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THE LOOMING FORECLOSURE CRISIS: HOW TO HELP FAMILIES SAVE THEIR HOMES

HEARING

BEFORE THE

COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

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THE LOOMING FORECLOSURE CRISIS: HOW TO HELP FAMILIES SAVE THEIR HOMES

WEDNESDAY, DECEMBER 5, 2007

UNITED STATES SENATE,
COMMITTEE ON THE JUDICIARY,
Washington, DC

The Committee met, Pursuant to notice, at 2:29 p.m., in room 226, Dirksen Senate Office Building, Hon. Richard J. Durbin, presiding.

Present: Senators Specter and Sessions.

OPENING STATEMENT OF HON. RICHARD J. DURBIN, A U.S. SENATOR FROM THE STATE OF ILLINOIS

Senator DURBIN. The hearing will come to order.

Good afternoon, and welcome to this hearing of the Senate Judiciary Committee on "The Looming Foreclosure Crisis: How to Help Families Save Their Homes."

I want to thank Chairman Patrick Leahy for scheduling this important hearing and permitting me to chair it. I believe I'll be joined by some colleagues during the course of this hearing, and they will play an active part in the interrogation, as well as follow-up questions.

America's mortgage crisis is not just your neighbor's problem, it is everyone's problem. It is putting families out on the streets, driving down home values, and sending our economy into a tailspin. It is a crisis that demands an urgent response.

Home ownership is a pillar of our society and an integral part of America's economy. But the mortgage melt-down means thousands of families are losing their homes. Millions more are at risk of foreclosure, and up to a third of all home-owning families in this country may see their homes lose value.

Why is this happening? The reasons are clear. During the heyday of the real estate bubble, through a combination of bad information and aggressive brokers and bankers, too many families signed up for bad mortgages. For a while, many homeowners were able to keep up with their mortgage payments because home values were on the rise, or because adjustable rate mortgages had not yet reset to higher interest rates. But many of these same homeowners are now struggling as housing prices have dropped and the adjustable rate mortgages have begun to re-set.

Whatever the reason that families may find themselves unable to pay their mortgages, the effect of foreclosure is the same: it's a disaster for the family, and for the neighborhood, and for our country.

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The Center for Responsible Lending estimated, a year ago, that 2.2 million homes might be lost to foreclosure in the coming months ahead. That estimates now looks conservative. The impact of home foreclosures is not limited to families who are put out on the street. Treasury Secretary Paulson said earlier this week, "Homes in foreclosure can pose costs for the whole neighborhood, as crime goes up and property values decline."

The Center for Responsible Lending recently released new estimates on the lost home value that the foreclosure wave will cause for neighboring families. The Center predicts that, nationwide, 44.5 million families will experience a loss in home value because of foreclosures in their neighborhoods. Forty-four point five million homeowners represent one-third of all residential homes in America. These families will see property values decrease by an average of $5,000.

Some metropolitan regions will be particularly hard hit. In Cook County, Illinois alone, the Center predicts that around 2 million homeowners will lose value in their homes because of neighborhood foreclosures. Somewhere between two-thirds and 85 percent of all Cook County homeowners will be affected by the 50,000 or 59,000 foreclosures in that county. These homeowners will lose, collectively, $15.7 billion in home value, an average of $7,000 a home.

These are astounding numbers. Home foreclosures pose other problems as well. The U.S. Conference of Mayors issued a report projecting the foreclosure crisis will result in 524,000 fewer jobs next year, a drop in consumer spending, a loss of billions of dollars in local, State, and Federal tax revenue, and a slower growth rate for our U.S. GDP.

This foreclosure crisis is looming over our entire economy right now. It is time to do something. The government, mortgage lending industry, and the nonprofits who help homeowners have to work together to save as many homes as possible. I am pleased that in Congress, we are now talking about how to tighten lending standards so we won't repeat this type of market melt-down, but there is more work to do. In the meantime, many families are already in a desperate struggle.

I have introduced the Helping Families Save Their Homes in Bankruptcy Act. This legislation can help save the homes of about 1 out of every 4 facing foreclosure, about 600,000 families who have nowhere else to turn.

Today, a bankruptcy judge in Chapter 13 can change the structure of any secured debt except for one: the mortgage on a home, a principal residence. When this exception was added to the law almost 30 years ago, mortgages were largely 30-year, fixed-rate loans that required 20 percent down, and were originated by a local banker who personally knew the homeowner. In 1978, when this provision was added to the Bankruptcy Code, it was rare, if ever, that a mortgage would be the source of financial difficulty that sent a family into bankruptcy.

Well, a lot has changed since 1978. Now, unregulated, out-of-town mortgage brokers sell exotic, "no-doc", interest-only, "2-28", or other exotic mortgages to families with few questions asked. The mortgages are then securitized by the big banks, sold into secondary markets to investors who have no knowledge of the home-

owner or their financial situation. Risk is dispersed, but so is responsibility.

In 1978, when a family realized it might begin having trouble making a house payment, it could go down to the local bank and work out a new plan to keep up. Today, families struggle to even get a straight answer from somebody on a telephone about what's happened to their mortgage. We need another solution for families who are losing their way in this brave new world of complicated mortgages. We need to provide families with more leverage so that banks will work harder to come up with reasonable compromises.

Bankruptcy has to be the last resort. I believe it is. But changing how family homes are treated in bankruptcy will help hundreds of thousands of families who would otherwise be out on the street. Who wins? Who wins in a foreclosure? All of the money that is being spent so that someone ends up with a home that can be worth no more ultimately than the fair market value? Do bankers really want to cut grass and wash windows? I don't think so. If we can keep the family in the home under reasonable terms, that's the best outcome.

My bill would allow bankruptcy judges to work out mortgage payment plans with the homeowners and the banks, and also protect those families from excessive fees. Under my bill, only families that desperately need the help will file for bankruptcy, and only reasonable mortgages will result. The bill will facilitate dealing with each family situation individually, and yet it would provide a method for processing the massive volume of needed modifications that the banks' voluntary work-out procedures simply cannot handle. It does not create a new government bureaucracy, and it wouldn't cost the taxpayers a penny.

This afternoon, I look forward to learning more about the current state of the mortgage market and discussing how we might make those changes to the Bankruptcy Code. Before I recognize him, I want to thank my colleague, Senator Arlen Specter from Pennsylvania. He and I have been talking this over for the last several months, and it was his suggestion that we have this hearing. I am glad we did. A lot of attention is being paid to this, as it should be. This is a national issue of great consequence. I thank Senator Specter for his continuing interest, and I give him the floor.

STATEMENT OF HON. ARLEN SPECTER, A U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Senator SPECTER. Thank you very much, Mr. Chairman, for that excellent background on the problem, and those generous words.

It is true that Senator Durbin, I, and others have been talking about this problem for a long time. We are very close to the same approach, with one difference. That is, Senator Durbin's bill would all the bankruptcy courts to cram down, or modify the principal obligation. My bill would deal only with the interest.

My thinking has been that on the adjustable rate mortgage, people didn't really know what they were doing and they were getting involved in financial transactions which were a surprise to them, where they expected to pay a given amount and then suddenly they found the adjustable rates are much higher and something they could not afford.

Some of these transactions, I think, border, if not cross the line, of fraud and misrepresenting to homeowners what was going to happen. With the principal sum, it's a little different. I think they knew what the principal sum was. But it is really anomalous that the Bankruptcy Code allows secure transactions to be modified by the bankruptcy court, but not first mortgages.

I noted with interest a notation from a concurring opinion of Justice Stevens in Nobleman v. American Savings. He wrote it this way, and he lays it out in very succinct terms: "At first blush, it seems somewhat strange that the Bankruptcy Code should provide less protection to an individual's interest in retaining possession of his or her home than of other assets. The anomaly is, however, explained by the legislative history, indicating favorable treatment of residential mortgages was intended to encourage the flow of capital into the home lending market."

So the concern that I have had, and candidly expressed to Senator Durbin, is that if we make a modification of the principal home, then the lenders will be reluctant to loan money for the principal home for fear that there will be another action by Congress to move the goal post. But when he and I talked about this, we were of the same mind, that we ought to know what the experts thought. We can sit and speculate about it, and our staffs, which are more astute than we, could work on it, but that it would be a good idea to hear from some of the experts.

This hearing has been set for the afternoon, which is sort of tough on our schedule. We ordinarily have these hearings in the morning. This is a major, major problem in this country. The lack of attendance of the 19 members of the Judiciary Committee doesn't signify any lack of concern, but only that people are occupied with many other matters. I personally will stay as long as I can, but we will be following your testimony very, very closely.

The President has addressed the subject. Treasury Secretary Paulson has. Secretary Jackson has. I believe this is a matter that the Congress ought to act on very promptly, so we're going to move the ball ahead with this hearing today.

Thank you, Mr. Chairman.

Senator DURBIN. Senator Specter, thank you very much.

Senator SPECTER. Senator Coleman is a cosponsor of my bill, and I would like to thank him for joining.

Senator DURBIN. Thank you.

This matter is before the full committee, the Judiciary Committee. It customarily would have been before the Subcommittee on Administrative Oversight and the Courts. Senator Sessions of Alabama is the ranking Republican member on that, and I would invite him now if he'd like to make an opening statement.

STATEMENT OF HON. JEFF SESSIONS, A U.S. SENATOR FROM THE STATE OF ALABAMA

Senator SESSIONS. I thank you for having this hearing. I'm a very strong believer that one of the most fantastic things about living in America, is that the average citizen with a decent job can borrow $100,000, $150,000, 6, 7 percent interest, pay it off over 30 years, and move into a nice house, at least in most areas of the country. It's more than that in some, for sure. So, I think it's a

great privilege we have. It used to be rather simple. There weren't many different kinds of mortgages and loans that you took out. Now we've gotten very complicated.

I think it's worthy of Congress to consider how we do this. But I do know that we're not going to change the law of supply and demand. If we make too many rules, particularly on the back end in court, we're liable to reduce the amount of money available for the average person to borrow to buy a house that he can raise his family in and retire in. So, that would be my concern as we go forward. We ask those questions to make sure that we are addressing the problems that we now face in the best way possible.

Thank you, Senator Durbin.

Senator DURBIN. Thank you, Senator Sessions.

Before we turn to the witnesses, I want to briefly enter several statements into the record. I have a letter in support of my legislation signed by a diverse group of consumer, civil rights, labor, retiree, housing, lending and community organizations. Without objection, they letter will be entered into the record.

I also have been asked to submit statements for the record from the following organizations: the American Bankers Association; National Association of Home Builders; and the Consumer Mortgage Coalition. Without objection, they will also be entered into the record.

Now we will turn to our witnesses for their opening statements. I am honored to welcome this distinguished panel. Each witness will have 5 minutes for an opening statement. You will see the timer in front of you turn red when the Capitol Police are about to arrive. Since we have a large panel, I ask you to please try to stay within 5 minutes if you can. Your complete written statements will be made part of the record.

I'd like to ask the witnesses, with the exception of Ms. McGee, who may remain seated, if they would please rise and raise their right hands to have the oath.

[Whereupon, the witnesses were duly sworn.]

Senator DURBIN. Let the record reflect that the witnesses all answered in the affirmative.

Our first witness is Ms. Nettie McGee. Ms. McGee is a great-grandmother who has lived in Chicago for the last 53 years. She is now retired after a career of working in a picture frame factory. In 1999, at the age of 65, Ms. McGee bought her first home on South Aberdeen, on the south side of Chicago. Now she is in danger of losing that home because of an increase in her mortgage interest rates.

Ms. McGee, I know it was a great sacrifice for you to come out here, and I thank you very much. I know it is also hard to talk about this situation, but believe me, you are speaking for many, many people who can't be here today. We wanted to hear your voice and your story as part of this record. Please proceed with your statement.

STATEMENT OF NETTIE MCGEE, CHICAGO, ILLINOIS

Ms. MCGEE. Senator Durbin, members of the committee, thank you for inviting me to speak before you today. My name is Nettie McGee and I've lived in Chicago, Illinois for 53 years. I live in a

home I waited my entire life to own. Now the interest rate on my mortgage is going up 3 percent and my payments are $200 more each month. I am here to ask you to please help me save my home.

In 1997, I began renting my current home on South Aberdeen Street. I rented it for 2 years with an option to buy. When I finally bought my first home in 1999, for $80,000, I was 65 years old. I made the payment for 6 years. I had a fixed rate mortgage and I knew what to expect each month: it was $735 every month. I was able to make my payments and pay my taxes. I could afford all of my bills.

Then in October of 2005, the sheriff came to my door to tell me that my backyard was going to be sold for auction for $5,000 because of an unpaid tax bill. I paid the taxes on my house every year. I just didn't know that I had two tax bills, one for my house and one for my backyard. The tax bill for my backyard had been sent to an address across town for years, since and before I moved in. I was desperate to keep my backyard and my beautiful trees, but I had to pay the city $5,000 and I had to do something fast because I would lose my yard.

I didn't have $5,000 in the bank. I live on Social Security and I get some rent from my daughter. Then I saw a commercial on TV about refinancing your home. I thought if I refinanced, I could get money to pay the tax bill and keep my yard. I called the number and a broker came to visit me the next day. He wrote down my personal information, and a week and a half later he called me and asked me to come down to sign the papers.

After I arrived at the crowded office, I was taken into a small room, handed about 40 pages, and told where to sign. The woman in charge of the closing stood over me and turned the pages as I signed them. The whole process took about 10 minutes. I thought I was signing a fixed-rate loan. Then, with no explanation of the loan, I was sent out the door. The mortgage company paid the taxes to the county.

Then, to my surprise, they called me a few days later to come back and get a check for $9,000. I didn't know they had me borrowing the extra $9,000. When I asked about it, the mortgage company said that I could use it for bills. I thought it was a good idea, so I used the money to pay some bills and fix my plumbing problem. I started paying the loan back. The payments were about the same as my original loan. It's been difficult at times, but I have never missed a payment.

A month and a half ago, in October of this year, I got a letter from my mortgage company that said that on December 1, my payment was going up from $706 to $912. I called the mortgage broker, but he doesn't work there anymore. I thought I signed a fixed-rate mortgage. I had no idea my payment would jump almost 25 percent. My interest rate went from 7.8 to 10.87, and eventually it will go higher.

I don't know how to make my payments now. They are higher than my Social Security check. The only reason I can get by now is because my daughter pays me a little rent. Right now, my lawyers from the Legal Assistance Foundation in Chicago are trying to help me negotiate with my lender, but we don't know if the bank will agree to lower my interest rate back where it was before.

I know I will lose my home that I waited my entire life to own if I can't get my original rate back. Many people who could originally afford their mortgage payments are losing their homes because they have an adjustable rate mortgage. Please help people like me, please, who waited their entire lives to own their homes. Please help me.

Senator DURBIN. Thank you for that great statement, exactly 5 minutes. You're a model for the rest of the witnesses. Thank you so much, Ms. McGee.

[The prepared statement of Ms. McGee appears as a submission for the record.]

Our next witness is Mark Zandi. Mr. Zandi is the chief economist and co-founder of Moody's Economy.com, Inc., where he directs the company's research and consulting activities. Moody's Economy.com provides economic research and consulting services to businesses, government, and other institutions. Mr. Zandi received his B.S. from the Wharton School at the University of Pennsylvania, and his Ph.D. at the University of Pennsylvania.

Thank you very much for joining us today. We look forward to your testimony.

STATEMENT OF MARK ZANDI, CHIEF ECONOMIST, MOODY'S ECONOMY.COM, INC., WEST CHESTER, PENNSYLVANIA

Mr. ZANDI. Thank you for the opportunity to be here today. I am the chief economist and co-founder of Moody's Economy.com. We're an independent subsidiary of the Moody's Corporation. These are my own personal reviews and do not represent those held by, or endorsed by, Moody's.

I will make six points in my remarks. First, the Nation's housing and mortgage markets are suffering an unprecedented downturn. Housing activity peaked over 2 years ago, and since then home sales have fallen by over 30 percent, housing starts by 40 percent, and house prices by 7 percent. Over half of the Nation's housing markets are currently experiencing substantial price declines, with double-digit price declines occurring throughout Arizona, California, Florida, Nevada, the northeast corridor, and the industrial midwest.

Further, significant declines in housing construction prices are likely into 2009 as a record amount of unsold housing inventory continues to mount, given the impact of the recent subprime financial shock and its impact on the mortgage securities market and, thus, mortgage lenders. There is now a broad consensus that national house prices will fall by between 10 and 15 percent from their peak to their eventual trough. Even this disconcerting outlook assumes that the broader economy will avoid recession and that the Federal Reserve will continue to lower interest rates.

The second point. Residential mortgage loan defaults and foreclosures are surging, and without significant policy changes, will continue to do so through the remainder of the decade. Falling housing values, resetting adjustable mortgages for recent subprime and all-day borrowers, tighter underwriting standards, and most recently a weakening job market, are all conspiring to create the current unprecedented mortgage credit problems. Even if mortgage loan modification efforts soon measurably increase, I expect ap-

proximately 2.8 million mortgage loan defaults, the first step in the foreclosure process, in 2008 and 2009.

Of these, 1.9 million homeowners will go through the entire process and ultimately lose their homes. The impact on these households or communities in the broader economy will be substantial. Foreclosure sales are very costly after accounting for substantial transaction costs and can serve to significantly depress already reeling housing markets are foreclosed properties are generally sold at deep discounts to prevailing market prices. In much less stressful times, these discounts are estimated to be between 20 and 30 percent.

Point three. There's a substantial risk that the housing downturn and the surging foreclosures will result in a national economic recession. The stunning decline in housing activity and prices will combine with rising gasoline prices, crimping consumer spending, and the job market appears increasingly weak as it struggles with layoffs in housing-related industries. Regional economies, such as California, Florida, Nevada, and much of the industrial midwest, together, accounting for well over one-fourth of the Nation's GDP, are, in my judgment, already in recession.

The turmoil in the housing and mortgage markets also threaten to further up-end the fragile global financial system, with very clear negative implications for the U.S. economy. Estimates of the mortgage losses global investors will eventually have to bear range as high as $500 billion. The losses recognized so far to date are now more than $75 billion. If the U.S. economy does slide into recession, then of course house prices will decline. Foreclosures will rise to an even more serious degree.

Point No. 4. Without a quick policy response, mortgage loan modification efforts are unlikely to increase enough to forestall a surge in foreclosure. A recent Moody survey of loan servicers found that very little modification had been done, at least through this past summer. This highlights the substantial impediments to modification efforts. Some tax, accounting, and legal hurdles appear to have been overcome, but large differences in the incentives of first and second mortgage lienholders and the various investors in mortgage securities are proving very daunting.

Given the overwhelming number of foreclosures, loan servicers are also having difficulty appropriately staffing the modification efforts. While the total economic benefit of forestalling foreclosure is significant, these benefits do not accrue to all parties involved in determining whether to proceed with the loan modification.

A recent initiative by the Treasury Department in the Nation's lenders to freeze interest rates on re-setting subprime ARM loans is a good step, but should not forestall passage of your legislation, the Helping Families Save Their Homes in Bankruptcy Act. If the Treasury plan is successful in helping many borrowers, then these borrowers will not avail themselves of the opportunity to avoid foreclosure and Chapter 13 provided by this legislation. If, however, Treasury's efforts are unsuccessful, which may very well be the case, then this legislation will prove invaluable.

The fifth point. Senator Durbin's legislation, which would give bankruptcy judges the authority in Chapter 13 to modify mortgages by treating them as secured only up to the market value of the

property, would significantly reduce the number of foreclosures. An estimated over one-fourth of homeowners likely to lose their homes between now and the end of the decade, equal to an estimated 570,000 homeowners, would benefit from this legislation.

This calculation is based on the number of homeowners who face a first payment re-set through the end of the decade that would meet the means test required in the 13 that are still current on their mortgage loans. This would be very helpful in reducing the pressure on the housing and mortgage markets and will measurably reduce the odds of recession in the coming year.

Note that in order to limit any potential abuses in the Chapter 13 modification process, Congress should provide firm guidelines to bankruptcy courts, such as providing a formula for determining the term to maturity and the rate of a property's market value.

Finally, this legislation will not significantly raise the cost of mortgage credit, disrupt secondary markets, or lead to substantial abuses by borrowers. Given that the total cost of foreclosure to lenders is much greater than that associated with a 13, there's no reason to believe that the cost of mortgage credit across all mortgage loan products should rise.

Simply consider the substantial costs involved with navigating through 50 different State foreclosure processes in contrast to one well-defined bankruptcy proceeding. Indeed, the cost of mortgage credit to prime borrowers may decline. The cost of second mortgage loans, such as piggy-back seconds, could rise as they are likely to suffer most from bankruptcy. Such lending has played a clear contributing role in the current credit problems.

