were encouraged (as they are today), often through aggressive marketing campaigns that deceptively tout lower payments and tax benefits, to use their home equity to consolidate non-mortgage debts.

The range of interest rates charged to subprime borrowers during this period was very broad, especially compared to the range in the conventional mortgage market. The rate range for subprime loans in the mid- to late-1990s, often on fixed-rate loans, was as much as 17 percentage points, as compared to the conventional market's range of no more than 2 percentage points.[9] I have reviewed loans from this period in which some of the most abusive subprime lenders made loans with APRs from 15% to 20%. Practices such as charging high points and fees and flipping loans through multiple refinancings often stripped homeowners of their most valuable asset, the equity in their homes.

Thus, even before the advent of today's more dangerous "exotic" subprime mortgages, Chapter 13 was becoming less viable as a safety net for the growing numbers

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[7] Daniel Immergluck & Marti Wiles, Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development, at 12, Woodstock Institute (Nov. 1999).

[8] Inside Mortgage Finance Publications, The 2003 Mortgage Market Statistical Annual (2003); Glenn B. Canner, Thomas A. Durkin & Charles A. Luckett, Recent Developments in Home Equity Lending, 84 Fed. Res. Bull. 241, 250 (April 1998).

[9] *See* Cathy Lesser Mansfield, The Road to Subprime "HEL" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market, 51 S.C. L. Rev. 473 (Spring 2000)(based on loan data for over 1 million loans securitized between 1995 and 1999).

of homeowners in foreclosure. In my experience working with housing counselors and bankruptcy attorneys who assist homeowners facing foreclosure during this period, a common concern I would hear was that options for curing a mortgage default, whether under a Chapter 13 plan or workout agreement, were becoming increasingly incapable of helping homeowners with high-cost loans, especially those made without proper consideration of the homeowner's ability to pay.

Not surprisingly, the ability of homeowners in the above example to cure their mortgage default would be seriously undermined if they had a higher interest rate loan:

Workout and Current Chapter 13 Plan with High-Cost Loan

Assume that the borrowers have a fixed-rate subprime mortgage with an interest rate of 10.50%. Their monthly principal and interest payment is $1,692. Once again, they have not been able to negotiate a reasonable workout agreement with the lender. Since the loan was made based on an inflated appraisal the originating lender had obtained, and the loan includes a prepayment penalty, the borrowers have also not been able to refinance their loan.

Current Status Under 12-month Workout Agreement

$	14,000	total arrears
$	1,917	ongoing monthly mortgage payment (including taxes and insurance)
$	1,167	payment on arrears (assuming cure over 12 mos.)
$	**3,084**	monthly to keep current and cure the arrears

The monthly payment under the workout agreement represents 69% of their gross monthly income and is completely unaffordable.

Result After Addressing Problem in Chapter 13 Bankruptcy

$	1,917	ongoing monthly mortgage payment (including taxes and insurance)
$	389	payment on arrears (assuming cure over 36 mos.)
$	46	interest on arrears payment each month (assuming required by mortgage documents)

$	44	trustee's fee each month (assuming plan permits regular monthly payments to be made directly to servicer and not considering other administrative costs, such as attorney's fees, or other payments under plan)
$	**2,396**	monthly to keep current and cure the arrears for 36 month plan (TOTAL)

This total housing payment during the plan will represent 53% of their gross income. The plan under current bankruptcy law will likely fail.

III. Specific Limitations under Current Law.

The right to cure a mortgage default under section 1322(b)(5) has several significant limitations. Taken alone, this provision does not permit the homeowner to change the amount and timing of installment payments, the interest rate, and other similar terms of the mortgage. It also does not give the homeowner the right to reduce the mortgage creditor's lien to the value of the collateral as compared with the outstanding balance owed on the secured debt.

Other provisions of the Bankruptcy Code do however provide the right to "modify" secured claims to debtors in Chapter 11, 12 and 13 cases.[10] This ability to modify secured claims is possible for virtually every type of debt except for the mortgage on the borrower's primary residence.[11] This well-entrenched principle of bankruptcy law generally permitting modification of secured claims and the exception for home mortgages in Chapter 13 cases can be summarized as follows:

[10] *See* 11 U.S.C. §§ 1123(b)(5), 1222(b)(2), 1322(b)(2).

[11] Chapter 12 "family farmers" are permitted to modify home mortgages.

Bifurcation and Modification. In determining the allowed amount of a creditor's secured claim, section 506(a) of the Code provides that the claim is secured only to the extent of the value of the collateral and that any amount of the claim in excess of the collateral will be treated as an unsecured claim. This "bifurcation" or "cram down" of the creditor's claim means that the unsecured portion of the claim will be paid with other unsecured claims the debtor may have, based on the plan's treatment of unsecured claims. In addition to this claim bifurcation, section 1322(b)(2) permits the plan to modify the rights of holders of secured claims, such as by extending the payment term or adjusting the interest rate and installment payment amount under the underlying contract.

Cram Down Limitation. Although section 1322(b)(2) generally authorizes the modification of allowed secured claims in a Chapter 13 plan, an exception preventing modification is provided for those claims secured "*only by a security interest in real property that is the debtor's principal residence*." While four Circuit Courts had found that this language in the 1978 Bankruptcy Code did not prevent a cram down of a mortgage lender's lien when considered with section 506(a),[12] the Supreme Court in *Nobleman v. American Savings Bank*, 113 S.Ct. 2106 (1993) held that modification of home mortgage lender's rights, including the cram down of its lien, is impermissible.

[12] *In re* Bellamy, 962 F.2d 176 (2d Cir. 1992); *In re* Hart, 923 F.2d 1410 (10th Cir. 1991); Wilson v. Commonwealth Mortgage Corp., 895 F.2d 123 (3d Cir. 1990); *In re* Hougland, 886 F.2d 1182 (9th Cir. 1989).