There is also no evidence that the secondary mortgage markets will be materially impacted as other consumer loans already have similar protection in 13 and have well-functioning secondary markets. However, the non-conforming residential mortgage market has already effectively been shut down in the wake of the financial shock and will only revive after there are major changes to the process. The changes proposed in this legislation are immaterial by comparison.

It is also unlikely that the abuses by borrowers will increase as a result of the legislation, given that a work-out in a 13 is a very financially painful process. Indeed, the number of filings has remained surprisingly low since the late 2005 bankruptcy reform, likely reflecting the now much higher cost to borrowers in a 13 proceeding. Short-term investors, or flippers, those who have borrowed heavily, looking to make a quick profit in the boom, would certainly not consider 13 a viable solution to their problem.

The housing downturn is intensify, foreclosures are surging. A self-reinforcing negative dynamic of mortgage foreclosures begetting house price declines, begetting more foreclosures, is under way in many neighborhoods across the country. The odds of a full-blown recession are very high. There is no more efficacious way to short-circuit this developing cycle and forestall a recession than passing this legislation. Thank you.

Senator DURBIN. Thank you, Mr. Zandi.

[The prepared statement of Mr. Zandi appears as a submission for the record.]

Senator DURBIN. Professor Joseph Mason is an Associate Professor of Finance at Drexel University's LeBow College of Business in Philadelphia, and a senior fellow at the Wharton School. Before joining Drexel, Professor Mason spent 3 years at the Office of the Comptroller of the Currency. Professor Mason has an M.S. and a Ph.D. from the University of Illinois, and a B.S. from Arizona State University.

Professor Mason, you may proceed.

STATEMENT OF JOSEPH MASON, ASSOCIATE PROFESSOR, DREXEL UNIVERSITY, PHILADELPHIA, PENNSYLVANIA

Mr. MASON. Thank you, Mr. Chairman, Ranking Senator Specter, and members of the committee, for the opportunity to be here today. I am pleased to appear before you to talk about this foreclosure crisis and the legislative options for addressing the economic and social concerns arising from that crisis.

People only file for bankruptcy if they are, first, vulnerable—i.e., they have debt greater than their assets—and second, only if some financial shock occurs that prevents them from keeping debt service payments current. The typical shocks that cause bankruptcy—divorce, illness, accident, and addiction—have all increased over the last several decades and are particularly prevalent among individuals in their 30's, in a time when they have the highest debt load of their lives. With the advent of subprime mortgages, we must now add adjustable rate mortgage payment shocks to the list of classic influences.

The question today, therefore, is to what extent legislative intervention can, and should, insulate individuals from the payment shocks in their mortgage contracts. I offer you three main conclusions from an economic perspective.

First, mortgages and other real assets are poor candidates for bifurcation in bankruptcy because they can be fully expected to regain value later on in the life of the contract. Hence, bifurcation of a debt secured by real estate may be considered a taking, in a sense, not applicable to fully depreciable assets.

The reason a bifurcation makes sense for a fully depreciable collateral, is that the value of that collateral is decreasing throughout the life of the loan. If a court bifurcates a claim on an automobile loan, the automobile is not expected to ever be worth more than the market value established by the courts at that time.

For real estate, even in today's market conditions, the value of the collateral can be expected to grow in the future, so that bifurcating the claim is akin to taking away real value from the lender and giving that value to the borrower. The concept is especially egregious in real estate markets that are highly sensitive to economic or market conditions. High-flying real estate markets of 1980's returned handsome profits for investors after the relatively brief market disruptions of the late 1980's and the recession of 1991.

The Case-Schiller Mortgage Price Index, which begins in January 1987, shows that Boston home prices hit a high of 75.53 on the index in July 1988, and retreated thereafter, only to reach and exceed that level again in May, 1997. Boston now stands at an indexed level of 170.73, providing 127 percent total return for a

buyer who bought at that January 1987 peak, or 4.2 percent annual return since 1987.

Los Angeles, similarly, peaked at an index level of 100 in June, 1990, and after a similar hiatus reached that level again in January of 2000. Los Angeles now stands at an indexed level of 254.79, which provided a buyer at that previous peak, 155 percent total return, or 5.7 percent annually since 1990.

It's important to point out, these are worst-case returns obtained from buying at the top of the market and holding. The cases do not account for the fact that the investment made by a home buyer is leveraged so that an investment of 20 percent down, along with periodic payments, is enough to obtain the full gain of the property value.

Second, legislative changes to enable bifurcation of mortgage contracts will increase the cost of credit to mortgage borrowers to cover the expected aggregate value of judiciary settlements. The cost of mortgage credit can be expected to rise to levels on par with other secured non-mortgage credit, like automobile loans, and unsecured credit, like credit cards.

The problem, however, will also extend to secondary markets for securitized loans that have been devastated by uncertainty over the last year. Since the ability to bifurcate mortgages will extend to contracts already written and sold in securitized pools, existing loans will decline in value by the risk difference employed in the spread between non-real estate and real estate secured credit. That means that the value of residential mortgage-backed securities will decline further as well.

In the event that markets will not be able to adequately ascertain the impact of judicial intervention, they will impose an additional "Lemons" discount above and beyond that already imposed on the market for fundamental opacity and ratings agency malfeasance to account for the maximum possible effect a priori. Knock-on effects will reverberate through resecuritization markets like those for CDOs and SIVs.

The point is that judicial adjustment will add further information difficulties to an already uncertain market environment. The effect will not be limited to changes in bankruptcy law. Loan modifications will have a similar influence. For additional background on that, you can see Marty Feldstein's op-ed in today's Wall Street Journal.

In addition, changing the nature of mortgage priority in bankruptcy further incentivizes the shift away from building equity in one's own home by paying down the mortgage. If mortgage debt is tax-exempt and can be discharged in bankruptcy, it becomes even more advantageous for consumers to maximize their mortgage debt relative to the value of the home.

Addressing Senator Session's opening remarks, as a result of similar incentives we face a generation that stands to enter their retirement years without the historically largest retirement asset, their home equity, intact. Poorly funded 401(k)s, pension funds that will eventually have to face up to subprime mortgage losses in their own portfolios, and Social Security will not make up for that shortcoming, which will therefore create a tremendous drag on economic growth and social well-being.

Last, the act of bifurcating mortgage credit will increase the cost of bankruptcy to cover appraisal and other transactions costs needed to establish the fair market value of the underlying real estate, imposing yet another cost on filers above and beyond those imposed in the Bankruptcy Abuse, Prevention, and Consumer Protection Act that went into effect on October of 2005.

In the case of bifurcating the automobile loan mentioned previously, the judge need only look at a Kelly Blue Book to establish a reasonable market value for the collateral asset. In the case of a mortgage, however, getting the fair market value is not so simple. The judge will have to order an appraisal of the property to assess a fair market value. That will cost approximately $300 to $500, and the cost would be expected to be paid by the debtor.

In addition to the cost, however, the accuracy of appraisals also has to be considered. The fact is, appraisals have not been very accurate in recent past. Appraisals skewed to the high end fueled recent over-borrowing and home price inflation, causing much of the present-day mortgage market difficulties. An industry experiencing such difficulties, which has contributed so much to the recent mortgage crisis, is hardly a reliable basis for a substantial component of bankruptcy law.

In conclusion, the U.S. economy continues to experience very real problems stemming from the mortgage crisis. The problems originate in a variety of unsafe and unsound practices in the mortgage industry, ranging from predation to speculation. It is easy to see the need to address predation in the mortgage industry. It makes sense to seek judicial remedies that have the power to nullify contractual terms that violate terms of the Real Estate Settlement Procedures Act, the Truth in Lending Act, the Homeowner Equity Protection Act, and/or other laws and regulations relating to the mortgage industry.

Giving the judiciary the power to fully bifurcate mortgage contracts, however, sets the stage for potential abuse of the bankruptcy system to further speculative purposes and further incentivizes cashing out home equity rather than sustainable home ownership.

Senator DURBIN. Thank you very much, Professor Mason.

[The prepared statement of Professor Mason appears as a submission for the record.]

Senator DURBIN. Our next witness is Professor Mark Scarberry. Professor Scarberry is a Professor of Law at Pepperdine University College of Law in Malibu, California, currently the Robert Zinman Resident Scholar at the American Bankruptcy Institute in Alexandria, Virginia. He graduated from Occidental College in Los Angeles, and the UCLA School of Law.

Thank you for joining us today. Please proceed.

STATEMENT OF MARK SCARBERRY, PROFESSOR OF LAW, PEPPERDINE SCHOOL OF LAW, AND RESIDENT SCHOLAR, AMERICAN BANKRUPTCY INSTITUTE, WASHINGTON, DC

Mr. SCARBERRY. Chairman Durbin, Ranking Member Specter, and members of the committee, I am Mark Scarberry, Professor of Law at Pepperdine University and Resident Scholar at the American Bankruptcy Institute, or ABI. I teach and write primarily on

bankruptcy law and am pleased to appear today to speak on the bankruptcy bills dealing with the mortgage crisis.

ABI is a nonpartisan, nonprofit association of over 11,000 professionals who represent both debtors and creditors in consumer and businesses cases. ABI is not an advocacy group and does not lobby. It is a neutral source for bankruptcy information and a resource for Members of Congress and their staff. As a professor and ABI resident scholar, I can give my views, but they should not be taken as the ABI's views.

You have a chart I prepared comparing the four pending bills. A key difference between the two Senate bills is that Senator Durbin's, S. 2136, allows a Chapter 13 plan in some cases to reduce the amount of an under-secured mortgage to the value of the home without the consent of the mortgage holder, a result that is called "strip-down" or sometimes "cram-down". Senator Specter's S. 2133 would require consent of the mortgage holder before a strip-down could take place. The Code currently does not permit home mortgage strip-down under Chapters 7, 11, or 13.

Now, a side point. Bankruptcy courts may not be able to handle the needed volume of cases on a one-case-at-a-time retail basis. Congress, instead, could use its bankruptcy power to help Secretary Paulson as he seeks a wholesale solution that could help hundreds of thousands of homeowners like Ms. McGee.

Mortgage servicers may lack authority to modify mortgages on such a wholesale basis as is sought by the Secretary. Legislation under Congress's bankruptcy power may be particularly appropriate to validate such agreements if made per Treasury guidelines and to immunize servicers from liability for making such agreements.

Now, no Circuit Court had permitted home mortgage strip-down in Chapter 13 until 1989. By 1993, strip-down was becoming so widely used that it threatened to further damage the already weak home lending industry. But that year, the Supreme Court, in *Nobelman*, held that Section 1322(b)(2) prohibited home mortgage strip-down in Chapter 13. The next year, Congress gave home mortgages in Chapter 11 cases the same protection. S. 2136 would remove that protection in some Chapter 13 cases.

Allowing home mortgage strip-down in Chapter 13 would, in fact, treat holders of home mortgages worse than other secured creditors. If a secured credit's lien is stripped down under current law, the stripped-down amount must be paid off, with interest, during the Chapter 13 case over no more than 5 years. As a practical matter, a debtor cannot strip down a first mortgage on a substantial vacation home because the payments needed to pay off the stripped-down amount over 5 years would be too large.

S. 2136 would let a debtor pay off a stripped-down home mortgage over a period that could be nearly 30 years. Strip-down, thus, would become feasible, but primarily only for home mortgages, with the lender forced to accept a court-determined interest rate for that very long period.

Indeed, after the 2005 amendments, the other major kind of secured consumer debt, purchase-money auto loans, may be stripped down only if the loan was made more than two and a half years before the petition filing date, which is at least half the life of a

typical auto loan. Home mortgages, thus, would be treated worse than car loans.

Home mortgage strip-down would substantially change the risk characteristics of home mortgages. Permitting strip-down would likely cause difficulties in the secondary market that is so important to the availability and affordability of home mortgages, and it would cause unjustified harm to holders of home mortgages and mortgage-related securities, including investors of modest means, through their retirement plans.

Under the approach in S. 2136, home mortgage holders would receive little benefit from the upturn in the real estate market that ordinarily follows a downturn. Under current law, in many cases the mortgage holder benefits from appreciation. Some financially distressed debtors can tighten their belts, make their current mortgage payments, and use Chapter 13 over 5 years to make up any missed payments. When the market recovers, the mortgage holder benefits from the increased value backing the full amount of its mortgage and may suffer no loss at all.

Under S. 2136, such debtors typically could, in fact, qualify to strip down their mortgages, despite provisions designed to prevent them from doing so, and I think they would opt to do it. The later upturn then will provide equity for the debtor rather than a restoration of value to the mortgage. Home mortgage strip-down thus eliminates the up-side potential and dramatically changes the risk characteristics of the mortgage. And note that under current law, even after a foreclosure, the mortgage holder can hold the property and wait for it to appreciate.

Compounding the problem, losses from strip-down probably are not covered under private mortgage insurance if there is no foreclosure. Strip-down would deprive home mortgage holders, likely, of the benefit of insurance protection that they bargained for.

Changing the risk characteristics of home mortgages retroactively likely would depress further the value of existing home mortgages. Increased risk would mean increased interest rates on new mortgages to compensate for the risk, and denial of mortgage credit to some who presently qualify. There would be a further shadow cast on the trustworthiness of American mortgage-backed securities with implications that would be disturbing, given that such securities are held worldwide by investors who count on the protection of vested property and contract rights under American law.

My written statement includes specific substantive and technical recommendations for the legislation, should Congress choose to move forward. I'd be happy to discuss those in response to questions.

The final point. Let me add that many Chapter 13 plans fail. Under section 1325(a)(5)(b)(2) of the current law added in 2005, any modification of the mortgage holder's lien would be reversed if the plan were

not successfully completed, even if the failure involved a debt other than the home mortgage, such as a priority tax claim.

Thank you again for the opportunity to appear today. I'd be very happy to answer any questions.

Senator DURBIN. Thank you, Professor Scarberry.

[The prepared statement of Professor Scarberry appears as a submission for the record.]

Senator DURBIN. Our next witness is Judge Jacqueline Cox at the U.S. Bankruptcy Court for the Northern District of Illinois, based in Chicago. Judge Cox has served as a Federal Bankruptcy Judge since 2003. From 1988 to 2003, she served as Judge of the Circuit Court of Cook County. Judge Cox has also worked in government service in the office of the Cook County State's Attorney, the City of Chicago Law Department, and the Chicago Housing Authority Law Department. She received her undergraduate degree from Cornell and her law degree from Boston University.

Judge Cox, thank you for joining us. We look forward to your testimony.

STATEMENT OF JACQUELINE P. COX, BANKRUPTCY JUDGE, U.S. BANKRUPTCY COURT FOR THE NORTHERN DISTRICT OF ILLINOIS, CHICAGO, ILLINOIS

Judge COX. Thank you, Senator Durbin, Senator Specter, and Senator Sessions. I genuinely appreciate the opportunity to address the Senate on protecting home ownership and helping families deal with burdensome home mortgages. I speak for myself, however. I do not represent the Judicial Conference of the United States or the Administrative Office of the Courts.

Because home ownership represents economic inclusion in the American dream, and because of the disparate impact of the mortgage crisis on African-Americans and Latinos, passage of the Durbin bill is critical. The Bankruptcy Code generally allows reorganizing debtors in Chapters 11, 12, and 13 to bifurcate secured debt.

The plan strips down claims to the value of the collateral. The balance, the amount of the claim that exceeds that value, gets treated as an unsecured claim. In the Chapter 13 context, the unsecured amount would be paid under the plan by a percentage generally based on the debtor's income.

Section 1 of the Helping Families Save Their Homes in Bankruptcy Act will, for the first time since 1978, allow a debtor to modify mortgage debt if the debtor's income is insufficient to pay the mortgage. This income limitation is important. It limits this extraordinary relief to those homeowners who need it. Homeowners who can afford their payments will not receive a windfall. Allowing the strip-down of mortgage debt to the collateral's fair market value reflects the economic realities of the lender's situation. The lender who forecloses a loan will recover the value of the home and may receive a deficiency claim when the debt exceeds the value of the home.

When Americans purchase homes, the most important consideration is affordability. Most of us anticipate modest future increases in income but cannot afford mortgage interest debt that increases up to 40 percent. The Durbin bill interest rate section allows the debtor to pay the strip-down amount at an interest rate equal to the rate published by the Board of Governors of the Federal Reserve system regarding the annual yield on conventional mortgages with a reasonable premium for risk.

Under the U.S. Supreme Court decision in *Till* v. *SCS Credit*, Chapter 13 debtors now follow a similar standard when adjusting

interest rates on non-residence secured debt. I will quote from the Supreme Court: "Taking its cue from ordinary lending practices, the approach begins by looking to the national prime rate, reported daily in the press, which reflects the financial market's estimate of the amount a commercial bank should charge a credit-worthy commercial borrower to compensate for the opportunity costs of the loan, the risk of inflation, and the relatively slight risk of default. Because bankruptcy debtors typically pose a greater risk of nonpayment than solvent commercial borrowers, the approach then requires a bankruptcy court to adjust the prime rate accordingly."

I quote the Supreme Court to emphasize that interest rates are adjusted in our proceedings routinely. In fact, since the 2004 *Till* decision I have heard only two or three hearings involving disputes over interest rate adjustments. The Bar and the financial services community have very little trouble in this regard.

The Durbin bill also waives the pre-petition credit counseling requirement which was added to the Bankruptcy Code by the Bankruptcy Abuse, Prevention, and Consumer Protection Act. Because most debtors facing foreclosure, probably because of fear or denial, wait until the week of a foreclosure sale to seek bankruptcy relief, credit counseling offers them no help. The briefing that debtors are required to receive outline the opportunities—I paraphrase the statute—outline the opportunities for available credit counseling and assist them in performing a budget analysis. Once a foreclosure is pending, it's too late for those kinds of relief.

I am particularly supportive of the bill's section 201, which combats excessive fees. It allows fees, costs, and other charges to be added to the secured debt only if notice of such additional charges is filed with the court within a year of when they are incurred, or 60 days before the conclusion of the plan. This policy reflects the practice of our bankruptcy court. We have a very similar provision in our model Chapter 13 plan.

The bill allows a plan to waive prepayment penalties. This assists those debtors who can arrange to refinance their obligations under more favorable terms, and we see a lot of that in Chapter 13. Such penalties do not compensate lenders for costs, they only serve to punish debtors.

I agree with the position of the National Bankruptcy Conference in remarks presented to the House of Representatives in October. On behalf of that organization, Attorney Richard Levin compared the plight of homeowners today to the plight of family farmers in the 1980s. There is clear precedent for Congress to solve this mortgage crisis by allowing debtors to bifurcate or strip down mortgage debt. That was done for the family farmers and it enabled lenders to renegotiate farm debt to reflect falling land prices. The good work of Senator Charles Grassley and Representative Mike Synar created Chapter 12. I ask that Chapter 12-style adjustments that include home mortgages be applied to Chapter 13 for the same reasons.

In conclusion, I support passage of Senator Durbin's Helping Families Save Their Homes in Bankruptcy Act. A lot of the provisions are things we do routinely. They are not new. We just don't do them for home mortgages. I agree that there would be a lot of them, but I think we can do them. As in the family farmer case,

once the bankruptcy community sets a model of how to do these things, more of the modifications will be made in out-of-court situations. I believe this bill provides a sensible and much-needed modification to the Bankruptcy Code. Thank you very much.

Senator DURBIN. Thanks, Judge Cox.

[The prepared statement of Judge Cox appears as a submission for the record.]

Senator DURBIN. Our next witness is Judge Thomas Bennett. Judge Bennett has served as a Federal Bankruptcy Judge for the Northern District of Alabama since 1995. He is currently president-elect of the National Conference of Bankruptcy Judges. From 1980 until his appointment, he was a partner with the law firm of Bowles, Rice, McDavid, Graff & Love in Charleston, West Virginia. He holds undergraduate, graduate, and law degrees from West Virginia University. Following his graduation from law school in 1976, he served as law clerk for the Honorable John R. Brown of the Fifth Circuit Court of Appeals.

Judge Bennett, thank you for being here. We look forward to your testimony.

STATEMENT OF THOMAS BENNETT, BANKRUPTCY JUDGE, U.S. BANKRUPTCY COURT FOR THE NORTHERN DISTRICT OF ALABAMA, BIRMINGHAM, ALABAMA

Judge BENNETT. Thank you, Senator Durbin. I want to thank you and Senator Specter and Senator Sessions for inviting me.

I'm not going to repeat what I've already submitted in my written comments. What I would like to do, is maybe expand on some things that I think may be misperceived and make some comments. Feel free to interrupt me if you want to.

One of the things that I want to follow up on, was a statement by one of our prior witnesses. It's something that I have written down: why is bankruptcy the ticket to get this relief? There really is a bigger picture here, in my opinion. In order to get this relief, you have to file bankruptcy. I would suggest to you that there are a group of people that otherwise would not have to file bankruptcy that will be forced to file bankruptcy to get this relief. It's a fact that should be looked at.

Senator SESSIONS. When you say "forced", you mean a lawyer would advise them that it only makes common sense that they file bankruptcy? Is that what you mean?

Judge BENNETT. If you faced the prospect of losing your property because you cannot afford the increase and you only have the ability to forestall that by filing bankruptcy, you'd have to file the bankruptcy if you wanted to preserve that property. This particular type of relief could be made available to a broader segment, is my point, potentially, that otherwise would not have to file bankruptcy. I point this out, because in the context of bankruptcy there are certain dynamics. Those people that are filing bankruptcy because they have overall financial difficulties that go beyond just mortgages will file bankruptcy anyway. They will have to.

Those that only have to deal with the increase in the mortgage cost and don't have other financial problems would not otherwise necessarily have to file bankruptcy if the bill were structured in a fashion that gave a broader scope than simply looking at bank-

ruptcy. That's why it's a fact that you ought to look at—I would suggest you look at.

There are two principal areas in the other comments that I want to expand on that have been made by others. One, rises out of my comments, my written comments. There are really two stages of losses in a bill that writes down mortgages. The first stage is the stage that exists today with respect to any mortgage. If there is a loss on the market, it's there. The testimony of the others is correct. If you have to foreclose the mortgage today, you will suffer a loss. If that loss is in bankruptcy on a write-down, you will suffer that loss. A significant difference is the second loss.

The second loss that occurs under a restructuring of principal, particularly over an attenuated time frame, is with respect to what would be the fully secured portion of the debt. When you restructure a debt over an up to 30-year period that is currently not a 30-year obligation, that fully secured debt, if the interest rate is below the market rate, will be significantly impaired. That is on somebody that just holds all payment streams. The current mortgage structure is such that there are multiple payment streams.

When you take a payment stream on what will be a written-down mortgage to its fully secured value and you bust those streams up, as they have done, into interest and principal, and some of those interest streams can be broken down and some of those principal streams can be broken down, and then you drag out the payment for 30 years, on some of those—particularly interest—streams it is very possible that they become worthless, despite the fact that the debt may be fully secured. It's because of the interest rate discount factors. This is a very, very complex problem. It is not simply just writing down the principal up front. There is a second tier of write-downs that really has to be given serious consideration.

The pooling factor, when you pool these mortgages, the pooling is designed to take care of some of the risk that I've told you about. In fairness to you, you should look at the mitigation that is caused on those losses by pooling or packaging of these streams of income. But it is a very serious issue. That's one.

The next is—and there is testimony that you've received—there really is no evidence that the interest rate and cost of interest and supply of credit has changed. There are examples in prior periods. But I would tell you, it's really like comparing apples and oranges. The reason is this: the discussion should always be on what would have otherwise been there. When you know the cost of something goes up or the supply decreases, you will not, in the future, be able to say, look, I told you so, because in the dynamics of what is going on here you could have two impacts. You could actually have lower interest rates.

But what you need to know is, how much lower would they have otherwise gone but for legislation that may go awry? You could have higher interest rates. The question, though, becomes: how much lower would they have been had the legislation not been passed?

Likewise, the supply of credit could generally increase. The real question is, how much more would it have increased but for the legislation? The supply could have decreased. The question may be

how much less it would have decreased but for the legislation, and giving historical examples will not demonstrate that. That is another issue that is of serious consequence.

What I would like to also address, is that I think there is merit in something. Where I'm coming from, if I were you, I would ask me what would I do. What I think, is there needs to be a pause for a while. As much as I may hate to admit this, it may be somebody that is from a different political background than I that has suggested something.

I think it is maybe wise to pause for a short time frame. It might be 60, 90 days, something, to try to stop what's going on, leave everything where it is at this point in time. Maybe stop foreclosures on an interim basis. But a short enough time frame to get it better fixed so you develop a broader picture. It may entail fixing of interest rates or not allowing changes in interest rates for a short time.

But my main thrust is, what you are getting ready to do may have much more serious, much broader implications than what people may contemplate. We as lawyers and judges are very bad when we deal with words and understanding what are really multivariant dynamics. That's the main thrust of what I want to do, not to tell you not to do something, because these are difficult times for many people.

The difficult times sometimes require we do things we may not otherwise do, but we need to do them in a context and a framework, I think, that addresses the overall picture, not a segment of the picture. We need to do it in a way that does the least amount of harm, and hopefully a lot more good, than the greater amount of harm.

I would like to say that there is another category of people here that we will never know exists without some very quantitative analysis, and that is if what is done by the legislation forces writedowns and converts over to a fixed interest rate and causes the cost of credit to increase incrementally enough, there will be people who would never have had to have gone to bankruptcy or elsewhere to restructure mortgages.

The numbers? I can't tell you. But what will happen is, they may have otherwise potentially been able to pay their mortgages without having legislation. The incremental cost adjustment could be such that they now face the same problem of people that you wanted to help, but because of what's occurred they now are pushed into that group you want to help. So, it's a really complex problem that I don't think, in fairness to what people may perceive is my side or the other side, that a rush to judgment on these benefits—those are my principal points. I mean, I don't want to belabor what I've already said.

Senator DURBIN. Thank you very much, Judge Bennett.

[The prepared statement of Judge Bennett appears as a submission for the record.]

Senator DURBIN. Our final witness is Henry Sommer, supervising attorney at the Pro Bono Consumer Bankruptcy Assistance Project in Philadelphia; president of the National Association of Consumer Bankruptcy Attorneys; former head of the Consumer Law Project of the Community Legal Services in Philadelphia, where he worked for 21 years; Editor-in-Chief of Collier on Bankruptcy. He served as

lecturer at University of Pennsylvania Law School received his undergraduate degree from Harvard, and his law degree from Harvard as well.

Mr. Sommer, thank you.

STATEMENT OF HENRY J. SOMMER, PRESIDENT, NATIONAL ASSOCIATION OF CONSUMER BANKRUPTCY ATTORNEYS, PHILADELPHIA, PENNSYLVANIA

Mr. SOMMER. Thank you, Mr. Chairman, Senator Specter, Senators Sessions. Thank you for inviting me to testify today.

It is now quite clear that our country is facing approximately 2 million mortgage foreclosures over the next few years. These foreclosures are already having widespread effects in neighborhoods across America, as well as in financial markets, and those effects will get much worse in the months to come. Not only will millions of people lose their homes, but other homes in the vicinity will decline in value as a result of nearby foreclosures, causing an enormous loss of wealth to most American homeowners.

It is also clear that it is within the power of Congress to prevent hundreds of thousands of these foreclosures and the ripple effect they'll cause throughout the economy.

Senator Durbin's proposed legislation, S. 2136, which would make modest changes in the Bankruptcy Code, could save as many as 600,000 families from losing their homes. Allowing families to modify their mortgage debts and reduce their payments would utilize an existing, efficient, well-established, and predictable template to prevent foreclosures and it would not require the use of government funds to bail out homeowners or lenders. No other legislative proposal has the potential to save nearly as many homes.

The basic principle underlying the bill, that liens are reduced to the extent they exceed the value of the collateral and the payment terms modified to reflect a fair rate of interest, is popularly known as "cram-down". The concept is one of longstanding importance in bankruptcy law. Essentially, it simply permits the debtor to buy back an asset from a creditor's lien at the current market value that anyone else would pay for it. The principle is fundamental to the way the bankruptcy laws reflect economic reality.

The basic underlying fact in these cases is that bankruptcy does not cause the loss to the creditor. The debtor's inability to pay has already caused the loss. The loss already exists as a matter of economic reality, whether or not the creditor has recognized it on its books. If cram-down is not permitted for debtors who cannot pay their mortgages, debtors and creditors have several other alternatives: there could be foreclosure; there could be a short sale of the property; there could be a deed in lieu of foreclosure; or there could be a voluntary modification to terms similar to cram-down. In each of these scenarios, the creditor will take a loss equal to, or greater than, what would occur with the cram-down.

I understand that industry lobbyists have been arguing that such legislation is unnecessary because: 1) lenders will solve the problem through voluntary modifications; and 2) the legislation would cause interest rates to increase dramatically. Neither of these arguments has merit.

First, voluntary modifications are not being made in any significant numbers. When I testified in the House 8 months ago, an industry witness testified that such efforts were well under way to solve the problem. But now even the Secretary of Treasury has recognized the inadequacy of the industry's response. That inadequacy was predictable for the same reasons that the current administration effort and any voluntary modification program would be inadequate, reasons I have detailed in my written testimony.

With respect to the claim that interest rates would increase by 1 to 2 percent on all mortgages, the fact is that legislation such as this has no measurable impact because, again, ability to pay, not the bankruptcy law, is what is causing the losses. In the current mortgage situation, as I discussed previously, the lenders will suffer the losses, perhaps greater losses, even if this bankruptcy legislation is never enacted. You have to remember that the alternative to cram-down is not the debtor paying the loan according to its terms. The alternative is foreclosure.

Industry lobbyists have also argued that enactment of S. 2136 would bring uncertainty to the financial markets. Just like the losses that they claim would be brought about by the legislation, that uncertainty already exists. It would be hard to imagine how this bill could bring even a small fraction of the uncertainty that the lenders themselves have already caused. If anything, allowing modification in Chapter 13 will foster more certainty and stability because it will create a predictable template for dealing with defaulted mortgages.

I also hope you will remember that those who are making those projections are the same people who not long ago told this Congress that there were no problems with abuses or excesses in subprime mortgage lending that needed regulatory or statutory action. The people who now say they are so concerned about risk are the same people who saw no problems when it was repeatedly pointed out that they were giving loans without even determining

whether borrowers could pay those loans. In other words, these are the people who created this mess and are now suffering billions of dollars of losses, not because of any bankruptcy laws, but rather because of their poor ability to predict what would happen in the mortgage market.

The mortgage modification remedy in S. 2136 is narrowly tailored. It will not be used where it is not needed because there are strict eligibility requirements based on the stringent means test enacted in the 2005 bankruptcy bill. A family that cannot afford a feasible plan to repay a modified mortgage will not be eligible to have its plan confirmed.

S. 2136 will help the many families who refinanced their homes with predatory mortgages, often because they were deceived into refinancing an affordable mortgage into one they could not afford, and especially the many families who in fact qualified for better terms all along. It will help their neighbors, whose homes will not lose value because of foreclosures on their block, as well as their local governments who will not suffer a precipitous loss in their property tax base.

In conclusion, Congress has an opportunity to prevent hundreds of thousands of families from losing their homes if it acts soon. Pro-

viding resolution in such cases is more likely to rationalize and stabilize the market rather than destabilize it.

Thank you.

Senator DURBIN. Thank you, Mr. Sommer.

[The prepared statement of Mr. Sommer appears as a submission for the record.]

Senator DURBIN. Senator Specter has another meeting to go to, and I'm going to allow him to ask first if he'd like to, and I will follow him.

Senator SPECTER. Thank you very much, Mr. Chairman. We started off by saying this was a very complex issue. As we've listened to seven witnesses, it's become even more complex.

Professor Scarberry, you suggest that the bankruptcy courts can't handle this on a case-by-case basis. If one of our bills is adopted and the bankruptcy courts are faced with the gigantic flood, will they be unable to adjudicate these issues?

Mr. SCARBERRY. I don't know for sure. I think it would mean a very substantial increase in caseload, and depending—

Senator SPECTER. Judge Cox, Judge Bennett, you're bankruptcy judges. Can you handle it?

Judge COX. I would definitely put my arms around it. As I indicated in my remarks, by the lawyers and the financial services industry, testing us for a few cases, finding out exactly what we do, how the U.S. trustee would set up guidelines on how mortgages—

Senator SPECTER. So you think, after you ruled in a few cases, they'd know better and could handle it themselves?

Judge COX. They would know better and they would be guided by those out of court.

Senator SPECTER. Judge Bennett, what do you think?

Judge BENNETT. I think, on the volume, in the short term it would be difficult, in the long term it's handleable. Yes.

Judge COX. Yes.

Senator SPECTER. Short term?

Judge BENNETT. Short term.

Judge COX. Our U.S. Trustee's Office is excellent in getting these sorts of things organized. They're excellent.

Senator SPECTER. Professor Scarberry, you have your hand up.

Mr. SCARBERRY. One of the difficulties is that S. 2136 refers back to the Chapter 7 means test, which includes a good number of ambiguities and has given rise to a great deal of litigation. I think the bankruptcy judges here might agree that they have not been the easiest provisions to apply, and in fact have in some cases been counter to what was intended.

Senator SPECTER. Wouldn't it be wise to, at least at this moment, freeze interest rates so that people like Ms. McGee are not facing this variable adjustment which comes as such a shock before we adjourn for Christmas and come back and we're in gridlock on some other matters and nothing happens? That at a minimum, if some administrative action can be taken to freeze the interest rates, that that would provide some relief right now? What do you think, Ms. McGee? Would you like that?

Ms. MCGEE. Sure. [Laughter].

Senator SPECTER. I thought I'd get a direct answer from you.

Judge BENNETT. Senator, may I say this?

Senator SPECTER. Go ahead, Judge Bennett.

Judge BENNETT. I mean, in fairness to everybody, I think that a short-term potential freeze on foreclosures so that they don't impend at this time frame, it gives a breathing spell to analyze and to get a game plan that really encompasses everybody—

Senator SPECTER. So you're for a freeze?

Judge BENNETT. For very short term, yes.

Senator SPECTER. How long?

Judge BENNETT. Well, 60, 90 days. With people working, potentially, it could—I can't tell you off the top of my head. Also, an interest rate holding for short term, I think, would give everybody a chance to analyze a lot of things that may not have been looked at fully.

Senator SPECTER. What I'm trying to get a handle on, and perhaps it's not handleable, as to the real question as to whether this cram-down will affect the future markets, as Justice Stevens said in the Supreme Court decision, that in the long term effect it will increase costs.

Professor Mason, you say in your testimony that investors are likely to impose a lemons discount, so that it will have an effect. Mr. Sommer, you think that it will be fine to have the cram-down and the market will adjust to it. Is there anything you can really grab ahold of, any empirical evidence which would give us some sense of, if not certainty, reasonable likelihood, aside from just the opinions? You are experts and we value your opinions, but opinions are not as valuable when we seek to legislate on something harder. What can you say, Mr. Sommer, that's more definitive?

Mr. SOMMER. Well, obviously there's no certainty to these predictions. But I will point out that cram-down on cars did not exist before 1978, and no one has ever suggested that car interest rates went up after it was adopted in 1978. Cram-down was limited somewhat on cars in 2005. No one has suggested that interest rates went down as a result. In 1986, Congress passed the Family Farmer Bankruptcy law, which permitted cram-down on farm loans and farm mortgages, and no one has suggested that farm interest rates changed. So we have those examples.

I think the real issue is, we're talking about a very—even though it's a large number of foreclosures, in total we're talking about a very small part of the total market. We're not talking about wiping them out completely. What we're talking about is—

Senator SPECTER. Mr. Sommer, aren't cars, as a depreciable asset, very, very different from homes?

Mr. SOMMER. Cars are different from homes. But I think that—

Senator SPECTER. So different that the analogy is inapt?

Mr. SOMMER. Well, I don't think it is because the fundamental principle of bankruptcy is all based around liquidation of assets. Remember here, the alternative is foreclosure. There's going to be a liquidation. It's not like the homeowner is going to keep making payments while the property increases in value. It's not like the mortgage company, if it forecloses, is going to hold onto the property—

Senator SPECTER. Excuse me. My time is almost up. I want to give Professor Mason a chance to answer that question.

Mr. MASON. I wanted to address your points about the lemons discounts, and in particular the evidence that we have for that lies in George Ackerloff's Nobel Prize-winning work in the economics of asymmetric information discounts and premiums that are invoked in markets. There is a very clear understanding: you add more uncertainty to a market, the price is going to react. Right now, you're getting ready to enter the earnings season where banks report their earnings, in particular, the year-end earning season where we're looking for annual reports to give us some notion of the losses on bank balance sheets.

Senator SPECTER. What does all that mean?

Mr. MASON. If you freeze interest rates on adjustable rate mortgages right now you're going to add further uncertainty to the value of those holdings on bank balance sheets and fuel this crisis even further.

Senator SPECTER. So you are against the freezing?

Mr. MASON. Right now is, in fact, a low point in the adjustment cycle for adjustable rate mortgages. Next spring, that will accelerate.

Senator SPECTER. Before my red light goes on I want to start a question to Mr. Zandi. You testified that cram-downs will significantly decrease the number of foreclosures. Why do you think that? People won't foreclose when they go into a bankruptcy court, they have their principal sum go down?

Mr. ZANDI. I think borrowers, given the choice of a Chapter 13 bankruptcy or a foreclosure and losing their home, will take the Chapter 13 bankruptcy. The number of folks that would benefit, that would apply under the means test, would be about 500,000 to 600,000 people. Yes.

Senator SPECTER. I have great sympathy for the Chairman. I like to help the Chairman, when my light goes on, to stop.

Senator DURBIN. Well, spoken like a former Chairman.

Senator SPECTER. One who aspires to be a Chairman again.

[Laughter].

Judge COX. We understand.

Senator DURBIN. We hope that God will answer your prayers, but not too soon.

[Laughter].

If I might, I'm trying to put this in context. We're talking about 500,000 or 600,000 people who may be affected by this bill. We're talking, I think, roughly about 130 million mortgage owners in America. We are talking, as I see it, less than one-half of 1 percent. I've heard speculation here that this is going to warp the market. It's going to have this dramatic dislocation in trying to figure out the credit future. But that ignores the obvious. Doing nothing has an impact on the market, too. It has an impact on Mrs. McGee and a lot of other people.

I'd like to go back to your point, Mr. Zandi. If I heard you correctly, you said that a foreclosure sale—and I'll let you correct me if I'm wrong—will result in a price that is 20 to 30 percent below fair market value. Is that what you said?

Mr. ZANDI. That is correct. The literature on this subject, some of it coming from the Federal Reserve, suggests, in normal times,

not stressful times like the one we're in today, the discount is 20 to 30 percent.

Senator DURBIN. And there is also a cost associated with foreclosure itself.

Mr. ZANDI. Quite significant. The cost of maintenance, the realtors involved in selling the home. Many, many other costs.

Senator DURBIN. And like a banker from one of the biggest financial institutions in America recently told me over dinner, bankers don't like to cut grass.

Mr. ZANDI. They don't.

Judge COX. They don't.

Senator DURBIN. Well, they're stuck with a situation cutting grass on a property in foreclosure until they get it sold.

Mr. ZANDI. Exactly. Right.

Senator DURBIN. They have to hire somebody to do that, as one example. So the point I'm trying to get to is, all the arguments that have been made by some, that this is creating a real hardship on financial institutions, ignore the obvious. Foreclosure is a real hardship on financial institutions. They're going to lose money. Our outcome is based on a crammed down/stripped down discount, whatever you want to call it, no lower than fair market value. That is the bottom line here. It seems to me like it is a reasonable bottom line.

Judge Cox, a point was raised earlier, and I think it was by Mr. Scarberry, about how difficult it would be to come up with fair market value of property. Do you have to cope with that challenge?

Judge COX. We don't have that much of a problem. Sometimes people bring in expensive appraisals. Sometimes they just put a real estate broker on the stand and talk about prices in the area. It can be done cheaper than that.

Senator DURBIN. And if it's disputed, I mean, you can take more than one appraisal.

Judge COX. We hear those matters all the time.

Senator DURBIN. So that is not an issue.

Judge COX. That is not a big problem.

Senator DURBIN. You mentioned coming up with an interest rate, you said earlier, was something you could calculate.

Judge COX. By the Board of Governors of the Federal Reserve Board. The interest rate published for today is 6.1. We add premiums for cars. We could add a premium for loans. These issues are never disputed in our court. We never have hearings on these. That is not difficult for the financial services market and the debtors and the debtor's bar to do.

Senator DURBIN. If God would smile down and decide that this bill should become law, would it be an incentive or a disincentive for financial institutions to renegotiate the terms of a mortgage before foreclosure and bankruptcy? Anybody have an opinion?

Judge COX. I'm not sure that will happen without some sort of immunity for a suit from their shareholders and bondholders, but I think that by having debtors come into bankruptcy, certainly shields the lenders from those sorts of civil actions.

Senator DURBIN. Any other thoughts on that?

Mr. SCARBERRY. It would certainly encourage that sort of thing. I tell my students all the time that one of the key functions of

bankruptcy law is to provide a backstop for consensual negotiations. Certainly in Chapter 11, that's the case.