While there is scant legislative history directly addressing the anti-modification clause in section 1322(b)(2),[13] it may have been intended to promote the flow of capital into the residential mortgage market at a time when such lending was experiencing pressures from record-high interest rates. Congress enacted other laws at approximately the same time, for example, to assist lenders in making market-rate loans despite state usury caps.[14]

As mentioned earlier, however, efforts to expand the availability of credit at that time were soon replaced by serious concerns about the explosive growth in the residential mortgage lending and abusive lending practices. In 1994, Congress passed the Home Ownership and Equity Protection Act (HOEPA) to prevent some predatory lending practices after reviewing compelling testimony and evidence presented during a number of hearings that occurred in 1993 and 1994. This law created a special class of regulated closed-end loans made at high rates or with excessive costs and fees.[15] It was hoped that HOEPA would reverse the trend of the prior decade, which had made abusive home equity lending a growth industry and contributed to the loss of equity and homes for many Americans.

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[13] *See* Grubbs v. Houston First American Savings Assn., 730 F.2d 236 (5th Cir. 1984).

[14] Depository Institution Deregulation and Monetary Control Act ("DIDMCA"), 12 Pub. L. No. 960221, 94 Stat. 161 (1980), and the Alternative Mortgage Transaction Parity Act ("AMTPA") (1982), 12 U.S.C. §3801. The legislative history for these laws suggests that Congress was concerned about the solvency of the savings and loan industry, as well as concerns about the general viability of consumer lending. *See* Cathy L. Mansfield, The Road to Subprime "Hel" was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market, 51 S.C.L. Rev. 473, 495 (2000).

[15] 15 U.S.C. § 1602(AA)(1)(B).

Regulators had also begun to express alarm at the practice of making high loan-to-value (LTV) mortgages.[16] In issuing a warning to lenders in 1998 about the risks involved with such loans in comparison to traditional mortgage loans, the Office of Thrift Supervision described the practice as follows:

> An increasing number of lenders are aggressively marketing home equity and debt consolidation loans, where the loans, combined with any senior mortgages, are near or exceed the value of the security property.... Until recently, the high LTV home mortgage market was dominated by mortgage brokers and other less regulated lenders. Consumer groups and some members of Congress have expressed concern over the growth of these loans, and the mass marketing tactics used by some lenders.[17]

Unfortunately, as is apparent from the current foreclosure crisis, HOEPA and limited regulatory efforts have not stopped abusive lending practices. Indeed, the problem has only grown worse. Bankruptcy attorneys, legal services offices, housing counselors, and attorneys who assist homeowners in foreclosure now routinely see clients with mortgages whose terms are so oppressive that traditional tools for dealing with foreclosures such as workout agreements and Chapter 13 cure plans are no longer effective. Many of these non-traditional loans which predominate in the subprime market take the form of adjustable rate mortgages (ARMs), such as payment-option ARMs or the more common the 2/28 hybrid ARMs. These loans have an initial short-term fixed rate for the first twenty-four months that is followed by annual or six-month rate adjustments

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[16] In 1995, home equity lenders had made $1 billion in such loans. By 1997, the amount of these loans had increased to $8 billion. High-Loan-To-Value Lending, General Accounting Office, GAO/GGD-98-169, August, 13, 1998; "Paines's High LTV Specialist is Out", National Mortgage News, October 27, 1997, 1997 WL 12863567.

[17] Thrift Bulletin TB 72, Office of Thrift Supervision, Department of the Treasury, August 27, 1998, at 1.

for the balance of the loan term. By mid-year 2006, hybrid ARMs made up 81 percent of securitized subprime loans.[18]

Almost all 2/28 loans include terms by which the interest rate that applies for the initial fixed period of the loan is the *lowest* rate that can ever be charged. In other words, the interest rate can climb, but even if the index upon which the interest rate is based drops, the interest rate charged the borrower can never go down. Many of these loans have an initial rate set lower than the fully indexed rate when the loan was made, often referred to a "teaser" rate.

The interest rates and payments can rise significantly on these loans. Almost all of the subprime ARM loans I have reviewed are based on the six month LIBOR index. During the past eight years, the six month LIBOR index has had peaks and valleys from a low of 1.12% (in June, 2003) to a high of 7.06% (in May, 2000).[19] The first rate change on these loans is generally in the 24th month, with the change payment rate occurring in the 25th month. Subsequent rate changes occur every six months thereafter. Typically, there is a cap on the increase in the first adjustment of 200 basis points, and caps on subsequent adjustments of 100 basis points.

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[18] Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs, Fitch Ratings Credit Policy (August 21, 2006).

[19] HSH Associates Financial Publishers, http://www.hsh.com/indices/fnmalibor-2007.html.

Consider the following changes in interest based on the six month LIBOR history and the effect on the payments on a loan for $185,000 made in December 2002.[20] Note that this example is based on a loan *without* a teaser rate, so the payment shock is *less* than many borrowers are experiencing.

Months	**LIBOR rate**	**LIBOR + index**	**Payment**
1-24	1.38% (Nov. 2004)	7.38%	**$1,278.39**
25-30	2.63% (May 2004)	8.63%	**$1,433.40**
31-36	3.51% (Nov. 2005)	9.51%	**$1,545.70**
37-42	4.58% (May 2006)	10.58%, but capped at 10.51%	**$1,674.80**
43-48	5.32% (Nov. 2006)	11.32%	**$1,781.14**
49-54	5.35% (May 2007)	11.35%	**$1,785.08**

Such rate increases and changing payment amounts can cause serious affordability problems for many homeowners who do not have the flexibility to make adjustments to their household expenses. In a Chapter 13 plan, there is even less flexibility because the consumer's disposable income based on his or her expenses is fixed at the time of confirmation for the duration of the plan, and must be paid to the trustee to satisfy creditors' claims and other obligations under the plan.[21] In effect, every dollar the family earns is accounted for and whatever small cushion the family has in

[20] This example assumes a $185,000 principal amount in a standard sub-prime 2/28 adjustable loan, with an initial rate based on the LIBOR rate plus a margin of 6, and applicable rate caps.

[21] While modification of the plan may be possible, doing so every six months would be impractical and costly, and other requirements the debtor must satisfy under § 1322 and § 1325 may prohibit it.

their budget will cover only minimal additional expenses. A change in mortgage payment of over $500 per month (or $700 or more for loans with initial teaser rates) can be more than an average family spends on their entire food budget.

Bankruptcy courts are currently powerless to defer or change these payment increases as that would be a modification of the mortgage not permitted under section 1322(b)(2). Quite simply, while consumers outside of bankruptcy have great difficulty absorbing the payment shock from ARMs, the problems are compounded in Chapter 13 resulting in almost certain plan failure.