But to go back to a point, Mr. Chairman, that you made earlier, that this is a small percentage of loans, I might analogize that to saying that it only snows 1 percent of the time, but when it snows you really want to have your warm weather gear. So, these are the mortgages on which the need to look to the protections of the real property secured transactions laws is important. If that protection is taken away when it's needed, that has a substantial effect, especially when what is taken away is the up-side, and the possibility occurs that during a severe market downturn, the up-side is removed.

Senator DURBIN. But that's the point I want to get to. You are arguing that real estate, unlike the car, is an appreciable asset. It can appreciate in value. Historically, that is what has happened and we hope it will continue to happen. But ultimately in a foreclosure, you are making a sale at that moment in time. You are selling at that moment in time at fair market value, knowing that if history serves you, 10 years from now that property is going to be worth more. That doesn't mean you're going to get that much more when you sell it.

Mr. SCARBERRY. Mr. Chairman, that depends. That depends, first of all, on whether there is a foreclosure. And to the extent that this bill creates moral hazard and people end up using it to strip down mortgages, where they could—but for the bill, and they would but for the bill, in some cases—tighten their belts and use existing provisions of Chapter 13 to keep their homes, there wouldn't be a foreclosure.

It also assumes that there would not, under these circumstances, be further developments. Typically the bank is going to buy at the foreclosure sale, so there's no actual money, in many of these cases, that changes hands. If they decide that they want to set up a subsidiary to handle rental property and wait out a couple of years until the market recovers, they have that option now.

Mr. MASON. No, they don't have that option. Even under Gramm-Leach-Bliley, banks don't have a real estate option.

Mr. SCARBERRY. Well, most of these aren't held by banks at this point.

Senator DURBIN. But I really struggle with this notion that when it comes to immoral conduct, it's always the consumer.

Mr. SCARBERRY. Oh, no, no. No.

Senator DURBIN. In this circumstance here, I'd like to ask Mr. Sommer, do you think these people would race into bankruptcy court because the Chapter 13 work-out under Durbin might be available?

Mr. SOMMER. We find people who, even when we advise them to file bankruptcy, don't want to do it. It's really the converse.

Senator DURBIN. And it's harder to do it today than it was before we changed the law.

Mr. SOMMER. It's harder. And for this particular remedy they would have to pass the—they would have to live under the expenses set by the means test, 2005 means test. Only then, if they didn't have enough money to pay their mortgage, could they use this remedy.

Senator DURBIN. Well, I think that if the prospect on the horizon that we've heard about the economy going into a tailspin, I've heard the word "recession" from several different witnesses here, how many financial institutions out there are looking at that and viewing it as a sanguine result? That has to be something that is painful to anticipate. If we can slow down, as Senator Specter has suggested, what is coming and stabilize the situation, it's got to be in the interests not only of homeowners, but also of financial institutions.

Judge BENNETT. Senator, may I say something? I think if it can be done properly, yes. My concern is, it's not being done properly. What's happening—let me give you an example. If you strip down the mortgage to its principal balance, you are then going to refinance, theoretically, under your proposal, up to another 30 years. The interest rate that you use on that could actually be negative, be bad for the borrower in certain instances. It already occurs in cars right now, that car dealers are coming in that sold cars at zero percent interest.

Under our current statutory framework, they asked for the increase to the market rate. The bill, the way it's structured, for instance, does not apply to these teaser rate loans only. It applies to the broad market. But my bigger point here is that when you then subdivide all of the ownership, who owns what makes a big difference. Second, the whole structure of what's going on for a 30-year period is far more dramatic—up to a 30-year, I should say—than what are short-term loans. Third, we need to bear in mind that, unfortunately, in all bankruptcies the failure rate is astoundingly high. We can disagree on what failure or success is, because sometimes success is restructuring, being able to hold onto the property and dismissing the case. So, dismissal numbers are not that great.

Senator DURBIN. Judge, I'm sorry to interrupt you. My time is up.

Judge BENNETT. I'm sorry.

Senator DURBIN. I would note that Senator Sessions has another meeting to go to, and I'd like to yield to him at this point. We can return to this after Senator Sessions.

Senator SESSIONS. Thank you, Mr. Chairman. It certainly is highlighting the complexity of the problem we're dealing with, the amount of money that has been brought forth to allow borrowers to buy houses. I mean, lenders are out to make a profit. They write the contracts that help make themselves a profit and protect their interests in every way they can, but the lender puts the money out. They give $100,000, $200,000, $500,000 and they can't do that if we have a problem and make it too difficult to get the repayment.

That's why I will offer three letters here for the record. One is from Mr. Clark, former Comptroller of the Currency, and Mr. Isaac, a former FDIC Board Chairman, and Mr. Powell, FDIC Chairman, and the Mortgage Bankers Association, and from the Securities Association.

I'd just point out that these pieces of legislation have the tendency to increase interest rates. I think Judge Bennett said, I don't know exactly what the interest rate will be, but if you put a burden

on it, Mr. Mason, an uncertainty, you say whatever it will be, it will be a little bit higher. Is that right?

Mr. MASON. Yes.

Senator SESSIONS. One of the letters said it could be 2 percent. Do you think that is excessive? Would you give an opinion on that?

Mr. MASON. I don't think that would be excessive at all. The problem is, with the amount of uncertainty markets can't accurately price, so they throw up worst-case scenario—

Senator SESSIONS. Well, Ms. McGee indicated, what, a 3 percent increase in your interest rate, resulting in a $200 a month increase in payment? One percent can easily be $100 a month for the average borrower. So half a percent, even if it went up only a half a percent, could be $50 a month for the average borrower. So we've got to be careful about this, is all I'm saying.

Now, with regard to the question of 600,000 foreclosures perhaps being avoided, does that contemplate 600,000 more bankruptcies being filed to avoid the foreclosures? If I could get an affirmative answer there.

Mr. MASON. Yes.

Senator SESSIONS. So we're talking about really moving foreclosures into Chapter 13 bankruptcies. But you can file Chapter 13 now, right, without this legislation? Professor Scarberry, maybe you could tell me. Put it down here where the horses can eat it, I guess. What does this mean? I mean, what are the forces at work here? You talk about moving. Who is it going to help? What is the overall economic impact?

Mr. SCARBERRY. That's a big question, Senator Sessions. I'll try to answer it. Who is it going to help? It will help the homeowner who is able to make payments at a court-determined interest rate on a mortgage on the value of the property, but not able to make the mortgage payment that is called for under the contract, or even a mortgage payment at an appropriate interest rate on the full amount of the debt. So, it would help that person.

Senator SESSIONS. Now, you indicated earlier, did you not, that this could cause them to lose their appreciation?

Mr. SCARBERRY. No. It could cause—and the Chairman and I were having a discussing a moment ago—

Senator SESSIONS. I'm sorry I missed it.

Mr. SCARBERRY.—as to whether the holder of the mortgage is harmed by not having the possibility of benefitting from appreciation in the future. So if we catch the value of the property when it's at a low point and fix the amount of the mortgage there, then if the property appreciates the debtor gets the equity from the appreciation and the mortgage holder is still stuck with the loss. One conceivable possibility would be to have some sort of revaluation several years down the road in which the value of the property is considered to get—

Senator SESSIONS. There's no free lunch there. If you cram down the value of the property, somebody loses.

Mr. SCARBERRY. Somebody loses, yes.

Senator SESSIONS. And if it goes to the lender, more lenders in the future are going to charge higher interest rates.

Mr. SCARBERRY. I don't see any other way, Senator Sessions. If risks are increased and costs are increased, then interest rates will

be higher than they otherwise would have been. I think that simply follows.

Senator SESSIONS. Now, I supported cram-down for automobiles. I think it makes sense. I think we came pretty close. Senator Durbin was articulate on that issue, I know, when we discussed it, and Senator Feingold. I think we came close to the right amount there. But it does appear to me that since homes tend to be generally upward and you can have periods of decline, that it is less appropriate.

Judge Bennett, you've been at this a while. Would you agree, whether you should or not, it's less appropriate than in an automobile?

Judge BENNETT. I'm going to leave the policy decisions to those that make those. I will tell you what I think from an economic point of view. The answer is, the risk and the uncertainty is far greater than on what are shorter term and smaller dollar amounts. So, from that point of view I think I would tell you that by pushing these out at longer terms with bigger dollar volumes and with interest rates, that really—and I could tell you the experience of interest rates on cars is, it's prime plus 1, 2 or 3. Realistically, in the real market, the credit quality of the people who get prime or prime plus 1, 2, or 3 are not bankrupts. So, the idea that the interest rate on the cram-down really reflects the market rate misses the point in the real world.

Senator SESSIONS. You mentioned in your written statement, Judge Bennett, and discussed—you suggested, I'll just say it that way—that we're putting a lot of police pressures on bankruptcy judges to make decisions that that's not their training or their normal requirement. Did you say that? Would you discuss what you said in that regard?

Judge BENNETT. Well, let me tell you my framework. The framework of what I did, was to set forth, here are some over-arching issues that are of more economic significance. Here's a comparison of the two bills. If you look at what I did, I really laid you a blueprint out on each bill as to where I think there are interpretation and other problems. So if you want to take those into consideration, you can structure around those. I did that in more of a bipartisan sense to tell you where I think there are interpretation problems.

What I think, and have always thought and used to tell my clients, you can always file bankruptcy but you cannot unfile. In that sense, I think right now—I don't think the economists of this world—and I'll take the fall for being one of those in a prior life—really know where we are headed, necessarily, and really know whether the mortgage issue is the cause or the symptom, or whether it's both. I really urge caution until we get a better picture, and we do the whole picture. I think that something will ultimately have to be done. That's where I come from.

Lawyers and judges are not professionals in these areas. What we are, are professionals at arguing positions for our clients and resolving positions. The function of the legal system is not necessarily solely to get it right—hopefully we do most of the time—but is to bring finality to an issue. From that point of view, our training is not in other things. I would suggest that if you look at the car issues and the real market rates that would be paid out on

these, that the cram-downs on cars are effectively well below market rates of comparable credit risk. That same thing will happen in the context of mortgages, which means that the risk of loss for those that hold a residual portion of the cram-down mortgage will be under-paid and will be a further diminution of the value, if that answers your question.

Senator SESSIONS. Professor Scarberry?

Mr. SCARBERRY. Senator Sessions, you asked a moment ago about the 600,000 cases. I would suggest caution in assuming that the litigation in those cases will be similar to the litigation over car loan strip-downs or cram-downs. In a car situation, you may be arguing about $1,000 in difference. In a home mortgage situation, you may be arguing about $50,000 or $100,000 or more. With the incentive to litigate, and the greater uncertainties in valuation for real property, especially when so few properties are being sold, it seems to me we have a potential for a very large amount of litigation in a very large number of cases.

That's why I suggested that it might be useful for Congress to think about using the bankruptcy power to assist in resolving this problem, not in bankruptcy cases, but through the process that Secretary Paulson has attempted. So, perhaps in a sense I'm reflecting on what Judge Bennett said. To do this in a Chapter 13 creates all sorts of problems and it may not be the best way to do it. In particular, as I pointed out, unless the Congress changes the provision that was added in 2005, if the Chapter 13 fails for any reason before the end of, typically, 5 years, the modification of the mortgage will disappear.

So, failing to pay priority tax claims or other sorts of things—perhaps that's a technical aspect of the bill. But to tie this to a 5-year payment plan, which tends to be how you deal with other kinds of debts, may not be the best way for Congress to use the bankruptcy power here, to help in a situation where I think there needs to be something done.

Senator SESSIONS. Go ahead.

Mr. MASON. If I can jump in for just a moment. I'm not sure that addressing this in bankruptcy is really the most effective way, but as I've said before, I'm not sure that modifying the terms of all existing mortgages is appropriate either. I think that Senator Durbin raised an extremely important point that I want to come back to, which is the foreclosure system in the United States.

It's not clear, when we're working on a bankruptcy, that the property will be foreclosed upon. From an economic point of view, if it was economical for the lender to restructure the loan on behalf of the borrower, that would be carried out. I wrote an article on this that was picked up in The Economist and cited very widely.

Senator SESSIONS. In other words, they would do it on their own because it's in their own self interest. They don't want to have another house in the inventory. If they can't get a price for it, they have an incentive themselves, or selfish interest, to refinance.

Mr. MASON. Precisely. Precisely. And given that the matter is in bankruptcy should be a flag to the lender that we're getting pretty close to a foreclosure point here, and if it's economical we can still negotiate in a bankruptcy court, notwithstanding anything that

this committee might do. So it strikes me that the market should be working and there shouldn't really be an issue.

I think the bigger issue that is sometimes lost in what we've been talking about with the mortgage crisis, is the foreclosure system, because in the U.S. we're going to put this house on the market and auction it off for cash on the barrel head to an individual buyer. Oftentimes, even if that individual who was just foreclosed upon might have some amount of cash, let's say it's 70 percent of the market value, they would even be locked out of the bidding process. We don't have a chance for banks to buy the home back because banks can't own real estate.

As a banking specialist, that was one power that was left out of Gramm-Leach-Bliley. They can't own real estate and couldn't lease it back. But it strikes me that there is a tremendous opportunity here, a tremendous market opportunity for the market to purchase real estate and, in fact, lease it back to the existing occupant to fight the urban blight problem.

Now, I'm not saying, give that power to the banks. But I am saying that there could be a role in fixing this foreclosure system to allow greater efficiencies in bidding, similar to structures that we do see in Europe where properties are placed on the market, and, say, 100 properties at a time, a corporation will buy them, will maintain the homes, and will lease them to occupants so that they do not go idle.

Senator SESSIONS. Thank you.

Mr. Chairman, this is an able panel on an important issue. Thank you very much.

Senator DURBIN. Thank you, Senator Sessions, for being part of this. I have a few more questions.

Ms. McGee, what is going to happen to you if you lose your home?

Ms. MCGEE. Well, I really don't know.

Senator DURBIN. You're living on Social Security, right?

Ms. MCGEE. Yes. That's my source of income. But I was hoping that somebody would come up with an idea or something today, not only for me, but to help people who—I got in this situation on my own, you know. But now they're talking about bankruptcy. I don't think I could afford bankruptcy. You know, I couldn't afford bankruptcy. So then that means that if I can't pay the mortgage, I lose my home. Then I go where?

Senator DURBIN. Have you seen any homes in your neighborhood or where you live that have gone through this?

Ms. MCGEE. Well, not right where I live, but where my granddaughter lives at 69th and Hermitage, there are five foreclosed houses in one block. One block. It's all over, you know. But mine will be next, I guess.

Senator DURBIN. I hope not.

Ms. MCGEE. I don't know. I don't know what to say or what to do.

Senator DURBIN. Professor Scarberry, who wins in a foreclosure?

Mr. SCARBERRY. I don't think anyone wins. I don't think anyone wins in a foreclosure.

Senator DURBIN. But you raised a point that somebody raised to me, which I want to try to bring out on the record here, about some insurance.

Mr. SCARBERRY. Yes. Well, my understanding—I'm not an expert on this. I have spoken to people who are involved in it, and the committee should look more closely, and perhaps others here know more about private mortgage insurance, which often is required on loans where not very much money is put down, often less than 20 percent.

Private mortgage insurance ordinarily, as I understand it, only pays to the mortgage holder if there is a foreclosure. So to the extent that the lien is stripped down in a Chapter 13, and that there is no foreclosure, the mortgage holder suffers a loss, but does not get the benefit of the insurance that they bargained to receive and that went into the pricing of the whole mortgage.

Now, that, it seems to me, is a problem. Now, perhaps there could be some sort of—on the other hand, if too much is asked of the private mortgage insurers, their ability to handle the load—again, it's not my area. One would question, if we have 2 million foreclosures, how a private mortgage insurance system is going to work.

Senator DURBIN. It's a legitimate policy question, probably beyond the Judiciary Committee, and something that we shouldn't ignore.

Mr. SCARBERRY. And so it does seem to me that if the process of securitization of mortgages, with the dividing up of the rights to the various income streams and to so many different forms of securities, if that has resulted in there being no one who can really negotiate the loan modification with the homeowner because the servicer says, "oh, well, I can't do that. I would do it if I owned the mortgage, because it makes sense, but it would hurt this security holder who has the right to the first bit of the interest."

It seems to me it would make sense for Congress to say there will be someone who can act, it will be the servicer, and the servicer will act, perhaps, to try to get the best value overall, and if that hurts some of the securities, it hurts them. But that seems to me to be something that might be very useful.

Senator DURBIN. One of the goals here was to hope that passing this would encourage work-outs so that people wouldn't have their homes lost, that Ms. McGee and others might find some terms or interest rates that they can live with. But as you just described the situation, as the paper moves further and further away from the original transaction and the only protection for the ultimate paper holder is insurance that depends on foreclosure, it strikes me that you've just created a disincentive for a work-out in the negotiation.

Mr. SCARBERRY. Well, yes. Yes, you have. So in that sense I understand your initial question: who wins in a foreclosure. In a sense, the beneficiary of the private mortgage insurance may gain from a foreclosure.

It is true that mortgage originators—and others, perhaps Professor Mason will know a lot more about this than I do—have taken back some of the risk by way of reinsurance. So, I think it's very complex. But initially, at least, it would seem that, absent a foreclosure, the loss will be borne by the mortgage holder, not by

the insurance company. The insurance coverage, essentially, has been rendered worthless.

Mr. ZANDI. Senator Durbin, can I pipe in for just a second?

Senator DURBIN. Sure. Go ahead, Mr. Zandi.

Mr. ZANDI. There are certain investor groups that do benefit in a foreclosure, and that's why the modification efforts are not working. There's a market failure because of the way the securities are structured. Certain investor groups want the process to go through foreclosure and the losses to be realized because they won't suffer the losses, the folks who took on the most risk in the securities will. So they have no interest whatsoever to see these things modified, and that's why they're not happening, and that's why there's a failure in the marketplace. That's why the Treasury Secretary has put forward his proposal, because he realizes it's not going to happen in a significant way.

Senator DURBIN. I think that's the point Mr. Sommer made.

Mr. ZANDI. Yes. That's exactly the point. Yes. So there is a market failure here and you can't let the market do it by itself because it's not going to happen. It's not going to work.

Senator DURBIN. Anyone like to comment on that before summation?

Mr. MASON. I'd like to address that a little bit more accurately. There aren't security holders that will benefit from foreclosure. In fact, the problem is really more accurately characterized by Professor Scarberry: nobody really wins here. But the problem is that nobody wins in a modification in the sense that the servicing structures are built so that the serving contracts that pay the servicer to send out the bills and make the phone calls aren't written to handle any of the activities that we see in modification.

So let's say a servicer goes ahead and, let's say I'm late on my loan, the servicer calls me, we have some talks, we work some things out, they freeze my interest rate for a couple of years, or maybe permanently, who knows. But we work some things out and I keep paying the mortgage. Well, they've just incurred some additional expenditures in that activity. The problem is, nowhere in their contract do they get to recover those expenditures because I didn't go into foreclosure.

Senator DURBIN. Do you acknowledge and concede the earlier point, that the sale and foreclosure is going to be at a loss to fair market value; that the foreclosure proceeding itself is an expensive undertaking; that a financial institution is not in the business of cutting grass and selling property?

Mr. MASON. I do. I completely concede.

Senator DURBIN. Conceding all those points, doing nothing is expensive to someone in this process who is the ultimate mortgage owner, right?

Mr. ZANDI. There's obvious winners in modification. Obvious winner. The borrower is the obvious winner. The community in which the borrower lives is an obvious winner. The economy is an obvious winner because house prices aren't going to fall quite as much. The costs of foreclosure are substantively greater, by anyone's measure, to modification. Those benefits have to go to somebody. They're going to go to the borrower, they're going to go to the lender, they're going to go to the servicer, and they're going to go to the

investor. So, there are significant benefits to modification of a foreclosure.

Mr. MASON. Now, that being said, that borrower is a winner and it's not clear that every borrower out there deserves that status. There are certain borrowers that—

Mr. ZANDI. Now, that's a different argument in a different story, in a different point.

Mr. MASON. There are certainly borrowers like the one sitting at this table that has been truly harmed by the mortgage system, by abuses and by predatory practices. Those borrowers certainly need redress. But we have also had a tremendous amount of speculation.

Senator DURBIN. Well, I might just add, though I have my differences, and have had many with the administration, I talked to Secretary Paulson yesterday. What they are proposing is certainly not paying homage to the sanctity of the contract. They know that we cannot continue these contracts. We've got to either not allow a re-set or come to some sort of—eliminating pre-payment penalty, whatever it takes, that is going to step into this situation and say it has to stop. This is not good for this Nation for this to continue.