Using the examples above, it becomes obvious that an ARM, even with modest reset adjustments and no initial teaser rate, will make it impossible for the borrowers to propose a feasible Chapter 13 plan.

Current Chapter 13 Plan with ARM

Assume that the borrowers now have a subprime 2/28 ARM mortgage with an initial interest rate of 7.38%. Their monthly principal and interest payment is $1,278 for the first 24 months. The borrowers file Chapter 13 bankruptcy in the eighteenth month to stop a foreclosure sale. To cure the arrears and maintain current payments based on rate adjustments, they would need to make the following payments using the historical example above. This assumes that taxes and insurance will remain constant during the plan.

Result Addressing Problem in Chapter 13 Bankruptcy

$	389	payment on arrears (assuming cure over 36 mos.)
$	46	interest on arrears payment each month (assuming required by mortgage documents)
$	44	trustee's fee each month (assuming plan permits regular monthly payments to be made directly to servicer and not considering other administrative costs, such as attorney's fees, or other payments under plan)
$	**1,982**	monthly to keep current and cure arrears for first six months of plan (including taxes and insurance)
$	**2,137**	monthly to keep current and cure arrears for months 7-12

	of plan
$ 2,250	monthly to keep current and cure arrears for months 13 - 18 of plan
$ 2,379	monthly to keep current and cure arrears for months 19 - 24 of plan
$ 2,485	monthly to keep current and cure arrears for months 25 - 30 of plan
$ 2,489	monthly to keep current and cure arrears for months 31 - 36 of plan

By the third year of the plan, the total housing payment will represent 55% of the couple's gross income. The monthly payment in year three will also be $986 more than what the borrowers were paying for their total housing expense ($1503) before filing bankruptcy.

IV. Proposals for Change.

To help families save their homes from foreclosure, we propose an amendment to the Bankruptcy Code to give bankruptcy courts the same authority to modify home mortgage loans as they have for virtually every other kind of secured and unsecured debt. Our recommendation does not attempt to revisit the changes to the Code made by the 2005 amendments. Rather, it addresses the limitations in current Chapter 13 based on the special protection afforded to home mortgage lenders by the 1978 Bankruptcy Code. With respect to this issue, we suggest the following changes:

Repeal Special Protection for Home Mortgages in Section 1322. This change will permit some borrowers who were provided unaffordable loans to lower their monthly payment to an amount they can pay and to keep that payment amount permanent by converting their ARM to a fixed rate mortgage. It will help borrowers blunt the devastating effect of future rate adjustments which were often not properly considered by lenders when assessing ability to repay at the time the loans were made. For high LTV

loans made based on the lender's careless underwriting decisions and inflated or fraudulent appraisals, and which have prevented borrowers from refinancing out of unaffordable loans, borrowers who file Chapter 13 to deal with a foreclosure would have the right to reduce the mortgage claim to the value of the property. This change will extend to low- and middle-income consumers the same protections that are afforded family farmers, corporations, and wealthy individuals who own investment properties.

Amend Section 1322 to Permit Reamortization. Permitting modification by itself does not fully address the problem based on the current structure of the Code. This is because modified secured claims in Chapter 13 must be paid in full during the three to five years of the plan. For home mortgages with large outstanding balances, this is impossible for most borrowers and they would not benefit from the change permitting modification. To address this, we propose a solution which Congress has already provided for family farmers in Chapter 12 cases. Section 1322 should be amended to include a provision similar to section 1222(b)(9) which permits the borrower's loan to be reamoritized based on the modified terms and paid over a period beyond the plan term, generally up to thirty years.

Based on the above example, these changes would permit the homeowners to save their home from foreclosure by obtaining an affordable reamortized loan and still return to the lender the value of its lien with reasonable interest.

Proposed Chapter 13 Plan with Mortgage Modification

The borrowers propose to extend the mortgage term, so that it has another 360 months to run, to reduce the interest rate going forward at a fixed rate of 8.5%, and to reduce the current loan balance to $165,000 based on the fair market value of the property.

$165,000 current loan balance
360 month term
8.5% interest

$ 1,494	ongoing monthly mortgage payment (including taxes and insurance)
$ 60	trustee's fee each month (assuming mortgage payments are made by the trustee under the plan and based on a reduced commission of 4%)
$ 1,554	monthly to keep current for 3 year duration of plan
$ 1,494	monthly to keep current for remaining 27 years of mortgage term (subject to adjustment only for taxes and insurance)

These changes allow debtors to repay their mortgages on fair and reasonable terms that fully protect the mortgage holder. Like any secured creditor, the mortgage holder would be entitled to adequate protection of its property interest during the Chapter 13 case. Lenders will receive at least as much as they would realize if the property were foreclosed, even if there is a cram down based on the property's value. For lenders who make high LTV or no equity loans based on risky underwriting practices, they can hardly expect a different outcome since they did not take a security interest in the consumer's home based on its true economic value.[22]

[22] This was clearly recognized by the Office of Thrift Supervision in its 1998 announcement to lenders:

> When the combined LTV exceeds 90 percent, however, the proceeds from the sale of the security property will likely not be sufficient to fully liquidate the

These changes will also provide borrowers with an opportunity for loan modifications similar to those which many lenders have said they are willing to make. However, for many homeowners, these workout offers have been illusory. Some of the pooling and servicing agreements of securitized loans which control the mortgage servicer's loss mitigation practices place restrictions on the servicer's ability to offer loan modifications.[23] Homeowners are often unable to get through to someone in the servicer's operation with authority to negotiate such deals, or may find out at the last minute just before a scheduled foreclosure sale that the modification has not been approved or that some additional paperwork requirement is needed. Because of these practices, bankruptcy attorneys and other attorneys who assist homeowners are often contacted just days before a scheduled sale when servicers may no longer be willing to negotiate reasonable workouts.

Incorporating this modification right in Chapter 13 will provide needed assistance to families who for one of many possible reasons have not been able to obtain workouts which include loan modifications. It will also provide an incentive for many lenders and servicers to work with homeowners and their representatives early in the foreclosure process and to make good on their claims that loss mitigation options are available. In

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> home equity loan and any outstanding senior liens. The portion of such loans that exceeds 100% of value is effectively unsecured, ... High LTV lenders state that they recognize that these loans are more or less unsecured, and it is not likely they will benefit from foreclosure.

Thrift Bulletin TB 72, Office of Thrift Supervision, Department of the Treasury, August 27, 1998, at 1.

[23] In one review of such agreements, it was found that one-third of the agreements included a limit on the percent of loans that may be modified, typically requiring that no more than 5 percent of the loans in the original loan pool may be modified. *See* "The Day After Tomorrow: Payment Shock and Loan Modifications," CreditSuisse Fixed Income Research, April 5, 2007.

my experience, consumers are never eager to file Chapter 13, so a change that encourages the availability of reasonable modifications will help many homeowners actually avoid filing Chapter 13 bankruptcy.

Suggestions that these changes will deter investment in mortgage-backed securities or drive up costs to homeowners are unfounded. Simply put, the number of residential mortgages that would realistically be subject to cram down is so insignificant in comparison to the total mortgages made that such an impact is highly unlikely. As mentioned, these changes could cause fewer Chapter 13s to be filed. But even if current filings remain constant or even modestly increase, the number of potential Chapter 13 filings will be small. Given the difficulties of living under a strict court-supervised plan in which all of disposable income must be dedicated for a three to five year period, only homeowners who have no other option for dealing with foreclosure can reasonably be expected to seek a loan modification in Chapter 13. And consumers in Chapter 13 cases do not receive the benefit of any cram down of secured debts until they have completed their plans at the end of a three- to five-year period.

While there are other changes to Chapter 13 not discussed here which we would welcome the opportunity to discuss with the Subcommittee, we also urge consideration of the following:

Lender Fees During Bankruptcy. Another necessary change is a provision to control the enormous problem of mortgage creditors adding unauthorized or excessive fees to the accounts of debtors who are in Chapter 13. Many of these debtors emerge from a Chapter 13 case after three to five years of struggling to cure an arrearage only to have the lender begin foreclosure anew based on claims of unpaid fees for such items as

attorney's fees, property inspections, broker price opinions, and other charges allegedly incurred during the Chapter 13 case. These fees and charges are added to mortgage accounts without notice to the borrower, trustee or bankruptcy court while the case is pending. Many bankruptcy courts have decried these abuses, but usually they go unremedied because the bankruptcy case is over and the debtor has no money to litigate about them. A provision to remedy this problem could provide that all fees and charges based upon occurrences during the pendency of a chapter 13 case must be disclosed to the debtor and trustee, who may then have an opportunity to file an objection with the court.

Prebankruptcy Credit Counseling for Consumers in Foreclosure. The requirement of a prebankruptcy credit counseling briefing added by the 2005 Bankruptcy Code amendments often causes a delay that borrowers facing bankruptcy cannot afford, and could make these proposed amendments meaningless for borrowers who need them most. Several courts have also held that a pending foreclosure is not a sufficient "exigent circumstance" which would merit a deferral of the counseling under the procedure Congress adopted in the 2005 law to presumably deal with emergencies such as foreclosures. Credit counselors deal primarily with unsecured debts and generally do not assist borrowers with foreclosures. The services they offer, debt management plans and budget advice, cannot stop a foreclosure. Thus, the requirement should be eliminated for debtors who are responding to a scheduled foreclosure. Of course, these debtors would remain subject to the requirements of section 1328(g) that they complete an instructional course in personal financial management.

Mandatory Arbitration Clauses. Mandatory arbitration clauses are found in many consumer contracts, including home mortgages. The enforcement of these arbitration agreements under the Federal Arbitration Act is often in direct conflict with the goal of bankruptcy jurisdiction to have one centralized forum for the prompt resolution of disputes affecting the bankruptcy estate. In order to protect homeowners, both Fannie Mae and Freddie Mac have prohibited the use of arbitration clauses in home loans they purchase. This conflict between the Bankruptcy Code and the Federal Arbitration Act has led most courts to hold that, at least as to core proceedings such as claims and defenses raised as objections to a creditor's proof of claim, a bankruptcy judge may refuse to enforce an arbitration agreement and may stay any pending arbitration proceedings. Unfortunately, two Circuit Courts have recently held that the bankruptcy courts in those cases did not have discretion to decide claims asserted by the debtors in core proceedings.[24] An amendment which clarifies that bankruptcy courts may properly exercise discretion in core proceedings to deny a referral to arbitration will assist borrowers who may need to challenge an abusive mortgage loan as part of the bankruptcy claims process.

[24] *In re* Mintze, 434 F.3d 222 (3d Cir. 2006); MBNA America Bank, N.A. v. Hill, 436 F. 3d 104 (2d Cir. 2006).

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Ms. SÁNCHEZ. Thank you, Mr. Rao. Your time has expired.

We will now begin our round of questioning. And I will begin by recognizing myself for 5 minutes.

Judge Morgan, in your written testimony, you indicate that Congress should enact legislation to change chapter 13 of the Bankruptcy Code, so that bankruptcy courts can modify the mortgage on the debtor's primary residence. What standards for implementing this change would make your job easier, make the process more efficient, and give more predictable results for both the lenders and the borrowers?

Judge MORGAN. We need your help setting standards, so that we have a formula that would allow us to set interest rates, particularly, appropriately. I think that the legislation that I have seen does make suggestions that appear to me to be appropriate and would be very helpful in creating that kind of predictability, so that I can say to the people in the audience: It is not the judge who is stripping down the loan. It is Congress that has determined that this is the appropriate standard to use.

So in all honesty, that would be the approach that I would take. And I would hope that you would give us very firm standards.

Ms. SÁNCHEZ. Thank you. If bankruptcy judges are given the authority to order easier terms for borrowers, should borrowers who were subject to predatory lending be treated differently than those borrowers who knowingly entered into those risky mortgage agreements?

Judge MORGAN. Okay. One thing that you all probably need to be reminded of is the fact that there is a good faith standard for chapter 13. And so I wouldn't expect that we would see people filing cases that were not acting in good faith. Moreover, there are some very stringent rules for chapter 13 that would be applicable to whoever is filing. And it is the kind of thing that people wouldn't voluntarily want to subject themselves to.