Mr. MASON. I also want to point out another thing that Ms. McGee mentioned in her testimony. There are these fundamental problems with the mortgage closing practices under RESPA, where she was put in a room for 10 minutes with 40 pages of paper. There was no way possible she could read, much less digest the terms of the contract. Giving her that contract, a firm contract 2 weeks beforehand might have given her a fighting chance where she could show that to her daughter, or her friend, or her friend's friend, or an attorney.

Senator DURBIN. Oh, no. Having been an attorney at closings, I can just tell you, I'm sure Ms. McGee's daughter is a very smart young lady, but give me a week with it and I might be able to make some sense out of it.

I'll just say this. Let me close by saying this. I had a meeting today with the realtors. We talked about a lot of things, including this issue, obviously. I am hopeful, at the end of the day, that we not only deal with this crisis, but look prospectively. There ought to be a simple, simple sheet that you put in front of a borrower which says this is how much you're borrowing, this is the interest rate, it is either permanent or it's going to change, here is your prepayment penalty if there's going to be one.

Now, this debate was started a long time ago by the first man I ever worked for, Paul Douglas, who initiated Truth in Lending. I am sure Senator Douglas, if he saw that stack of papers pushed in front of Ms. McGee, or Senator Proxmire, who ultimately passed the bill, would consider this a great victory for consumers. We've got to get to the point where consumers have some basic information so that they know what they're getting into. The moral hazard argument, I think, is applicable if in fact people are informed and make a bad decision. In most cases, people are not informed.

Mr. MASON. Let me just say, that's very true, but I've seen the development of the Schumer-Box for credit card contracts and I've seen the terms in credit card contracts move beyond the Schumer Box, so that what you've legislated to be presented no longer contains—accurately—represents accurately the important terms of

the contract. So I am worried about prospectively is the industry moving beyond these requirements.

Senator DURBIN. Being a legislator means being hopeful, so we're hoping that we can do better.

Mr. SCARBERRY. Mr. Chairman, the idea of a single sheet very clearly setting forth terms, it seems to me, is crucial. One of the problems with mandating disclosure is, the more disclosure you mandate, the harder it is to read and the less is actually conveyed. So that seems to me to be an extremely valuable approach.

Senator DURBIN. My thanks to the entire panel. To Ms. McGee, for your sacrifice in coming here. We hope that we can help you work this out. To the judges, for coming and giving us an important perspective, and to all the members of the panel. Thank you very much.

This meeting of the subcommittee, or the full committee, will stand adjourned. There may be some written questions sent your way. I hope you can respond to them in a timely way for the record. Other members who wish to make statements and put them in the record will be given that chance.

We stand adjourned.

[Whereupon, at 4:18 p.m. the hearing was adjourned.]

[Questions and answers and submissions for the record follow.]

QUESTIONS AND ANSWERS

Response to written questions by

Hon. Thomas B. Bennett
United States Bankruptcy Judge
United States Bankruptcy Court for the Northern District of Alabama
Birmingham, Alabama

before the
Senate Committee on the Judiciary

"The Looming Foreclosure Crisis: How To Help Families Save Their Homes"

December 24, 2007

Chairman Leahy, Presiding Member Durbin, Ranking Member Specter, and Members of the Committee, I am responding to the written questions received by me on December 18, 2007, from Chairman Leahy. I have received two sets of questions relating to my written testimony of December 5th and my oral testimony given during the December 5, 2007, hearing held by the Senate Committee on the Judiciary. The two sets of questions are composed of six submitted by Senator Durbin and another three by Senator Sessions. All of these questions are addressed in this response..

Before addressing the substance of the questions, I want to once again preface my remarks with a caution regarding the status in which I reply. My earlier written testimony and oral testimony of December 5, 2007, set forth my views and not those suggested by others. The same is true with respect to these responses to written questions. Likewise, I appeared at the December 5th hearing held by the Senate Committee on the Judiciary in my individual capacity and not as the representative, member, or officer of a group or an organization. Once more, this applies to these written responses.

I. Responses to Questions from Senator Richard J. Durbin to the Honorable Thomas B. Bennett

Question 1(a). Are you aware that an overwhelming proportion of the adjustable rate mortgages originated in the last few years does not permit reductions in the interest rate?

Question 1(b). How does your criticism apply given this current market?

Response to Questions 1(a) and 1(b). My criticism regarding this aspect of S. 2136 remains

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unaltered. This arises from the fact that having floor interest rates in adjustable rate mortgages is nothing new to the last few years. It has existed for many years. The existence of such floors limiting the downward adjustment of interest rates was taken into account by me for purposes of my testimony.

I want to point out that your question indicates that the important point of my testimony on this aspect of S. 2136 may have been missed. It was and is that the proposed alteration of mortgage loan terms by the language of the bill coupled with that of existing language of the provisions governing what is to be included in a Chapter 13 plan mandates that adjustable rate loans secured by one's principal residence be converted to fixed rate obligations. Since S. 2136's ambit is not limited to loans made within the last few year--it applies to ALL unpaid adjustable rate loans secured by a debtor's principal residence made at any time--it will encompass adjustable rate loans with no interest rate floor along with both (1) those with a floor which is below what would be the rate set by S. 2136's calculation as a fixed one and (2) those with a floor which may be above the converted to fixed rate determined under S. 2136. Thus and in a declining interest rate environment, those who file a Chapter 13 bankruptcy case with adjustable rate mortgages with no interest rate floor or a floor rate below that which the rate S. 2136 requires to be the fixed rate will have an interest rate which in future months and years may be higher than the one such a borrower would otherwise have had to pay but for the requirements imposed by this bill. The one group for which the rate could potentially be lower is that composed of mortgage secured loan transactions where the floor rate is above what would be the rate set using S. 2136's fixed rate setting mechanism. However for this to occur, the application of S. 2136 needs to happen in advance of a market adjustment to the selected indexing rate specified in S. 2136 which if great enough could result in S. 2136 not lowering the rate which would have been charged under the adjustable rate regime. This rather complex discussion of some of the various permutations on what will occur should S. 2136 be enacted in its present form overshadows my major testimony points regarding this portion of S. 2136 to which I need to return.

The primary significance of my earlier testimony regarding this aspect of S. 2136 is that what the bill does for some is the opposite of what I perceive to be the intention of the bill. Instead of helping all, it could for some increase the interest rate above what it would have been in the future when compared to the adjustable rate that would have been set under the loan documents. Furthermore, it highlights further why I said that the task facing the Committee's Members is a complex one requiring greater information of sufficient quality being taken into account before enactment of such legislation. Lastly, it poignantly illustrates the problem of using only verbal analysis of a complex universe of fact and law variations without use of at least some of the readily available quantitative methodologies.

Question 2. Do you agree that a wholesale solution is warranted in this marketplace?

Response to Question 2. This question arises from a portion of the written testimony of Professor Scarberry which you quote in part that "...a wholesale solution may be necessary if any

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effective legislation action is to be taken." I am not certain what the Professor refers to as a "wholesale solution." If the wholesale solution is a reference to his belief that the solution should not be limited to being within the confines of the Bankruptcy Code, I agree that any legislative action should not require one to file bankruptcy to obtain assistance. The reasons I gave were stated during my oral testimony of December 5th when I expressed my position that there are at least two subsets of those who may need assistance to avoid foreclosure. One is those who are in such a dire financial situation in an overall sense that they would of necessity have to file for bankruptcy protection regardless of the status of an adjustable rate mortgage secured loan. The second is composed of borrowers whose only reason for being forced to file for bankruptcy protection is the already adjusted upward interest rate or pending upward adjustment for an adjustable rate mortgage secured loan. These individuals are those who are able to afford to pay all living expenses and other obligations including the adjustable rate mortgage loan at its present interest rate or the one which existed before it adjusted. My position was and is why is the filing of bankruptcy for all such borrowers required as the sole means to obtain whatever assistance may be accorded adjustable rate mortgage loan borrowers with the concomitant increase in costs and complexities incurred by the filing of a bankruptcy case when it is not legally necessary? I believe such a requirement should not be imposed on such borrowers and that the contemplated goal can be accomplished, if desirable, in a broader setting than just those who file a bankruptcy case. To the extent that this is what Professor Scarberry refers to as a "wholesale solution," I agree with him.

However and as written the question references a "...wholesale solution...in this marketplace" which contains a nuance which I believe Professor Scarberry may not have contemplated. The question adds to the quote extracted from the Professor's written testimony "...in this marketplace." It is unclear what "...this marketplace" references. It appears to mean some market for adjustable rate mortgages and not the credit market in its totality. To the extent that this is what is meant, I was very careful in my prior written and oral testimony to avoid discussing whether such a market exists from an economist's point of view. This is because it gets into a broader discussion which has been debated in the economic literature for awhile as to whether what economists call sub-markets for goods and services exist and should be evaluated separate and apart from what is the market, here the market for credit. Regardless of the referenced market, I do not believe that legislative action should be taken which causes greater uncertainty in the market and increases risks to lenders/owners of credit instruments, or parts thereof, constituting what are called adjustable rate mortgages which would impose total costs greater than the value of the perceived total benefits. If this is the type of "wholesale solution...warranted in this marketplace," I do not agree with the question as drafted which, I believe, is broader than the solution mentioned by Professor Scarberry.

Question 3. Do you believe that voluntary loan modifications agreed to by lenders and homeowners outside of bankruptcy lead to higher interest rates and less available credit?

Response to Question 3. My earlier written and oral testimony regarding the impact of S. 2136

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and S. 2133 were made in the context of proposed legislation specifying at least to some degree what is to occur. Based on the two bill's texts, it is clear that there will be an impact on the credit market which when one holds all other variables constant allows one to assess each's repercussion. As I testified, S. 2136 will have an effect which would tend to cause a shift in the supply of credit to a level less than it otherwise would have been without its enactment and that this shift when isolated from other market forces would cause an increase in the cost of credit higher than it would otherwise have been. I also pointed out in my oral testimony that there are assertions contained in some of the written testimony presented in support of S. 2136 that no such effect will occur which are premised on a supposed historical review of interest rates and supplies of credit encompassing all of the myriad of variables affecting each and not just the effect of legislation. As I have stated earlier, this is like comparing an apple to an orange and saying that they are the same. The reason is that the correct comparison is what the supply of credit and the cost of credit would have otherwise been but for the legislation. It is not what was the actual market supply or what was the actual market rate of interest. This incorrect analysis proffered by some who testified in support of S. 2136 will hide what the result of such legislation actually will be by covering up the true costs imposed by S. 2136. The true costs are hidden by such an incorrect analysis by the effects of the other, unrelated forces which act on supply, demand, and prices.

Furthermore and to clarify this point, I discussed that the supply of credit could increase or decrease after the legislation and the cost of credit could increase or decrease following legislation due to factors unrelated to the legislation. Therefore and to assess the result of this legislation on both the supply and cost of credit, one needs to isolate the effect of all of the unrelated factors to assess what the legislation did to the supply and cost of credit. From this context, the analysis is whether an increase in the supply of credit and/or the cost of credit following legislation would have been a greater increase in the supply and/or a lower increase in its cost without the legislation. Similarly, the study should be if the legislation had not been enacted would a decrease in the supply of credit and/or decrease in the cost of credit have been less of a decrease in supply and/or more of a decrease in credit's cost. Not studying in this fashion what will be wrought by an enacted S. 2136 allows other factors such as a shift in the demand for credit to cover up the truth of what S. 2136 or other such legislation would do.

The point of putting in this response some of what is only in my oral testimony of December 5th is that Question 3 gives no parameters from which to assess what would occur by voluntary loan modification agreements made between a lender and homeowner outside bankruptcy. This makes it impossible to fully respond to the question. This remains true even if I assume–which I believe to be a correct one–that what is referenced is adjustable rate mortgage loans. There is one thing that I can state regarding a voluntary agreement between a lender and borrower. It is that the degree of uncertainty created by S. 2136 regarding, among other things, but not limited to, alteration of the term of the mortgage, its principal balance, and the interest rate is less when within the scope of a negotiation between the parties to the contract(s). Thus, it creates less risk in any restructuring of the loan transaction than one where third parties unrelated to the transaction have input and, indeed, control over the outcome as S. 2136 specifies. The

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voluntary agreement scenario is also one without the costs imposed by the bankruptcy system. The third parties I refer to are judges who have discretion to decide the value of the property, extend the term of repayment, and set interest rates to name a few of the variables. The other third parties are the lawyers, experts, and others with the ability to become involved in the valuation, term, and interest rate adjustments contemplated by S. 2136. The uncertainty and increase in risk associated with this third party participation in S. 2136's restructuring of adjustable rate mortgage transactions is heightened when one recognizes the vagaries of valuation of properties and the setting of interest rates in a court context governed by S. 2136's framework.

This greater risk and uncertainty is caused by various factors. One is that in a court context there frequently are competing valuations made by so-called experts to non-expert judges and similarly varying so-called expert testimony on what the risk premium should be for a bankrupt borrower again presented to a non-expert judge. What happens is conflicting methodologies and approaches are adopted by judges for what and how a property should be valued and what the proper interest rate should be. That this will occur if S. 2136 is enacted as currently drafted is demonstrated by what has happened in a similar context for the valuation of other properties in consumer and business bankruptcy cases for vehicles and other personal and real properties. This is also the case for the setting of interest rates. Furthermore, the continuation of variation in how to value and what to use as value along with the appropriate interest rate to be used will continue even after a ruling by the Supreme Court of the United States on the valuation and interest rate issues. To see that this will be the result, one only need review the reported case law on vehicle valuation and interest rate setting after the Supreme Court and other appellate courts set the so-called valuation and interest rate standards and methodologies: frequently lower courts deviate from what they are to be which is sometimes to the advantage of a consumer, sometimes to his or her disadvantage, and sometimes to the benefit or harm to a lender/owner of a debt obligation.

The upshot is continued uncertainty and an increased risk of loss as the result of such third party intervention when it is done without more rigid and market based standards which do not give a varying degree of discretion to third parties to a transaction. When analyzed by holding the other variables constant, the upshot of this portion of the uncertainty and increased risk created by S. 2136 compared to a voluntarily negotiated modification is that S. 2136 in its present formulation will have greater tendency to cause a decrease in the supply of credit and an increase in its cost beyond **what would otherwise have been the state of each if S. 2136 had not been enacted as currently drafted.**

Question 4. Do you agree with these statements? The statements referenced are a quote from (1) a spokesperson for JPMorgan Chase that "It is always in the best interest of the servicer, the borrower, and the investors if we can modify a loan because foreclosure means there's no chance the investor is going to recoup their money" and (2) Treasury Secretary Paulson that "Avoiding preventable foreclosures...is in the interest of all homeowners."

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Response to Question 4. Since both quotes are presented to me without reference to the whole of what was said, it is not possible for me to give an absolute yes or no regarding whether I agree or disagree with what was said in the context each statement was made. However, both quotes are presented in the form of being absolutes which hold true for all parties to a mortgage secured loan transaction. As such and if the actual context presented by the question is that these absolutes are always accurate, I disagree with both. The reason regarding the JPMorgan Chase quote is that what is in the interest of an investor to recoup money is not necessarily in the best interest of the other parties including the borrower. The value of what is expended by a borrower to enable an investor to recoup his/her/its investment may be less than the value of an alternative use of the borrower's resources. There are many instances when it makes sense--economic and otherwise--for a borrower to allow a foreclosure than to continue to pay a debt. Each is when in economic terminology the value or utility of keeping the home is less than the utility of an available alternative use for these resources. Likewise, the quote of a portion of Treasury Secretary Paulson's statement is not as quoted always correct. There are instances when a borrower may have an alternative which has a higher value to the borrower than retaining a home. In such an instance, a foreclosure makes economic sense to a borrower. For example in areas where housing prices are decreasing rapidly and are likely to continue to do so, retaining a home even after a borrower files bankruptcy to utilize, if enacted, S. 2136 to write down the secured portion of a debt and to fix the interest rate would still leave the borrower paying for a home worth potentially far less than what is owed after the S. 2136 secured amount write down. This could be the accurate state of affairs even if the Chapter 13 plan pays 0% for unsecured claims. In such declining home value market, that some borrowers would and should allow a foreclosure of her/his/their home is even more the case in jurisdictions which do not allow the collection of deficiency balances following a foreclosure.

Question 5(a). Are you arguing that those with the "training appropriate for the mission" are the mortgage industry bankers?

Question 5(b). If so, is it your belief that these professionals have managed the housing market well over the past five years?

Question 5(c). In any case, is it not precisely the role of the civil courts to adjudicate disputes in which two parties with some knowledge of a given situation cannot agree on the appropriate course of future action?

Question 5(d). More specifically, do you believe that bankruptcy courts should exist at all, or should the car lenders handle disputes in the auto market, commercial property investors handle disputes in the real estate market, etc.?

Response to Questions 5(a), 5(b), 5(c), and 5(d). I have never argued, nor have I hinted that the professionals with the knowledge and training appropriate for the mission--here to work on the adjustable interest rate mortgage loan foreclosure matters--should be what the question refers to

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as "mortgage industry bankers." The point of my earlier testimony and what I urged was for the Senate Committee on the Judiciary to obtain greater assistance from the various professionals who have extensive information regarding the problems presented by what S. 2133 and S. 2136 desire to address along with the requisite kind and quality of training and education in the relevant fields beyond legal training which is singularly lacking in requiring and giving lawyers and judges any sufficient degree and quantity of training for the development of the manner and means to address what is referred to by the Committee as "the looming foreclosure crisis." These individuals would of necessity be from varying backgrounds and disciplines and could include people employed by those who made mortgage secured loans, but would not and should not be limited to such people. Question 5(b) does not require a response because it assumes that question 5(a) represents my view on the personnel who should be utilized to assist in the development of any legislation to address the "looming foreclosure crisis." Question 5(a) does not represent my view on who should be further utilized to present a thorough, well thought out approach which does the least harm in the relevant market(s) and to the least individuals and entities.

Both questions 5(c) and 5(d) misapprehend what my written and oral testimony set forth. The import and my criticism of S. 2136 is in part that it is flawed by its design made on the assumption that the historical version of one lender and one creditor holding the debt obligation is the status of the lender-borrower relationship for all adjustable rate mortgage loans to which S. 2136 would have application. Because of this assumption, S. 2136 makes what is to happen in a bankruptcy case apply without full appreciation of and apprehension regarding what will happen, among various things, to the various owners of many of what makes up 100% of a significant number of mortgages: various and potentially numerous streams of payments of principal and interest over differing periods of time for what may be subdivisions of portions of up to a thirty year period. It also overlooks who owns these subparts of what make up the total mortgage obligation of many mortgage secured debts and assumes that it is one lender. In fact, the ownership is far more diverse and includes not just a mortgage company, bank, savings and loan, but also individuals and other entities unrelated to the underlying home loan transaction. The scope of ownership includes pension and retirement trusts and plans, IRAs, money market funds and other places where individuals hold their savings and other assets. Perhaps even more troublesome is that these mortgage secured transactions are not know to be, for want of a better term, indirectly the basis on which a money market fund or other investment vehicle is valued and which will cause losses in value greater than otherwise might occur if legislation does not fully take into account how to minimize disruption of the market system.

I cannot overstate how potentially more damaging to others passage of a bill could be which does not take into greater consideration these and numerous issues and factors which go beyond just what it may do to the credit market. Incomplete further analysis of the scope and quality necessary may increase the costs of what S. 2136 contemplates to occur which will be borne in significant part by the American public. One of the factors that I will not repeat here because I discuss it in response to Senator Sessions' first question is that S. 2136 and to a lesser degree S. 2133 are NOT without cost to the American public. Quite the contrary, there are costs

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of a potential magnitude which could exceed the aggregate benefit accorded to what has been estimated by some of the Committee's witnesses as borrowers for 600,000 mortgage secured principal residence debts.

A principle espoused by me that questions 5(c) and 5(d) evidence has been missed is that S. 2136 could be drafted in a fashion that lessens the risks and uncertainty that the current version will create in the market by modifications which do what other disciplines have done: utilize standards developed by experts who are not being paid to foster one side's or another's position and which are formulated outside a court setting. An example is how the interest rate adjustment is to be done. These individuals would not, without more guidance, do what S. 2136 does in section 101(a)(3) which is to set a base rate which is the average interest rate for thirty year conventional mortgages published by the Federal Reserve which, if one investigates further, is in reality the average rate for such mortgages calculated by FHLMC based on mortgage loans with a loan-to-value ratio of 80% and then leave to litigation what the bankrupt's risk premium above this base rate should be. Instead, a potentially better base rate could be used along with risk specific standards which, at the least, narrow what would be court determined variations in the adjustment to the base rate. Other possibilities exist which could lessen the degree of risk and uncertainty in the setting of the interest rate. This process may yet require court adjudications, but will make it less frequent with smaller variations from an appropriate interest rate. Having given this explanation by use of an example, it is obvious what my answer is to question 5(c) and that question 5(d) is based on a distortion of what I have testified to in writing and orally. I have never testified or even suggested, let alone intimated, that bankruptcy courts should not exist or that a particular type of lender or investor handle disputes with a borrower. In a nutshell version, what I have been saying is that S. 2136 invites disputes which do not need to exist and if modified could create less risk and uncertainty in the market to the benefit of all. This is why I do not believe what is suggested by question 5(d) and, instead, believe that the question is regrettably premised on a misapprehension of what I have said.