Ms. SÁNCHEZ. Great. I thank you for your answers.

Mr. Bartlett, the current provisions of chapter 13 allow borrowers who are wealthy enough to own two homes or speculators whose investments have gone bad to obtain relief from the mortgages on their vacation or investment homes. Yet the Bankruptcy Code prohibits chapter 13 debtors from modifying their home mortgage for their primary residence.

Do you think it is fair that, under current law, owners of vacation or investment homes are entitled to special protections that are not available to mostly low-wealth and middle-class families that own only a primary residence?

Mr. BARTLETT. Good question, Madame Chair. I don't think it is right that security for vacation homes or second homes should be also exempted and then allow a judge to withdraw the security or alter the security in any way. Congress chose to do that some years ago.

I would point out that the result of that is that vacation home mortgages are harder to get. They have tougher conditions. And the rates are higher. So that is one of the reasons that they cost more, and they are harder to get, is because a bankruptcy can put the security aside. The same would happen in the primary market, if we eliminated secured debt.

Ms. SÁNCHEZ. But do you agree that it seems fundamentally unfair not to allow people——

Mr. BARTLETT. I think it is unfair. And I think it also is disruptive to the market. And if the Committee wished to eliminate the ability of a bankruptcy court to set aside the security for a primary residence, that would be a good thing to do.

Ms. SÁNCHEZ. Thank you.

Mr. Stein, it has been argued that, if a mortgage loan can be modified or rendered unsecure during bankruptcy, it will be far more difficult to originate or sell mortgages in the secondary market. As a result, it has often been argued that the cost of mortgages would have to increase to reflect this additional risk. How would you respond to that argument?

Mr. STEIN. I honestly don't understand how it would hurt the market, because what we are talking about are borrowers how are going to face foreclosure if they don't do bankruptcy. As Judge Morgan said, why would somebody subject themselves to the strict expenditure requirements if they could otherwise pay their mortgage without it?

So lenders are going to get hurt worse, because they are going to get foreclosure value. And secondly, other property values are going to decrease with foreclosure, if people stay in the homes and the property be kept up. Thirdly, we have experience from that. So what I am saying is I don't see a secondary market problem. From 1978 to 1993, there was no problem in the 4th Circuit that allowed strip-downs at that time.

And I don't see—I have never heard the pricing of vacation homes debt or investment property is to be affected by the bankruptcy change. I think it has more to do with the risk inherent in someone's non-primary residence. And finally, all other secured debts have vital markets now. And finally, we are only talking about 1 percent of the total loans. So I just do not see a secondary market impact to this.

Ms. SÁNCHEZ. Great. I appreciate that. And last question, which I am going to get in under time. Opponents of Government intervention into the mortgage crisis have argued that borrowers and lenders should be penalized for entering into these risky mortgage agreements. How would you respond to that argument?

Ms. SÁNCHEZ. Well, I think that Chairman Greenspan just said in Newsweek that most mortgages were sold and not bought recently. If I had to decide, okay, I want a loan that the interest rate will skyrocket in 2 years, I can't get out of it for 2 years, because of a prepayment penalty. These loans were sold and not bought. Everybody trusts somebody when they get a mortgage. When I got a mortgage out of law school, I trusted the person who was giving it to me, because I didn't understand it. These people just trusted the wrong people.

And the final point I would make is that we are not just talking about the borrowers, we are talking about all their neighbors. If there are vacant boarded-up houses on your block, you are going to be in a lot of trouble in your house.

Ms. SÁNCHEZ. Thank you.

My time has expired. I will recognize our distinguished Ranking Member, Mr. Cannon, for his 5 minutes of questions.

Mr. CANNON. Thank you, Madame Chair. This is really actually a very, very complicated issue. And I appreciate everybody's perspective on the panel. I just can't help but say, Mr. Stein, that I never trusted a mortgage lender. But I have been in the situation where I could afford that, even—you know, a house is a big enough investment that I have gone to that extent.

But we have a market here with a bunch of people who have been sold a bill of goods. I think that is really, frankly, that is in many, many cases the problem. And that has happened because of other changes in our financial markets.

But there are a lot of questions about this bill. But let me, Judge Morgan, just ask you. I think the bill that we are looking at, or at least the one that has been introduced by Senator Durbin, allows the judge to reset the mortgage for 30 years, and then has guidance based upon interest rates. I think it is the published yields on mortgage loans, the most recently published yield, plus a premium for risk, whatever that might be. And then, frankly, I don't think that premium for risk is such a concern. You are going to have something there. And something is better than the standard rate.

But that locks a lot of money up for a very long period of time. In a volatile market, where you go up and down, maybe people refinance. But if interest rates go up, then a lender is stuck for up to 30 more years. Is there a way to deal with this issue in a shorter time frame, say 1 year or 2 or 3-year extension, or some period, maybe it is 5 years, so that a person with credit problems can get back on his feet, continue to make payments, get credit in place and then go back to the credit markets to either get a new loan that he can afford for the long-term, or perhaps sell his house.

And Mr. Bartlett, it seemed to me that the one thing we don't want are a whole raft of repossessions and forced sales on the market that blow value away. Is there someplace where the industry, the lending industry can agree on a shorter term context for redoing mortgages?

Judge Morgan?

Judge MORGAN. Yes. Well, there are many ways that lenders structure loans. And there is a whole breadth of ways that you could recommend to the courts that will you look at this problem. On the other hand, when a lender gave the loan, it was generally a 30-year loan. It may have reset and moved up. But it was generally a 30-year loan. I think that if it was a 15-year loan, you would want the court to do the same thing as the original 15-year loan.

Mr. CANNON. I think the current bill allows for the judge to set 30 years from the time of filing. So even if it was a 15-year loan, I think, the way it reads, it could become a 30-year loan.

Judge MORGAN. Okay. Actually I have seen proposed legislation that offered it, both from the commencement of the loan and perhaps, I don't remember seeing it——

Mr. CANNON. Let us talk about a guy who walks in. As a judge, what do you think would work best for the whole system, including the debtor that is before you? Can we do it with a relatively shorter term, so that he has his options for a period of time?

Judge MORGAN. Representative Cannon, it is not my role to make policy. And so I am going to defer on that to these people who maybe can speak to you better. It is really just my role to enforce the law that you give me.

Mr. CANNON. And it is a very hard thing to do, I will grant you, especially under these circumstances. But as a judge, if you were asking for the ability to do something here, and it is in the context of bills that have filed, which you are not responsible for.

But I am wondering, as we talked about it from a policy point of view, does 5 years, or is there some period of time that would give you the discretion to do something, so that people could keep their houses, where you maintain order in the economy. We don't foreclose on too many houses and give people a chance. Is that something that you think would solve the problem? Or do we need to give you 30 years of discretion?

Judge MORGAN. No, I don't think you need 30 years of discretion, necessarily. But I don't have a crystal ball. And I really don't feel qualified to answer the question for you.

Mr. CANNON. I guess the real concern is going to be on the part of Mr. Bartlett and those who are supporting him. Bartlett, what do you think?

Mr. BARTLETT. Congressman, first of all, I think it is true generally and specifically in this case that the other body's proposed legislation is far worse that this body's proposed legislation. But I am a creature of this body from history. So I will say that, on the foreclosure, a foreclosure is the absolute worst outcome for everyone—worst for the borrower. It is worst for the neighborhood, worst for the city, and worst for the lenders.

We do everything we can to avoid that, including paying for this gladly, by the way, inviting independent counselors, 120,000 counseling sessions. We are now running at the rate of 1,600 a day, which is huge. And we will modify the loans. We will work with the borrower to provide a solution. Introducing bankruptcy court into it would stop that process or at least slow down the process.

Mr. CANNON. Before I run out of time, if you are doing 1,600 a day—Madame Chair, may I ask a question?

Ms. SÁNCHEZ. I will allow you to finish up your question. And I will allow the response.

Mr. CANNON. That has got to be nearly everybody out there. That is a big portion of people that are in trouble with their mortgages.

Mr. BARTLETT. We invite all—there are actually more, unfortunately. We are advertising. We have a national ad council campaign, if you haven't seen it, in which the tag line is: There is nothing worse than doing nothing. So we are doing everything we can to invite, to bring, to cause borrowers to call us. We put them up with an independent counselor, a certified counselor by HUD, and provide a counseling session. And then we transfer them directly, with the counselor still on the line, to the lender.

The difficulty has been that borrowers oftentimes don't want to call. And they are embarrassed. And it is difficult to reach them. But once we reach them, we can avoid a foreclosure in virtually every case.

Ms. SÁNCHEZ. The time of the gentleman has expired.

At this time I will recognize the gentleman from Georgia, Mr. Johnson, for his 5 minutes of questions.

Mr. JOHNSON. Thank you.

This would be directed to anyone on the panel. What forces in the finance industry have contributed to the current mortgage crisis?

Mr. STEIN. I think Mr. Feeney had it right that the way that our mortgage market is structured, that people got paid. And they weren't paid based on how the loan performed. That used to be the case. You would walk into your savings and loan. And the person who made the loan was responsible for the ultimate losses. So they cared whether you made your mortgage payments or not.

But with the rise of mortgage brokers, with lenders who sell the loans off, with rating agencies that get paid when the securities are rated, with the investment banks that get paid when the mortgages are sliced and diced and securitized, and then the ultimate investor who may be in Europe or Asia or somewhere like that—every party along there gets paid and therefore succeeds, as soon as the loan is made, no matter how bad.

And the only ones that bear the cost are ultimately the holders at the lower tranches, the investors, who are just now realizing what it was they invested in. I think most didn't realize—and then the homeowner. And so I think that we have a mortgage system which has been great at bringing liquidity in. But it has not been good about making sure that liquidity serves the long-term purpose of home ownership.

And if you think about it, a loan where the interest rate is set to explode after 2 years makes no sense, if you are worried about someone staying in a home for 30 years.

Mr. BARTLETT. I concur with that, with both gentlemen. I think it has been a perfect storm. And it has not been very pretty. I do want to say—and this doesn't necessarily make us all feel better—but remember that the subprime market was developed to increase the home ownership among—in the affordable market; because too many people had been frozen out of the home ownership for too long. And when I was in Congress, also mayor, I saw that too much.

So 85 percent of the subprime loans are good loans. And the borrowers are paying them back and can pay them back, and will continue to. That other 15 percent is way too high. And we have got a problem that we have to deal with. So the causes have been a combination of the marketplace and making bad loans, of underwriting standards that were, at best, sloppy, bad credit decisions on behalf of both lenders and also borrowers, sometimes just loss of income though. There are traditional reasons that people can't make their mortgages. Sometimes it is loss of income or medical emergency.

The securities market today, in the nonconforming area, is frozen. There is no mortgage-backed securities market today. So that also contributes.

We believe that, beginning in about January of this year, the underwriting standards that we submitted to regulators, and they adopted as guidance, has essentially established strong, good underwriting standards for good credit decisions going forward. So it

is the old ones that we are dealing with, and we are dealing with them——

Mr. JOHNSON. And these old underwriting standards, or lack thereof, have resulted in a crisis that confronts our economy here in this country, with people losing their homes, rendering secured assets unsecured at this point. I guess what would be the worst thing to happen?

Would it be for this amendment to the Bankruptcy Act allowing the bankruptcy court to change the interest rates on mortgages that have already threatened the homeowner with foreclosure, thus potentially becoming unsecured. What would be worse? That kind of scenario or just a simple glut of mortgage company owned property that they were unable to sell in a over-glutted market, with homes sitting on a shelf. Which would be worse?

Mr. BARTLETT. Fair question, Congressman. We can choose a better way, which is to let the lenders modify the loans that they are doing now, provide forbearance, work it through.

Mr. JOHNSON. Well, I mean sometimes, though, those lenders are not as aggressive about working those situations out as possible, because it hurts their securities that have gone down the line.

Mr. BARTLETT. One of the things in my testimony is that beginning in July, we reached an agreement with the securities industry to eliminate that as a problem. But candidly, that was a problem up until June or July. And I put in the record, the principles that we got adopted. It is a complicated problem.

My concern about this approach is that it will make the problem better by further freezing up the market and then denying credit to millions of borrowers for the next 10 years.