Question 6(a). Do the same difficulties [determining who would lose if mortgages were to be modified in bankruptcy] exist when loan servicers attempt to voluntarily work out loan changes with at-risk homeowners?

Question 6(b). If so, is that a strong argument for allowing these changes to be made within the context of bankruptcy, since often it is too difficult outside of the court to sort out who must approve of each modification?

Response to Questions 6(a) and 6(b). Part of my written and oral testimony was to point out the structural change caused by what I called alteration of the traditional mortgage loan ownership of the entire principal and interest due over the live of a loan from one or a few individuals/entities into a commodity which is broken into numerous repayment streams of principal and interest, among other items. My discussion was and remains how S. 2136 for principal and interest and to a lesser degree S. 2133 for interest and other charges plus principal if agreed to by the borrower and owner(s) of the repayment streams do not take into account the

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ownership situation for many of the adjustable rate loans which each would affect. My testimony was not that these factors would not exist outside of a bankruptcy case, nor that the difficulties these present when compared to the historical one borrower-one lender model would not exist outside a bankruptcy case. The major focus of my testimony is that S. 2136 and S. 2133 disregard the implications of this structural change in ownership and assume that the usual mode of dealing with secured loans in a consumer bankruptcy case in Chapter 13 are up to the challenges these complexities present without causing significantly more risk and uncertainty in the credit market for an extended period of time–undoubtedly years–until, if ever, a means and procedure with sufficient certainty in approach and application by third parties is in place. What I have and continue to urge is that more consideration and analysis of what is involved with these types of loans occur and that a better framework should be developed for handling of the various issues. I additionally suggest this could be done by legislation that does not by its placement in the Bankruptcy Code, of necessity, require one to file a bankruptcy case to be able to use its provisions. This framework should be developed with the assistance of what I previously testified were those equally bright and capable professionals who are not lawyers and judges. This framework should be in some respects more explicit leaving for some matters less discretion to hundreds of judges and thousands of lawyers and litigants. If done better, it could create valuation, term extension, and interest rate methodologies with less risk and more certainty and consistency of outcome which would have less of an impact on the credit market and the cost of credit.

At least some of the same difficulties exist with modifications of the sort contemplated by S. 2136 should they be done within a bankruptcy case or outside a bankruptcy case. However, S. 2136 imposes what I view as an insufficient structural model on how to modify adjustable rate mortgages which by its model causes more and potentially greater "difficulties" that do not now exist outside bankruptcy. This is partly due to having the legislation placed within the Bankruptcy Code and some of what its current statutory provisions require. This is highlighted by recognition that any legislation achieving what S. 2136 desires to be done enacted outside the context of the Bankruptcy Code may still be utilized by those who initiate a bankruptcy case. This means that I do not agree that the question 6(b) proffered contention that bankruptcy is the way, and the only way, to achieve, if at all possible, what S. 2136 desires to occur to "...sort out who must approve each modification..." I would also like to mention that I have not read or heard any testimony regarding the extent to which the contractual provisions governing modification of the principal and interest portions of the mortgages may already exist for some mortgage secured ownership vehicles which specify the when, how and by whom such changes may be made. That the scope of the when, how, and by whom is not detailed to a sufficient degree by some or many does not mean that this is the case for all. A consequential question raised by the existence of the category of mortgage ownership vehicles with the necessary degree of specificity for these matters is whether those in this grouping should be treated the same as those which are not? As with other issues, consideration should also be given to this factor.

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II. Responses to Questions from Senator Jeff Sessions to the Honorable Thomas B. Bennett

Question 1. There are numerous references to the unintended consequences and potentially negative effects of the proposed legislation (S. 2133 and S. 2136). You urged Congress to be careful in considering these reforms, explaining that there are too many unknown variables and that we do [not] yet know whether problems in the home mortgage industry are simply a symptom of a larger problem. One unintended consequence of the proposed legislation, mentioned several times by several of the witnesses, will be on the cost of loans–interest rates will likely increase and the supply of credit will likely decrease.

a. Do you believe that the overall costs of loans to borrowers will increase?
b. Will this likely be true for all adjustable rate mortgages, including those that are not sub-prime?
c. Will this likely be true for all fixed rate mortgages, including those that are not sub-prime?
d. Will the small benefit to the subset of borrowers that will "benefit" from passage of S. 2133 or S. 2136 be offset by the harm to the larger overall group of borrowers?
e. Will the subset of borrowers affected by the passage of S. 2133 or S. 2136 also experience some likely harm(s)? Please explain.

Response to Question 1(a), 1(b), 1(c), 1(d), and 1(e). Initially, my testimony has been consistently that the cost of credit will be higher and its supply less than **each otherwise would have been should S. 2133 or S. 2136 be enacted.** It has not been that the cost of credit would necessarily increase or decrease or that the supply of credit would increase or decrease. The reason for this distinction is that there are numerous variables which interplay to cause the cost and supply of credit to move from where each is at a given point in time. Although the cost of credit, the interest rate, may go up or down following enactment of either bill and the supply of credit may increase or decrease after adoption of what is in either bill, the proper method to determine the impact of such legislation on the cost of credit and its supply is to fix the other variables and analyze in isolation the effect of the legislation. Because and to the extent that each bill, although arguably S. 2133 to a lesser degree, causes a greater degree of uncertainty in the market meaning increased risk, this as a non-price factor would cause a leftward shift in the supply of credit from where it otherwise would be and with a given demand for credit remaining where it was before the shift, the price of credit would increase at equilibrium. In the credit market, this is what one would usually expect to be the case when increased risk is associated with lending. There should be at least one caveat to this and it is one which involves a demand curve which has a portion or portions which are or are near being inelastic. However, there has been no evidence presented that this is the case for the demand for credit and it is not likely that such a state exists for purposes of what is being discussed with respect to S. 2133 and S.2136.

Given this somewhat technical response, an example will facilitate discussion of what would normally be expected to happen. If following enactment of either of these bills the relevant rate of interest goes down to 4% or up to 10%, the question is what the rate of interest

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would have been without enactment of the legislation. It may be that had the legislation not been enacted that the interest rate would have been 3.8%, not 4% should it go down or 9.8% and not 10% should it increase. Thus, the cost of the legislation given all other factors being held constant would be an interest rate which is higher by 2/10ths of one percent in each instance. This represents an additional 2/10ths of one percent which would be potentially paid by new entrants into the credit market, for example first time home buyers, those refinancing exiting obligations, and those with adjustable rate mortgage loans not within the purview of S. 2133 or S. 2136. Thus, the answer to questions 1(a) and 1(b) is that there would be an increase in the interest rate **above what it otherwise would be for borrowers** which would be true for all adjustable rate mortgages, not just for those to sub-prime borrowers. With respect to question 1(c), this will be true, too, for fixed rate loans made following enactment of such legislation for some period of time. The reality is contrary to what some said at the December 5, 2007, hearing: there is a cost to enactment of S. 2136 and to a lesser degree S. 2133. These costs which may be significant and will be borne by not just the lenders/owners of existing adjustable rate mortgage payment streams, but by other American consumers in the market for credit. This is a factor of importance which needs more analysis before one enacts legislation of the sort contemplated by S. 2133 and S. 2136. What should be of potentially greater moment to the supporters of S. 2136 and S. 2133 is the fact that this increase in the cost of credit above what it would have been will be paid by borrowers to some of the very lenders and owners of debts about whom the proponents of these bills complain in potentially an aggregate amount exceeding the value of the benefits argued to be gained from the legislation! The majority of those who will pay what is a hidden cost are the borrowers for whom S.2136 and S. 2133 do not apply!

One would hope that a quantitative review of the costs and benefits of such legislation would be made to ensure that what, in particular, S. 2136 contemplates must occur–principal write downs and interest rate reductions–does not result in aggregate costs which exceed the aggregate benefits. Given the representations that the number of adjustable rate mortgage loan transactions which would be able to benefit from use of S. 2136 is relatively small when compared to the total number of adjustable rate mortgage transactions coupled with the fact that numerous other refinancings and loans will be made in the future, this so-called relatively small number of loans may well receive an aggregate benefit which is far less than the aggregate costs of lost principal, lost interest, bankruptcy case related expenses, losses from further decrease in values of homes during the bankruptcy restructuring process, to list a few, PLUS what may be the greatest of all costs in the aggregate: the increase above what would have been paid in interest by other borrowers seeking mortgage secured loans, refinancing existing mortgage loans, and having a change in adjustable rate mortgage loans outside the application of S. 2136. It is possible that even a small fraction of one percent higher interest rate for borrowers not within the group to be helped by S. 2136 will increase the costs to this non-S. 2136 category of borrowers in a total amount which is greater, maybe much greater, than the total benefit to those S. 2136 hopes to assist. This would be due in large part by the larger number of other borrowers harmed compared to the benefits asserted to be accorded to the 600,000 homeowners estimated by S. 2136's proponents. There has been insufficient attention paid to this problem and I believe the true cost of the legislation should be determined in a more rigorous manner before enactment of

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either S. 2133 or S. 2136 in their current versions. To date, I have seen no testimony or evidence presented to this Committee in support of these bills which estimates these costs and benefits in any rigorous quantitative manner.

Perhaps more troubling is that the argument that 600,000 loan transactions–homes–would be saved from foreclosure or benefit from S. 2136 overlooks the stark reality of what has and continues to happen in a Chapter 13 case. It is the failure rate in Chapter 13. That is, it is the number of Chapter 13 cases dismissed without obtaining a discharge. The statistic most generally cited is that approximately 67% of Chapter 13 cases are dismissed before completing payments under a plan. I need to state that this number does not control for various factors such as achieving the desired result without the need of a bankruptcy discharge, whether the dismissed case was a debtor's first, fifth, tenth, twelfth or other number of bankruptcy case filed, and for other quantitative issues. Regardless, the point is that the failure rate in Chapter 13 is, as it is in other forms of bankruptcy reorganization, very high. When this failure rate is taken into account, the posited benefits from S. 2136 will be nowhere near what the proponents argue. It will be closer to one third of what is asserted or approximately 198,000 mortgage loan transactions if the 67% dismissal rate is close to accurate. Even if off by some amount, it is clear that the majority of cases will be dismissed before discharge should the historical norm remain unchanged.

Joined with this statistic is the fact that under current bankruptcy law dismissal of a case before its successful conclusion undoes all that occurred in the case unless the dismissal order provides otherwise. This is the general import of section 349(b) of the Bankruptcy Code. This means that unless the borrower files another Chapter 13 relatively quickly following the pre-discharge dismissal of an earlier Chapter 13 case, the holder of the adjustable rate mortgage secured loan gets to put the loan back to where it would have been as if no bankruptcy case had been filed. In other words, the entire debt is treated as secured, the interest rate that would have been charged but for S.2133's or S. 2136's application may be charged retroactive to before the filing of the initial Chapter 13, and other additional charges, fees, and expenses permitted under the contracts or applicable law may be imposed as if no bankruptcy case had ever been filed. The result is that the borrower may owe more on the mortgage secured loan than she/he/they would have owed had a Chapter 13 case never been filed..

This happens now in consumer chapter 13 cases dismissed pre-discharge with respect to real property, vehicle, and other secured loans. This puts the borrower in the posture of being potentially in a worse position than she/he/they would have been without filing bankruptcy. Many times, it also makes a second or subsequent case less likely to succeed than the earlier one with the concomitant increase in the likelihood that a foreclosure will ensue.

This sequence of events is made even more likely for some by the BAPCPA enacted amendments to the Bankruptcy Code for debtors who have more than one case filed within a one year period. This is due to the addition to the bankruptcy laws of the requirement of a substantial change in personal or financial circumstances of a debtor in the interval between the dismissal of the prior case and the filing of the new one which must be proven by the debtor to exist by clear

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and convincing evidence in order to have the automatic stay of section 362(a) of the Bankruptcy Code stop a foreclosure following the filing of a bankruptcy case beyond 29 days under section 362(c)(3)(A) or be put in place where none exists on filing a bankruptcy case which is the third case or more within one year under section 362(c)(4). Essentially and in response to question 1(e), all of this means that some of those borrowers who S. 2133 and S. 2136 are supposedly designed to help may be worse off under the scheme of either S. 2133 or S. 2136. For some of these, having a foreclosure before spending more monies on a home that will ultimately be lost is better in the long run, though a difficult outcome in the short run.

Question 2. Congressional actions in the home mortgage market will have consequences–there will be winners and losers under every proposed policy. Already, lenders are pulling back from loans they would have made earlier due to the uncertainty of the market. Your testimony explained how the effects of the proposed legislation (S. 2133 and S. 2136) will be far in their reach, going well beyond the scope of the bankruptcy courts. In your [oral] testimony to the Committee you stated that there are "two stages of losses" associated with this legislation and the effect it will have on the market. Can you provide more detail as to these stages of loss?

Response to Question 2. In my oral testimony, I was expanding on a point in my written testimony to demonstrate a particular problem with S. 2136 caused by the write down of the secured portion of the unpaid balance of an adjustable rate mortgage loan coupled with the extension of the term of the loan beyond that provided for under the terms of the loan documents and a reduction in the interest rate below the contract rate. S. 2136 purports to allow an adjustable rate mortgage loan's secured status reduced to the market value of the home once a bankruptcy case is filed. This converts the unpaid amount of the loan balance which exceeds the value of the security to an unsecured claim. Assuming that the valuation done within the bankruptcy case matches the true value of the security outside a bankruptcy case, here the debtor's residence, the diminution or loss in value of the secured claim in bankruptcy is the same as the loss that would be incurred outside bankruptcy should the property be sold at the time of valuation in the bankruptcy case. Assuming the accuracy of the valuation done within a bankruptcy case, this is the first loss on the secured claim and the proponents of S. 2136 are right to the extent of this loss being the same in or outside a bankruptcy case assuming the valuation within a bankruptcy case is accurate.

What is the second loss is what S. 2136 does to the written down, now fully secured claim in the bankruptcy case. It takes the fully secured portion of the overall claim and lowers the interest rate and extends the repayment period. This is done without regard to whether the amount of interest using the contract rate as applied to the secured principal balance plus amortization of the secured principal balance over the remaining contracted for life of the loan is fully repayable by a debtor in her/his/their bankruptcy case! The extension of the repayment period for the secured claim is especially longer than under the contracted for term for mortgage secured loans with maturities of less than thirty years, say seven, ten, and twenty year original terms. When one recalls that a number of mortgage secured obligations of the sort S. 2136 would govern in a bankruptcy case have been broken into various streams of principal and

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interest covering various portions of what makes up the total of payments due under an adjustable rate mortgage, the extension of the term of the mortgage beyond what was contracted for causes a loss to the holders of some of these streams of payments which are more attenuated in time from today to be greater than those with streams of payments closer to today. Indeed and if the extension is long enough and/or the interest rate reduction is great enough, the loss on this portion of what is supposedly a 100% secured claim may approach all of the value of this stream of payment. This is the second loss on what is the supposedly fully secured claim.

It arises from application of S. 2136 by setting of the repayment term and interest rate for the whole of the mortgage secured loan as if all streams of payment of principal and interest are owned by one person/entity and not by multiple persons/entities. This type of loss is caused by the application of an interest rate which for the total of the unpaid principal plus interest over the extended maturity may be appropriate in the aggregate, but with respect to some of the streams of repayments, especially those near the end of the extended repayment period, is too low by market set standards. What possibly may happen is that those receiving payments from the front end of the stream of repayments of principal or interest may have either a proportionately smaller loss, no loss, or a potential gain above what would have otherwise occurred. This will in some cases be at the expense of those owning a repayments stream later in time. What has happened to what was one long term debt with all payment streams held by one person or entity for up to thirty or more years in duration is that some have been divided into what may be viewed as more akin to short term, intermediate term, and long term repayment streams, among other types of compositions, which in the market usually have different valuations caused by different discount factors or interest rates for each. Unfortunately, this is not how S. 2136 will treat these differing types and terms of repayment streams. They are all lumped into one with no recognition of the differences in risks associated with each. This situation is not contemplated by S. 2136, S. 2133, and the current practice in consumer bankruptcy cases, and its applicable law. As a result, certain of the owners of these attenuated streams of what would have been found for claims allowance under the Bankruptcy Code to be fully secured will be, in reality, not treated as fully secured and, for some, could potentially be made nearly, if not totally, worthless.

Lastly, it is an incomplete comparison to assert that this already happens with vehicle loans and similar personalty loans in a Chapter 13 case. The reason that it is a misleading comparison is that these other sorts of vehicle and personalty secured loans have much shorter maturities than large parts of the streams of repayment of mortgage secured obligations which can be extended under S. 2136 for a term multiple years–tens of years–longer than can vehicle and other personalty secured loans under a Chapter 13 plan and the dollar amount of most of these mortgage debt repayment streams is also much greater than those for the majority of vehicle and other personal property secured loans. This makes any losses on adjustable rate mortgage secured obligations much greater than those for vehicle and similar shorter term secured debt instruments. This is another of those complex problems which should be thought about in greater detail before any version of either S. 2136 or S. 2133 is enacted.

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Question 3. Mr. Sommer testified that almost 600,000 homeowners will benefit from the enactment of S. 2136 by filing bankruptcy and being able to keep their homes.

a. In your opinion is this an accurate statement? Will 600,000 homeowners, as a result of this legislation, be able to keep their homes that might otherwise have been lost to foreclosure?

b. Or, are we likely just postponing the majority of home losses for a short time?

Response to Question 3. I have no reason to question that the estimated number of homeowners as calculated by Mr. Zandi was done properly based on the assumptions he used. My belief is that this is where Mr. Sommer may have obtained the 600,000 figure. If Mr. Sommer did a separate calculation, I have no reason to doubt that it was done consistent with the assumptions he used. Whether this number of homeowners will benefit from S. 2136 depends on how one defines "benefit." If it means keeping one's home for a longer time from one day to years longer than one would have kept it had a foreclosure occurred and the estimated number is accurate then the statement is accurate. However, if what is meant is that all of the 600,000 homeowners will not face foreclosure by filing a Chapter 13 bankruptcy case and be able to afford to repay in full the mortgage debt obligation, I do not believe it to be correct. The reasons are set forth in my response to Senator Sessions' question 1. Likewise and for some as I also set forth in my response to Senator Sessions' question 1, the result will only be the postponing of a foreclosure for a period of time which could range from a short to a longer one. Why these are the case is the very high failure rate in all bankruptcy cases, including Chapter 13. Whether less than most of the 600,000 homeowners asserted to be benefitted will prove to be the case remains to be seen, but should the historical rate of discharges granted in Chapter 13 cases remain at or near what it has been, those benefitted by avoiding foreclosure and keeping their home until paid for will be only about a third of the asserted 600,000 homeowners.

III. Conclusion. Mr. Chairman and the other Members of the Committee, I thank you for allowing me to set forth my perspective regarding each of S. 2133 and S. 2136. In summary, I have not argued that nothing should be done. Rather, I have addressed what I believe to be significant deficiencies in each of the bills along with some of what I believe to be each's merits on the hope that greater analysis and consideration will be given to what is being attempted to ensure that the least negative impact and the greatest net benefits, if possible, will be associated with whatever may be enacted. To that end, I am willing to give whatever other assistance which may be requested of me.

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Senate Judiciary Committee
Hearing on
"The Looming Foreclosure Crisis: Helping Families Save Their Homes"
December 5, 2007

Questions from Senator Richard J. Durbin for The Honorable Jacqueline Cox

1. Judge Cox, although many of the national mortgage industry associations have spoken out in opposition to my legislation, I still do not understand why lenders would be so opposed to a solution in which their legal liability issues surrounding loan work outs are resolved, and the number of empty houses they are forced to carry and unload are significantly reduced.

What are you seeing in your courtroom right now from the lending industry, from those who are actually dealing with the crisis every day? In your courtroom, are lenders typically eager to foreclose, or would they prefer to reach a settlement with homeowners?

A. The lenders generally prefer to be paid under the mortgage if the debtors can reasonably be expected to make plan payments or to refinance the debt. The lenders are very flexible and are giving debtors time to cure postpetition plan defaults by agreeing to default orders rather then seeking immediate modification of the automatic stay. These orders usually require the debtors to cure the postpetition plan defaults over a reasonable period of time; failure to make the payments results in the automatic modification of the stay without further court order.