Mr. JOHNSON. Well, now as I see it, you are forced with a dilemma: either have all of this inventory of unsold property that is unsecured and nonperforming, or to have consumers able to get out from under onerous and oftentimes unfair upticks in their interest rates that don't bear any relationship on their ability to pay.

Mr. BARTLETT. And we choose the second course. And we believe that that can be done and is being done today without removing our security in the bankruptcy court.

Ms. SÁNCHEZ. The time of the gentleman from Georgia has expired. At this time, I would recognize the gentleman from Arizona, Mr. Franks, for any questions he many have.

Mr. FRANKS. Well, thank you, Madame Chair.

One of the challenges that occurs to me that has been at the core of this potential meltdown—I mean, it has impacted the country significantly. And if it spills over into commercial paper, I am concerned that it could have a very significant impact on their Nation's economy.

And as I understand, the primary challenge has been that those who were people that measured the borrowers' credit, those who were the ones that measured the worth of the property, or that were the ones that estimated the property's worth—that there was sort of a cross-pollenization there with some of those who were securing the loan in the first place. And that the motivation was to try to qualify lenders that really weren't qualified, or to try to ascribe value to a property that was perhaps not as much as it

should have been, and also to not have the kind of meticulous scrutiny of the income of the particular borrower.

And I am of the conviction that that which gets rewarded gets done. And the reward here was to do all the wrong things for the subprime borrower. And so I am wondering if any of you believe that there is any advantage or any favorable consideration of a bill or a policy that would separate those entities and not allow the intrinsic—I am not sure what you would call it—conflict of interest. I hate to use that term. It is probably at the very core of where we are right now.

I mean, I saw, in the meltdown in 1986, the tax laws changed. And what happened was a lot of the S&Ls were heavily invested in commercial properties and second properties. When the tax laws changed, it adversely changed the status of those properties, and those portfolios were devalued sometimes 40 percent to 50 percent, which would just about break any S&L. And that was something Government did here. And I am wondering if Government hasn't failed to make sure that we have a separation of powers, as it were, in the lending process.

Ms. Morgan, I will ask you to comment on that first, if you have been able to divine what I am saying at all here.

Judge MORGAN. I do understand. And with respect to regulation outside of my field, I don't know that I have a suggestion. It strikes me that perhaps Mr. Stein is the best person to respond.

Mr. FRANKS. Mr. Stein, I think she has got a good idea.

Mr. STEIN. I agree with you that a large problem has been that the incentive's not been aligned between the person making the loan and the person receiving the loan. And I think that that is a problem. I mean, I think in the Financial Services Committee, they are talking about duties that originators would have to the borrower that currently don't exist. I mean, a mortgage broker has no duty to put the borrower in the best loan, or to give them even a good loan—none at all. And so I think that that should be looked at. And I think that is a significant cause of the current crisis.

Mr. RAO. Congressman, can I also add that one of the—in addition to the questions you asked about conflict of interest, there is also the question of the current situation in which these loans are transferred to different entities, and they are securitized. And I think one thing, a step, that would help is to make sure that all of the parties that are involved in the transaction, at all ends, are responsible for the bad acts of the originating lender.

Mr. FRANKS. I am glad you were able to put it better than I was. But I think in the bottom line, that is what happened. Those that were securing these loans or procuring them, as it were, were not doing it for themselves. They were the middle person that really didn't care what happened to either the borrower or the lender. And when you have a large resale of these loans that are packaged and then sold off to institutions and ultimately backed up, perhaps by large measure commercial paper down the road, think that that is the challenge.

So I guess my last question here is this. Do you think we have seen the end of this? I mean, with Government having to essentially subsidize and back up this process to try to let the industry stabilize itself or—I should say not just the industry, but the whole

process stabilize itself—it seems to me this has some pretty significant future implications. And I am wondering what your own predictions are, and what we can do while there is still time, if it is possible.

Mr. STEIN. About 4 million of these loans are still scheduled to reset. So we have not seen even the beginning of the problem——

Mr. FRANKS. About a year.

Mr. STEIN. A lot of—for the next year and a half, I would say.

Mr. FRANKS. Pretty frightening.

Mr. BARTLETT. Madame Chair, if I could take 30 seconds.

Ms. SÁNCHEZ. Certainly.

Mr. BARTLETT. The pipeline will continue until mid-to third quarter of 2008. And that is a real problem. That is why we are calling every single borrower without exception to try to reset the loans. After that, though, the pipeline is not getting fuller. The national standards, the strong underwriting standards, are now in place. And so we are not adding to the problem from here. So the problem will stay about where it is, maybe get worse for the next year. And then it will start to work its way out.

Ms. SÁNCHEZ. The time of the gentleman——

Mr. FRANKS. Madame Chair, is there anyone on the panel that suggests legislation to change this cross-pollenization I talked about?

Ms. SÁNCHEZ. Not to my knowledge. The time of the gentleman has expired. I understand that Judge Morgan has a plane that she must catch. So I will thank and excuse her.

Good luck in catching that flight.

And we will continue with our round of questioning.

Again, thank you for your testimony. And safe travel.

Judge MORGAN. Thank you.

Ms. SÁNCHEZ. I know that flight well.

At this time, I would like to recognize Ms. Lofgren for her 5 minutes of questions.

Ms. LOFGREN. Thank you.

And I guess I will see you at home, Judge Morgan. I will ask my question of you at home relative to the statute and the exigent circumstances. It surprises me that courts—I am inclined to think we need to change the Act, the 1978 Act. But pending foreclosure not being a sufficient exigent circumstance to merit deferral of the counseling requirement, does the bench have the right under the current law to find a foreclosure to be an exigent circumstance under the current act? Or do we really need to change the law on that as well do you think?

Judge MORGAN. We are really only able to avoid counseling in very, very limited circumstances. It is much stricter than simply just a foreclosure.

Ms. LOFGREN. So we need to address that.

Judge MORGAN. This is an area that I think is somewhat noncontroversial. I don't know that even Mr. Bartlett would disagree with——

Ms. LOFGREN. Well, thank you very much.

Judge MORGAN. Okay. Thank you so much.