I have seen many situations lately where the lenders agree to the imposition of the automatic stay under 11 U.S.C. §362 (c)(3) and (4) for debtors who, because they are multiple filers, are ineligible for the imposition of an automatic stay. On occasion I will either lift the automatic stay or decline to enter an automatic stay and learn later that the lender chose not to proceed with an imminent mortgage foreclosure sale where the debtor makes reasonable efforts to sell the home or to refinance the loan. I would say that lenders are somewhat less eager to foreclose based on their agreements to impose the stay for multiple filers and their agreements to enter default orders regarding past due postpetition plan payments.

The proposed bill requires debtors to repay mortgage debt at the interest rate recently published by the Federal Reserve System reflecting the annual yield on conventional mortgages plus a premium for risk. That rate is about 6.14% as of today's date of December 27, 2007. Lenders may prefer a performing loan at the Federal Reserve Bank rate of 6.14% "plus" to a foreclosure sale of the

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collateral at values lower than the amount of the loan. In fact lenders are making fixed rate loans to debtors in Chapter 13 cases to refinance mortgages in the 7% to 8% range. In this regard the bill appears to reflect current market activity.

2. Professor Mason states in his written testimony that under my bill "a judge will have to order an appraisal of the property to assess fair market value," and he uses that claim as evidence that my bill will increase the costs to debtors in Chapter 13.

a) Do you typically order appraisals on your own to assess the value of property? Or, do you typically review the two competing appraisals that the lender and borrower have already ordered to judge the value of a property?

A. I have never ordered an appraisal of real estate in a chapter 13 matter and the debtors and lenders generally do not submit appraisals of the value of the homes that secure mortgage debt. On occasion, the Chapter 13 Trustee suspects that there is equity sufficient to require the debtor to increase the percentage by which unsecured debt is to be repaid. The debtor will then be required to present a report of comparables, the selling price of similar homes in the area. The websites of Zillow.com, Housevalues.com and Domania.com provide much of this information free of charge. Realtors testify to value based in large part on this data for nominal fees, or without charge in anticipation of securing the listing to sell the home. This issue is rarely contested because strip down of mortgage debt is not now permitted, as the lenders are entitled to full payment of the mortgage obligation without regard to the value of the home.

b) Does Professor Mason misunderstand the way this process would work in Chapter 13?

A. Generally there are three approaches to the valuation of real estate. In the cost approach, value is generally measured as the current cost less an allowance for deterioration, functional obsolescence and external obsolescence. The current cost is measured in terms of replacement cost. In the income approach, value estimates are calculated by applying an appropriate multiplier or capitalization rate to the property's expected income or cash flow. Common direct-capitalization multipliers or rates include: (1) income multipliers such as potential gross income multiplier (PGIM), effective gross income multiplier (EGIM) and net income multiplier (NIM), and (2) several capitalization rates such as overall capitalization rate, land capitalization rate and building capitalization rate.[1] In the sales comparables approach, an examination of sales of similar properties in the

[1] Robert F. Reilly, *Value and Cents: How to Build A Strong Real Estate Appraisal Report*, American Bankruptcy Institute Journal, September 2004, at 44.

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surrounding area support the value opinion. "The sales comparison approach usually provides the primary indication of market value in appraisals of properties that are not usually purchased for their income-producing characteristics."[2] Because residences are not usually purchased to produce income, the sales comparison method of valuation is valid. *See In re Patterson*, 375 B.R. 135, 142 n.17 (Bankr. E.D. Pa. 2007) (stating the sales comparison method is "well accepted for non-income producing real estate"); *see also In re Zersen*, 189 B.R. 732, 738-39 (Bankr. W.D. Wis. 1995) (court stating that the sales comparison method is most appropriate for valuing the debtors' residence).

If Senator Durbin's bill allowing strip down of mortgages becomes law, I would expect value disputes, but am certain that they can be resolved via the less complicated and less expensive sales comparison method of valuation. Information regarding recent sales of comparable homes in the debtors' neighborhoods is readily available. Neither the creditor nor the debtor have any interest in running up unnecessary costs for a home that is already worth less than the amount of the lender's claim. The Professor may not realize that some home value information is readily available.

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[2] *See* Jason S. Kirwan, *Note: Appraising a Presumption: A Modern Look at the Doctrine of Specific Performance in Real Estate Contracts*, 47 Wm. and Mary L. Rev. 697, 713 (2005) (quoting Appraisal Institute, The Appraisal of Real Estate 419 (12 ed. 2001)).

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Senate Judiciary Committee
Hearing on
"The Looming Foreclosure Crisis: Helping Families Save Their Homes"
December 5, 2007

Questions from Senator Arlen Specter for The Honorable Jacqueline Cox

1. In your written testimony, you state that under Senator Durbin's bill, "Homeowners who can afford their payments will not receive a windfall." However, homeowners who cannot currently afford their payments are still likely to receive a windfall if their mortgage is crammed down, correct? Wouldn't it be better to get at the reason why most homeowners cannot currently afford their payments-adjustable interest rates? S.2133 would allow you to freeze or roll back interest rates that have reset, making the mortgage payment unaffordable for the homeowner. At the same time, it would not provide a windfall to the homeowner at the expense of the mortgage creditor.

A. When I stated at the December 5, 2007 Senate Judiciary Committee hearing that homeowners who can afford their payments will not receive a windfall, I was referring to Section (a)(3) of Senate Bill 2136 which would modify 11 U.S.C. 1322 (b) by allowing debtors of limited means to cram down their mortgages. Senate Bill 2136 allows cram down for debtors if, after deduction from the debtor's current monthly income of expenses permitted for debtors described in §1325 (b)(3), the debtor has insufficient remaining income to retain possession of the residence by curing a default and maintaining payments while the case is pending. Debtors who can afford their payments will not qualify for this relief

Your question is that homeowners who cram down their mortgages are still likely to get a windfall. Assuming that you mean that they would restructure the loan at a lower level while selling it at a higher price, you may be correct. However, the cram down value is market value or replacement value as explained by the Supreme Court in *Till v. S.C.S. Credit Corp.*[1] Any windfall or advantage to the homeowner would occur at an uncertain point in the future if home values increase. There would not be an immediate windfall; the homeowner would have to make mortgage payments, pay taxes and maintain the property indefinitely to realize any such benefit. As such, allowing homeowners to capture future increases in the value of their homes does not occur at the expense of the mortgage creditors who recover the lower value at foreclosure sales.

[1] 541 U.S. 465 (2004).

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You state that adjustable rate mortgages are the reason homeowners can not now afford their payments and that allowing the freeze or roll back of interest rates that
have reset making mortgage payments unaffordable. Senate Bill 2133 allows some modification of interest rates, this does provide needed relief, but does not address the situation of loans made in excess of actual value.

2. I am concerned both about current homeowners and those who try to become homeowners in the future. I am therefore concerned that any changes we make to the bankruptcy code might have a negative impact on the ability of future home buyers to obtain a mortgage. Some have attempted to allay my concern by pointing to the fact that cram down is already permitted for second homes and vacation homes. However, isn't it true that cram down is rarely permitted on second homes and vacation homes?

A. You ask if cram down is rarely permitted on second homes and vacation homes. We do not have discretion not to permit cram down on second homes or on vacation homes. The anti-modification provision of 11 U.S.C. §1322 (b)(2) covers "the debtor's principal residence" it does not cover additional residences owned by debtors.

In addition, cram down rarely occurs on second homes or vacation homes because few debtors have two homes. Second homes are usually rental properties, which because they are not a primary residence, the mortgage can be modified. Where debtors have multiple properties, they generally sell them. I require that the sale proceeds be given directly to the Chapter 13 Trustee at closing and that they be applied to the debtor's Chapter 13 plan obligations.

Allowing cram down should not have a negative impact on the ability of future home buyers to obtain a mortgage. Mortgage lending is a profitable business. When mortgages are extended to credit worthy Americans based on reasonable, accurate property values, they make sense for all concerned and will not cause lenders to abandon residential mortgage lending. The cram down reflects the decrease in market value which reflects the creditor's foreclosure recovery. Senate Bill 2136 allows a debtor to move forward from that price point.

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Responses to Questions from Committee Members with Regard to Dec. 5, 2007 Hearing on "The Looming Foreclosure Crisis: How to Help Families Save Their Homes"

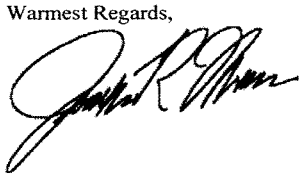
JOSEPH R. MASON†

The Office of the Honorable Patrick J. Leahy
United States Senate Judiciary Committee
224 Dirksen Senate Office Building
Washington, DC 20510a
Att'n: Mr. Justin Pentenrieder, Hearing Clerk

Dear Chairman Leahy, Ranking Member Specter, and Members of the Committee:

Thank you for your interest in my testimony and the follow-up questions. Enclosed are my replies, which often delve into subject matter in much more depth than was possible in the oral testimony. Like others, I did not receive the December 13 letter until December 21 and by then was travelling with family during the holiday season. These answers are my best effort to provide as much information as I can, given the short period of time allotted. Hence, I invite you to write or call if I can be of further assistance in clarifying my original testimony or these written responses.

Warmest Regards,



Dr. Joseph R. Mason

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General Question: Do you believe that assigning a pre-securitization rating based upon borrower information AND lender performance to mortgages would help to decrease the future likelihood and the type of meltdown we've experienced in the subprime market?

I interpret this question as relating primarily to secondary market problems, not the bankruptcy bill, per se. As such, that "pre-securitization rating" was supposed to have been issued on the pool of mortgages on the basis of borrower information and lender performance by the Nationally Recognized Statistical Rating Organizations, or NRSROs such as Moody's, S&P, and Fitch. Obviously, those organizations failed to perform their duties. Yes, had they properly undertaken their duties, the present crisis would be much less severe if not avoided altogether.

Both the House and the Senate conducted hearings into those issues through the summer and fall. It should now be clear that ratings agencies had appropriate information yet failed to take into account new loan and borrower types in the process of rating securitizations (such was admitted by Moody's over the summer when they reported how they planned to include such information going forward). Nonetheless, Congress has sought to make no changes to the industry as a result of those hearings.

More generally, without some liability stake for ratings accuracy (similar to, say, that of auditors in the accounting profession), ratings agencies have little incentive *not* to ignore relevant information in the next market boom and repeat the mistakes, albeit in different product areas. Recent market events should hammer home the message: when ratings are the key to regulatory and statutory investment limits, ratings have value far beyond a mere editorial opinion. (For more detail, see the attached Financial Times op-ed co-authored with Charles Calomiris.)

Questions from Senator Jeff Sessions: You concluded your written testimony by stating that bifurcation of mortgage contracts – what S. 2136 would permit – will encourage the "cashing out of home equity." It is assumed that by this you are referring to the fact that people will put all of their extra cash into a mortgage, which is tax exempt, rather than into other savings streams.

Let me clarify first my assertion in my written testimony. In my opinion, the most difficult aspect of addressing borrower troubles and formulating mortgage reform for this Congress stems from the fact that mortgages have been used for much more than just purchasing homes, whether they be primary residences or vacation homes (which is, itself, a problematic distinction). The problem is that the practice of cashing out home equity through cash-out refinancing has led many individuals to use the home equity built up through making their monthly payments and through home price appreciation for consumption purposes.

Such behavior leads borrowers to *maximize* the ratio of their mortgage *borrowing* to the value of the home, leaving them with higher mortgage payments and little equity cushion to help them weather temporary declines in home prices. (Note: No one ever believed that house prices could not decline regionally, and that certainly happened in the 1980s. Investors in mortgage-backed securities did believe, however, that it was highly unlikely that house prices would decline nationally, which (arguably) has not happened since the Great Depression.) Ask most borrowers why they choose to borrow via home equity rather than taking out an automobile loan, a student loan, or increasing

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their balance on their credit card and the response is, invariably, the mortgage interest tax credit and lower interest rates on mortgages compared to those other forms of borrowing. The ability to bifurcate a debt contract in bankruptcy proceedings creates *further advantage* to the consumer of borrowing via mortgages, which will *further incentivize* the practice of cashing out home equity for purposes other than purchasing or improving a home.

I hope that clarifies my initial assertion. That said, I am confused by the wording of the introduction of the question, which reads, "...people will put all of their extra cash into a mortgage, which is tax exempt, rather than into other savings streams." *A mortgage is not a savings stream*: a mortgage is debt. The tax advantage on the interest on the debt creates an incentive to keep the debt principal high rather than paying that debt down over time. *The savings stream that arises from a mortgage contract is the equity built up in the home as the debt is paid down over time.*

Further confounding the problem of addressing the crisis for individuals that truly sought to purchase a home, i.e., build up the equity in a home so that the mortgage debt would eventually be extinguished, is that a substantial number of individuals used low-payment teaser contracts (which are not low-interest rate loans, per se) where the borrower makes a payment and does not build equity in the home as a substitute for rental contracts during recent years. Hence, even with the temporary disruption of moving, those borrowers are better off than they would have been had they rented over the last decade. (See accompanying essay co-authored with Charles Calomiris in the appendix.)

As I mentioned earlier in this response, sorting out those who truly sought to establish residency in a community and own a home by paying down a loan over time from those that (i) used real estate debt and rapid home price appreciation in a speculative manner for consumption purposes as well as (ii) those who merely sought to replace rental contracts with a similarly expedient legal arrangement that made sense in certain market and regulatory conditions is the biggest economic and political hurdle facing legislators in crafting mortgage relief and reform.

Questions from Senator Jeff Sessions (cont'd): If this is a correct assessment of your statement, it seems that we could also expect to see a decrease in personal or retirement savings as an unintended consequence of this legislation.

(a) Is it correct to expect this unintended consequence?

(b) What will be the long term effect, in your mind, of such an unintended consequence?

Yes, we can expect to see a further decrease in personal or retirement savings as a result of such reluctance to build equity in our homes.

About thirty-five years ago my Grandparents had a "mortgage-burning" party, not uncommon at the time. They made their thirty years of level mortgage payments and owned their home, outright. My Grandfather retired from the steel mills of Gary, IN, on a fixed pension and Social Security and lived out his years in that house. My Grandmother is in an assisted living facility and the home, her largest retirement asset, pays for her care.

People do not live like my Grandparents any more. People usually do not live in one place for thirty years, as labor markets are more mobile today than they were in my Grandparents' time (which is a good thing, from an economic

perspective). Along the way, people became comfortable with buying a more expensive house when they moved, accounting for both inflation and wage growth. In a way, this seemed like they were not building home equity since their mortgage nominally increased. But as long as they used the cash from the sale of the old home as a down payment for the new home they were building equity in the transactions. The idea at work was that they could downsize later on as they approached retirement by selling the larger home and moving into a smaller one. They were, therefore, engaging in a form of personally-imposed forced savings, just as with any retirement or long-term savings account.

The ability to cash out home equity provided liquidity to this strategy. If people wanted just a little of that home equity they would not have to sell the home and move right away. Reverse mortgage arrangements are also being developed that have the potential to add further efficiency to those arrangements.

The key investment rule-of-thumb at work here is that one should never consume one's endowment, or equity capital. Problems arise, therefore, when home equity loans and cash-out refinancings are used for immediate consumption *outside a long-term savings plan*, and that is precisely what has happened recently. Without the long-term buildup and later liquidation of home equity across an individual's lifetime, that individual is forgoing the benefits of what has heretofore been an individual's largest retirement asset: the equity they build by *paying down* their mortgage debt.

Now, as an economist I advocate choice in one's own financial arrangements. It may be appropriate for some individuals to cash out home equity when they are young, for instance, to invest in a business or other endeavor. Hence, restricting the ability to do so would constrain economic growth. Nonetheless, economic growth will also be constrained by individuals continuing to cash out home equity merely for immediate consumption *outside a long-term savings plan*, which sets the stage for others to bear the costs of those individuals' retirement and long-term care expenditures. Greater reliance on backstop retirement programs like Social Security and Medicare as individuals willingly spend down their assets will exacerbate the impending Social Security crisis.

Questions from Senator Jeff Sessions (cont'd): Industry associations have noted that S. 2136 and S. 2133, which both allow for the modification of a mortgage loan during bankruptcy under different circumstances, will introduce new risks into the loan process that will create new, unpredictable, results. Increased risk means increased mortgage cost for future borrowers and adjustable rate borrowers that want to refinance.

(a) In your view, if Congress changes the bankruptcy code to allow the terms of a mortgage to be modified in a Chapter 13 bankruptcy proceeding, will there be a negative effect on future borrowers looking to obtain a new mortgage and on adjustable rate borrowers that want to refinance at a lower fixed rate?

Allowing bankruptcy courts to unilaterally change the terms of a mortgage to those less favorable to the lender will impose unexpected and un-forecastable costs upon lenders and therefore raise the cost of providing funds to borrowers that can qualify for such treatment.

Questions from Senator Jeff Sessions (cont'd): (b) Would the end result of allowing bankruptcy judges to bifurcate mortgages be an increase in interest rates for future borrowers? If so, please explain why?

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The cost of providing fund to borrowers consists of much more than the interest rate on the loan. Hence, this is an area that requires much more detailed discussion than previously accorded in the hearing or the initial written testimony. The increased cost of providing credit to affected consumers can result in a variety of outcomes, none of which are favorable to the consumer. Lenders may respond by increasing interest rates or collateral levels (that is, requiring higher down payments) or they may just choose instead to ration credit, that is, avoid lending to borrowers that may qualify under S. 2133 or S. 2136, as enacted. While it is not clear which combination of responses will occur, *a priori*, from an financial economic perspective it would be foolish to expect the effect to be benign.

According to Freixas and Rochet (The Microeconomics of Banking, MIT Press, 1999), credit rationing can appear as soon as the expected return on a bank loan (for a given category of borrowers) is no longer a smooth rising function of the nominal interest rate on the loan, as represented in Figure 1.

The bank facing the return schedule in Figure 1 will never offer an interest rate above R^*. This explains why a competitive bank may prefer to ration (not lend to) credit applicants.

Analyzing the entire banking sector requires taking into account the aggregate supply and aggregate demand for credit. The aggregate demand is straightforward, in that more credit is demanded at lower interest rates. The aggregate supply conditions, however, depend on the behavior of bank investors, i.e., primarily depositors (although, it must now be recognized the investors in securitizations fund about $9t of the consumer loan market today, compared to only $6t of aggregate bank deposits). Assuming that investors know the relationship between the quoted interest rate R and banks' rate of return ρ, a supply of funds increasing in the rate of return will determine a supply of loans on behalf of banks that is backward bending, like the expected revenue curve in Figure 1.

Figure 1: Expected Return for the Bank as a Function of the Nominal Rate of the Loan

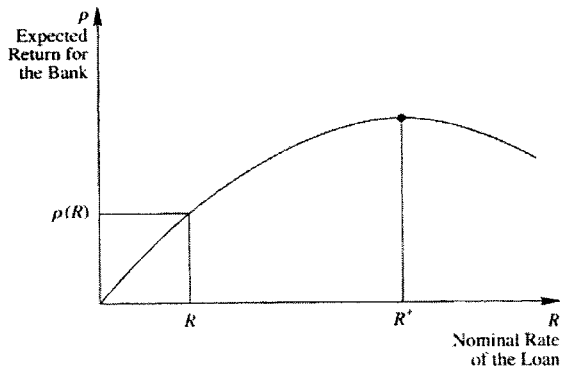

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Figure 2: Equilibrium Credit Rationing

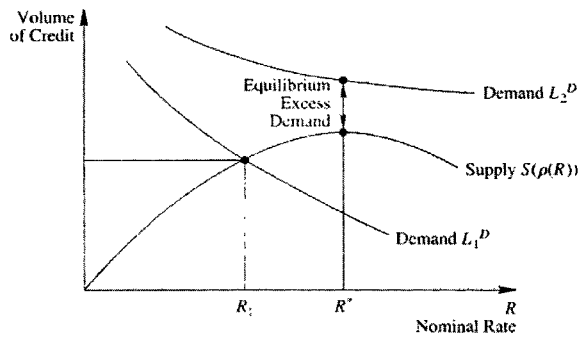

Figure 2 shows how credit rationing occurs. If the demand schedule is L_1^D, a competitive equilibrium exists characterized by equilibrium of supply and demand at nominal rate R_1. If, instead, the demand schedule is L_2^D, supply and demand do not intersect. Hence, the equilibrium rate of interest is R^* and borrowers would wish to borrow at rates above R^* (in particular, needier or subprime borrowers) will be excluded from the market.