Ms. LOFGREN. I have some questions for the other witnesses. I was actually thinking about—you know, it is interesting, I actually

worked on the 1978 Act. Don Edwards, then the chair of the what was called Subcommittee 4 that had jurisdiction over bankruptcy, and Allan A. Parker, who was the general counsel—and I actually e-mailed Allan as I was sitting here. And I think why did we do this? You know? I can't recall what the rationale was in 1978. Certainly there was not a lot of discussion that I remember on how to preclude mortgages from reorganizations.

And I think it may have been that the whole market was so different. But it seems to me a mistake on several levels to not change the law. Number one, just equitable issues. Number two—I guess this is a question. There has been a concern expressed, and I think we need to be mindful of the impact of whatever we do on liquidity and the ability to affect the market.

But it seems to me, in most States—in, for example, California—we are an anti-deficiency State. And so if somebody—you just walk away from that mortgage, and what we have got now in California are homes that are now valued more than the market. And so you have got banks ending up with this, they are eating it anyhow. It is a loss for the banks. But it is also a loss for the individual. So I don't see how the ability to restructure is actually going to be worse than the current situation. That is question number one.

And question number two, I guess, really is, does anybody else remember what the 1978 Act rationale was? I have been searching the memory bank. But I am not coming up with it. So whoever can answer those——

Mr. STEIN. Congresswoman, I wonder if I can address those. On the first issue, I agree with you completely that I think that the proposal to modify the chapter 13 provisions in the way that we suggest really goes to the very heart of loss mitigation policy, which the lending community has embraced at this point. It really would turn a nonperforming loan into a profitable asset and would preserve for lenders much of the value of the original obligation. So I think you are absolutely right, especially in States like California, where the option for the lender is that it really is just an asset that is only good for its liquidation value. This actually would return more than that.

As far as the reasoning for the 1978 addition for the protection for mortgage lenders, very little actual direct legislative history. In my testimony, I included a decision which goes through, looks at very carefully. The only thing I would say is that it was a time when interest rates were going up.

Ms. LOFGREN. Well, maybe what I will do is, when Allan Parker e-mails me back, I will share the answer with the Committee. And I would just like to—as I have listened—I mean, we have got a very significant problem on our hands as a country. And I think it is important that we act. I recall my grandparents in the Great Depression had a little house that they built. And every house on the block was going to be lost. And the banks went and said if you could just pay the interest, they wouldn't take the house, because they didn't want any more houses.

You can't really do that now, because of the securitization of these mortgage instruments. And I think, in some ways, the bankruptcy courts could fill in for what the banks themselves did in the Great Depression in this country. So I see the light is on, and my

time is up. And I haven't had a chance to let everyone answer. But perhaps we can get the answers in writing. I don't want to abuse the time.

Ms. SÁNCHEZ. Thank you.

The time of the gentle lady has expired. At this time, I would like to recognize one of the original co-sponsors of the proposed legislation and the very distinguished Member from North Carolina, Mr. Watt, for his 5 minutes of questions.

Mr. WATT. Thank you, Madame Chair.

Mr. Lofgren actually didn't get an answer to the question that I wanted to try to get an answer to, which was the historical justification for this. I have searched. And it didn't seem to me to make a lot of sense. I have some theories, I guess. If you were quickly selling home mortgage loans in situations where securitizers were not regularly looking at the terms of the loans, I guess it makes sense.

But other commercial loans are securitized and spun off, and securitizers are obligated to look more closely at those. So I think this is one of those situations where we need to incentivize securitizers to have a higher level of vigilance about what it is they are buying.

I think—at least Mr. Bartlett and Mr. Stein know that I probably spend as much time on this issue between the Judiciary Committee and the Financial Services Committee as most anybody. And it seems to me that this is a rational request. And if there is a justification for not doing it permanently, we need to look at at least doing it temporarily. And I am not sure that I understand that there would be a justification for not doing it permanently.

In fact, one of the reasons that I signed on to the Miller bill is that they approach that he was using seemed to me to be the most reasonable approach. And so I guess I would use part of my time to invite Mr. Bartlett to please take a closer look at the Miller bill, the House bill, which doesn't have a lot of the provisions that I understand—I don't know if Senator Durbin has even introduced his bill.

It was in proposal form at the time that we were looking at it and had a number of provisions in it that went beyond the bill that I joined, with the Chair of this Subcommittee, and Congressman Miller and Congressman Frank and a number of other people, who were thinking that this was a reasonable step. So I hope that the lender community will take a closer look at that bill and perhaps give us some very constructive suggestions about how it may be implemented.

So there seems to be a great deal of disparity between what Mr. Bartlett is saying about what lenders are doing, and what Mr. Stein and Judge Morgan were saying about willingness. Can you give me any backup information about what is happening in the market about willingness of lenders to re-look at these outstanding loans? What is your justification that it is not taking place, when Mr. Bartlett seems to be saying that it is taking place at record rates?

Mr. STEIN. As I mentioned, Moody's looked at loans serviced by 80 percent of the industry and found only 1 percent of loans, post-reset, were being modified. Counseling agency—Consumer Credit

Counseling in California—who sees 1,000 cases a month, said lenders are simply not modifying loans where the problem is the rate reset. If it is a temporary income problem, like a loss of job, they are. But if it is a rate rest which is causing the problem, he said lenders are uniformly not modifying loans. It is just not happening.

Mr. WATT. I just give my personal experience. I finally did get a letter last week, after I had refinanced out of the loan, offering to reset my rate. Now, I had already taken the step to get out of the adjustable rate loan. So maybe it is just beginning to trigger in that lenders are finding this to be in their interests.

But I hope that the lender community will look at the bill that we have introduced. And let us roll up our sleeves and try to solve this problem.

Ms. SÁNCHEZ. The time of the gentleman has expired.

I want to thank all of the witnesses for their testimony today. Without objection, Members will have 5 legislative days to submit any additional written questions, which we will forward to the witnesses and ask that you answer as promptly as you can, so that they can be made a part of the record. Without objection, the record will remain open for 5 legislative days for the submission of any other additional materials.

Again, I want to thank everybody for their time and patience. This hearing of the Subcommittee on Commercial and Administrative Law is adjourned.

[Whereupon, at 5:08 p.m., the Subcommittee was adjourned.]

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