Hence, while it is unclear exactly how lenders will react, economic theory suggests that lenders will, indeed, respond to the increased risks of lending to qualified borrowers under S. 2133 or S. 2136 in an economically rational manner. In particular, it should be acknowledged that collateral is a classic mechanism for distinguishing among which borrowers to ration. In general, banks prefer contracts with higher collateral and interest rates. (See Freixas and Rochet pp. 144-148 for a full discussion.)

The point is that S. 2133 or S. 2136 will lower expected collateral values to various extents due to the possibility of cram-down, creating the need for either higher interest rates, higher collateral levels (i.e., higher required down payments), and/or rationing, all of which increase the cost of credit to the consumer.

Questions from Senator Jeff Sessions (cont'd): (c) In your view, which proposal – S. 2133 or S. 2136 – will create the most negative effects? Which provisions of each bill create the most risk?

In light of the above, the bill that will create the least disruption to credit markets is that which limits relief to the narrowest sector of borrowers. Income limits and sunset provisions can limit the negative impact of the bills. Expanding the effect through judicial determination of the terms of the modification and abrogating other terms of the contract serve to increase credit market disruption.

Questions from Senator Richard J. Durbin: In your written testimony you argue... that "mortgages are other real estate assets are poor candidates for bifurcation [cram down] in bankruptcy because they can be fully expected to regain value later in the life of the contract." Do you think banks are eager to hold on to 2.2 million foreclosed properties to wait for the real estate market to turn upwards?

My response has three parts. First, banks are working to develop appropriate modification platforms and, if left to themselves, will come to appropriate

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arrangements that are reasonable and economical for borrowers and lenders, alike. Second, banks or other investors with spare capital will purchase properties and keep them occupied, substantially reducing the neighborhood effects of vacant properties. Third, banks that have made uneconomical loans with borrowers who cannot pay for properties that are not worth the outstanding balance of the loan will suffer and perhaps fail, and will therefore communicate to markets that some types of loans are uneconomical going forward.

While Moody's reported last summer that only a small proportion of loans were being modified, vendors and servicers have recently increased the pace of modification. Equifax recently unveiled tools to help them determine if certain borrowers are qualified for loss mitigation on that, much maligned, case-by-case basis. Equifax's new tool helps lenders classify borrowers based on income, employment, creditworthiness and available equity. According to Dann Adams, president of U.S. Consumer Information Solutions at Equifax. "Leveraging the power of our vast data and advanced analytics, we are equipping lenders with a systematic solution that offers a clear and concise way to segment their portfolios, evaluate loan modification requests and streamline the qualification process... as financial institutions are responding to thousands of customers requests to modify individual loans," (Kerri Panchuk, "New Equifax Solution to Aid HOPE NOW Alliance," *DS News*, Dec. 20, 2007).

Other necessary forms and procedures are also coming into place. (Kerri Panchuk, "MRG Offers Loan Modification Contracts," *DS News*, Dec. 17, 2007). Dallas, Texas-based MRG Document Technologies (MRG), a company known for providing documents to the financial services industry, recently began offering loan modification agreements to financial companies who are involved in a slew of loss mitigation efforts. According to Terry King, chairman of MRG, "Market conditions are forcing lenders to rethink existing loan agreements in order to reduce foreclosures and cope with ever-changing state and federal regulations... To help meet this demand, MRG now provides the capability to order and receive modification agreements through its Miracle DocPrep software package. In addition, we provide access to our legal staff for our customers to further enhance their ability to fully stay in compliance."

What we are seeing, therefore, is the market generating the ability to modify contracts where appropriate without government intervention. Those private sector initiatives will substantially reduce foreclosures where the borrower has means to make the loan payment and the lender can still recover a reasonable rate of return well prior to bankruptcy.

Some still argue that empty houses put downward pressure on other home prices in the same neighborhood. Well-functioning markets, however, abhor a vacuum. Hence, a property will not sit idle if it can be sold and/or rented to another occupant. Furthermore, markets are awash in ready cash waiting to take real estate off banks' hands to facilitate that transformation.

Markets are already at work in this regard. Vulture investors are already active in Florida, purchasing homes from both developers and banks. The fund strategies are simple: "Buy new homes cheap, rent them for a few years and sell them at huge markups when the real estate market inevitably rebounds," (James Thorner, "Funds picking over bones after collapse," *St. Petersburg Times*, December 17, 2007). In general, vulture funds are offering homebuilders about

70 cents on the dollar for unsold new construction and offering banks about 40 cents on the dollar for foreclosures.

Recent investment offerings include an "'REO pool' of 30 Tampa area homes worth $5-million. The pooler promises the fund will increase in value. In a few years, those homes could be worth a collective $7.5-million, a gain of 50 percent. Another Tampa Bay area developer said the amount of private equity chasing cut-rate real estate is staggering. A few years ago a $250-million fund was an impressive fund. Nowadays you hear a group's assembled $1-billion and you say, 'That's all?'" (James Thorner, "Funds picking over bones after collapse," *St. Petersburg Times*, December 17, 2007).

My own work on vulture investing estimates that high volatility and low interest rates lend value to waiting for recovery. It is easy to see why. High volatility suggests that values may be temporarily low right now. Low interest rates in the economy mean that there are few places where an investor can earn high returns as an alternative to waiting for recovery. Hence, it can be wise for investors to wait five or even ten years for returns from vulture investing. (Joseph R. Mason, "A Real Options Approach to Bankruptcy Costs: Evidence from Failed Commercial Banks during the 1990s." *Journal of Business*, July 2005 (79:3), pp. 1523-53.)

The interaction of volatility and interest rates to create vulture investing opportunities is precisely why private mortgage loan modifications rarely involve principal reductions. Suppose a borrower pays $1,000 now to file Chapter 13 and receives, in return a $5,000 principal reduction on their mortgage loan.

Table 1: Investment Returns from Recovered Principal in Judicial Cram-downs

Pay Now	Receive Later	Years to Recovery	Effective Investment Return
$1,000	$5,000	10	17%
$1,000	$5,000	9	20%
$1,000	$5,000	8	22%
$1,000	$5,000	7	26%
$1,000	$5,000	6	31%
$1,000	$5,000	5	38%
$1,000	$5,000	4	50%
$1,000	$5,000	3	71%
$1,000	$5,000	2	124%
$1,000	$5,000	1	400%

Table 1 shows that if the real estate regains that $5,000 value in as long as 10 years, the borrower obtains a 17% *annual* return on their $1,000 filing cost investment (a 400% total return). The gains are even higher if markets recover more quickly, as is expected in high-growth states like California and Florida. With such returns available, I can envision the growth of speculators willing to pay filing fees on behalf of borrowers in return for a portion of the gains, creating

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more bankruptcies unnecessarily as investors profit from the legal system while harming consumer credit unnecessarily.

There is another risk to be concerned with, as well: the risk that the Federal Reserve will drive interest rates too low and provide an incentive to wait for recovery. Japan faced extremely high volatility in real estate and zero nominal (negative real) interest rates for much of the decade of the 1990s, and is still waiting for recovery as few investment offerings trump expected returns from old vulture real estate funds that will eventually come back. Hence, it is important to fuel economic growth through fiscal as well as monetary policy so that markets can properly absorb losses and reallocate gains and move past the current crisis.

Last, for bank loans that are completely uneconomical, both banks and borrowers will lose. Except in specific cases of fraud, such as that involving Ms. McGee, it is hard to argue that borrowers who bought something they could not afford and the institutions that sold that product to them should not both suffer some sort of loss. Banks are now posting those losses and, where appropriate, investors are providing capital to tide them over the crisis (or not).

Questions from Senator Richard J. Durbin: You argue in your testimony that the real estate market will impose additional "lemons discount" that will raise interest rates on all loans if my bill's change to the bankruptcy law is implemented, because of increased uncertainty.

(a) Is the market already uncertain at the moment?

First, it is important to distinguish between risk and uncertainty. In his classic book *Risk, Uncertainty, and Profit*, Frank H. Knight (The Riverside Press: Cambridge, 1921) proposed a distinction between risk and uncertainty as descriptions of imperfect knowledge about the market environment. Risk, as defined by Knight, is a quantitative measure and uncertainty, a non-quantitative measure. By uncertainty, therefore, Knight meant situations in which markets collapse because of moral hazard or adverse selection, i.e., un-forecastable exogenous events or shifts in market behavior or institutional underpinnings. Those are elements that cannot *ever* be priced and therefore cannot be statistically estimated with any degree of accuracy.

Uncertainty is always and everywhere a part of market conditions. The question becomes the level of uncertainty. In that sense, the unexpected shift in lending on the basis of little or no documentation, the increased acceptance of leverage – and therefore default risk – on behalf of consumers, and the unbridled pace of financial innovation all represent sources of uncertainty plaguing markets today.

(b) Do mass foreclosures add uncertainty to the market?

On the basis of Knight's well-accepted distinctions, mass foreclosures do not add uncertainty to the market. On the contrary, the incidence and impact of foreclosures can be statistically predicted with a fair degree of accuracy: investors and policymakers simply do not like the recent results of that estimation exercise.

(c) Does the possibility of loan modification outside of bankruptcy not add just as much uncertainty as the exact same modifications within bankruptcy?

No. Increased reliance on loan modifications does not increase uncertainty in the classical sense. Again, the distinction is that the outcome can be statistically estimated with some degree of accuracy. If a lender modifies a loan of its own

accord and based on a single algorithm applied systematically across the entire pool of loans, it can be reasonably certain that the modification is in the best interest of the lender and the borrower alike. If, instead, modification is imposed upon the lender based upon differing algorithms, judicial fiat, and differing discretion and differs across jurisdictions it becomes unclear whether economic efficiencies are maintained, thus raising uncertainty.

(d) Do you have any statistical evidence to support your claim that higher interest rates would result from bankruptcy code changes?

In addressing this question let me first reiterate my reply to Senator Sessions.

The cost of providing fund to borrowers consists of much more than the interest rate on the loan. Hence, this is an area that requires much more detailed discussion than previously accorded in the hearing or the initial written testimony. The increased cost of providing credit to affected consumers can result in a variety of outcomes, none of which are favorable to the consumer. Lenders may respond by increasing interest rates or collateral levels (that is, requiring higher down payments) or they may just choose instead to ration credit, that is, avoid lending to borrowers that may qualify under S. 2133 or S. 2136, as enacted. While it is not clear which combination of responses will occur, *a priori*, from an financial economic perspective it would be foolish to expect the effect to be benign.

According to Freixas and Rochet (The Microeconomics of Banking, MIT Press, 1999), credit rationing can appear as soon as the expected return on a bank loan (for a given category of borrowers) is no longer a smooth rising function of the nominal interest rate on the loan, as represented in Figure 1.

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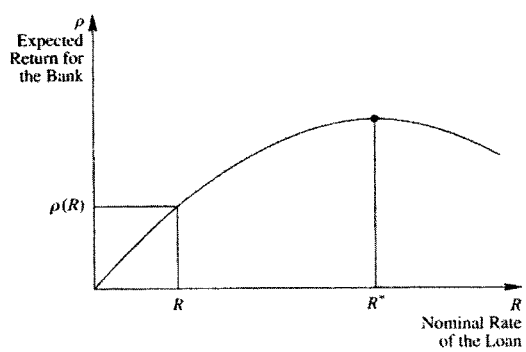

Analyzing the entire banking sector requires taking into account the aggregate supply and aggregate demand for credit. The aggregate demand is straightforward, in that more credit is demanded at lower interest rates. The aggregate supply conditions, however, depend on the behavior of bank investors, i.e., primarily depositors (although, it must now be recognized the investors in

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securitizations fund about $9t of the consumer loan market today, compared to only $6t of aggregate bank deposits). Assuming that investors know the relationship between the quoted interest rate R and banks' rate of return ρ, a supply of funds increasing in the rate of return will determine a supply of loans on behalf of banks that is backward bending, like the expected revenue curve in Figure 1.

Figure 2: Equilibrium Credit Rationing

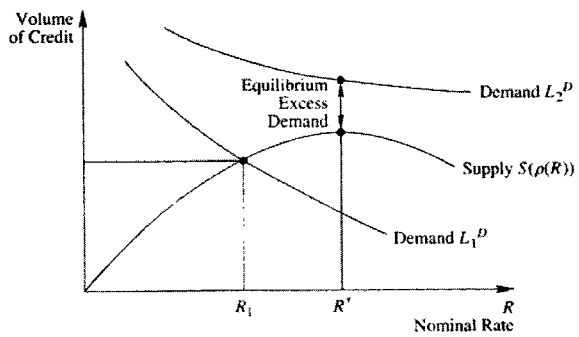

Figure 2 shows how credit rationing occurs. If the demand schedule is L_1^D, a competitive equilibrium exists characterized by equilibrium of supply and demand at nominal rate R_1. If, instead, the demand schedule is L_2^D, supply and demand do not intersect. Hence, the equilibrium rate of interest is R^* and borrowers would wish to borrow at rates above R^* (in particular, needier or subprime borrowers) will be excluded from the market.

Hence, while it is unclear exactly how lenders will react, economic theory suggests that lenders will, indeed, respond to the increased risks of lending to qualified borrowers under S. 2133 or S. 2136 in an economically rational manner. In particular, it should be acknowledged that collateral is a classic mechanism for distinguishing among which borrowers to ration. In general, banks prefer contracts with higher collateral and interest rates. (See Freixas and Rochet pp. 144-148 for a full discussion.)

The point is that S. 2133 or S. 2136 will lower expected collateral values to various extents due to the possibility of cram-down, creating the need for either higher interest rates, higher collateral levels (i.e., higher required down payments), and/or rationing, all of which increase the cost of credit to the consumer.

As regards statistical or empirical evidence, I am in agreement with the views put forth by Judge Thomas Bennett: there are too many statistical unknowns to be able to estimate the effects. Furthermore, appropriate data has never been gathered from lenders or the banking system to test the effects on differing aspects of loan prices (fees and collateral levels in conjunction with interest rates), much less to test credit rationing (because there are not records on loans that are denied). Nonetheless, we know that all those influences exist in the real world. It is important to realize, however, that those empirical shortcomings do

not mean that those effects do not exist – merely that it is difficult, of not impossible, to measure Knightian uncertainty since it cannot be statistically characterized in the first place. Hence, I would be skeptical of empirical studies that showed either statistically significant effects or the lack thereof.

Economic theory, therefore, complements statistical analysis because not all economic problems (particularly the most important economic problems) are able to be analyzed from a mere empirical approach. Economic theory can make sense of economic incentives and outcomes when there is little or no empirical method that can provide statistical answers. The theory we rely on to estimate the effects of increased uncertainty, that of George Akerlof, has been awarded the Nobel Prize in Economics. (See, for instance, George Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," *The Quarterly Journal of Economics*, August 1970 (84:3), pp. 488-500).

The basis for this work is the belief that some market participants have information that others do not. While many are familiar with the transactional effects of asymmetric information – moral hazard and adverse selection premiums – relatively few are familiar with the theory of how asymmetric information contributes to financial market conditions. With asymmetric information, when there has been a shock to asset values and investors do not know the incidence of that shock, investors rationally respond by divesting across all markets. Investors do not reinvest until they receive credible information about the incidence that helps them pick winners and avoid losers in the future.

The banking crises of the Great Depression are held as a primary example of asymmetric information-based events. In my work with Charles Calomiris ("Contagion and Bank Failures during the Great Depression: The Chicago Banking Panic of June 1932," *American Economic Review*, December 1997 (87:5), pp. 863-884), we showed that the information shock that precipitated the Chicago bank panic of June 1932 was the announcement that Congress and the Federal Reserve had turned down requests to accept Chicago "tax anticipation warrants" as eligible paper at the discount window. For more than a year leading up to the crisis, city employees were paid almost exclusively in these warrants and had passed them on to others in lieu of cash for local transactions. Bank depositors knew that city finances were weakening and that the warrants were illiquid outside the greater Chicago area but they did not know which banks held greater or lesser concentrations of the illiquid and questionably-valued warrants. Hence, depositors ran all the local banks until they received more information, which in this case came from bank call reports filed on June 30, 1932.

The same pattern played out on a much larger scale in the year prior to March 1933, when nearly all the banks in the US were closed "on holiday" due to heavy depositor withdrawals. Upon President Roosevelt's inauguration on March 3, it was announced that all the banks would be closed and only sound banks allowed to reopen, their soundness to be established by inspections carried out by bank examiners throughout the country. Again, depositors knew there had been a shock to asset values but could not distinguish the incidence of the shock and responded by divesting from the entire market. Once information was credibly restored, depositors reinvested their funds.

In 2007, we realized that the $9 trillion of US securitizations that spawned asset-backed securities (ABS) and residential mortgage-backed securities (RMBS), for whom lower-grade securities had been resecuritized into roughly $0.5 trillion of long-term capital market instruments (collateralized debt

obligations, or CDOs) and $1.2 trillion short-term money market instruments (asset-backed commercial paper, ABCP, and structured investment vehicles, SIVs), variously backed by almost $0.8 trillion of private mortgage insurance (PMI) that is usually issued by a subsidiary of bond insurers that back a total of more than $2 trillion of debt, hedged in a $45 trillion credit default swap (CDS) market, had grown into a monster of an unregulated and conflicted market. In other words, financial innovation had created vast uncertainties in financial markets.

In the latter half of 2007, the Federal Reserve attempted to stimulate markets with successive Fed funds rate decreases totaling 100 basis points, to little effect. Despite that massive expansionary monetary policy, both the Dow Jones Industrial Average and the S&P 500 will most likely post losses for the second half of the year. Hence, in a manner similar to previous examples, investors are punishing markets for increased levels of uncertainty and refuse to respond to typical economic stimuli in lieu of information about the magnitude and incidence of losses. Increasing the level of uncertainty through legislative changes that further mask the incidence of losses will exacerbate an already very risky economic situation.

In summary, while no one would doubt the significant effects of lemons discounts in any of these classic events and the applicable theory, the exact magnitude of those effects cannot be statistically estimated (because such an estimation would require some proxy to the magnitude of uncertainty in markets at any given time). Statistical evidence, however, is only one means of economic reasoning. Worse yet, statistical evidence without theoretical basis and intuitive application is not economics, but mere data mining. The lack of statistical evidence, therefore, is no excuse for proceeding without acknowledging the very real threats indicated by sound economic theory and the accompanying market experience.

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Reclaim power from the ratings agencies

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By Charles Calomiris and Joseph Mason
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Recent downgrades on residential mortgage-backed securities and collateralised debt obligations, and subsequent hedge fund failures and market turmoil, have led many to blame ratings agencies for the mortgage mess. Both the European Commission and Barney Frank, chairman of the House financial services committee in the US, promise hearings into the culpability of ratings agencies.

The agencies reply that accurately accounting for risk is not their job and that they are protected by the right of free speech. They point to disclaimers in their ratings that make it clear that they are paid by the companies they rate and that ratings are statements of opinion, not recommendations.

Savvy investors should know better than to invest only on the basis of a rating, but such admonitions ring hollow. Ratings agencies do more than opine; they play an active role in structuring RMBS and CDOs. They also serve as important sources of information about securitisation performance and often enumerate measures that issuers must take to maintain ratings in troubled securitisations.

Unlike typical market actors, ratings agencies are more likely to be insulated from the standard market penalty for being wrong - the loss of business. Issuers must have ratings, even if investors do not find them accurate. That fact reflects the unique power that the government has conferred on ratings agencies to act as regulators. Portfolio regulations for banks, insurance companies and pension funds set minimum ratings on debts these intermediaries are permitted to purchase. Thus, government has transferred substantial regulatory power to ratings agencies, since they now effectively decide which securities are safe enough for regulated intermediaries to hold.

Giving ratings agencies more power actually reduces the value of their ratings by creating a strong incentive for grade inflation and making the meaning of ratings harder to discern. Regulated investors encourage ratings agencies to understate risk so that the menu of high-yielding securities available to them is larger. The regulatory use of ratings thus has changed the constituency demanding a rating from free-market investors interested in a conservative opinion to regulated investors looking for an inflated one.

Although there is evidence that Moody's and Standard & Poor's remain relatively conservative when rating structured products, it is clear that even Moody's has allowed its ratings scale for securitised products to become inflated. Bloomberg Markets reported in July that: "Corporate bonds rated Baa, the lowest Moody's investment grade rating, had an average 2.2 per cent default rate over five-year periods from 1983 to 2005, according to Moody's. From 1993 to 2005, CDOs with the same Baa grade suffered five-year default rates of 24 per cent, Moody's found." In other words, long before the current crisis, Moody's was aware that its Baa CDO securities were 10 times as risky as its Baa corporate bonds.

Given the shifting meanings of Baa and other ratings as measures of risk and given the high rate of financial innovation and the lack of transparency inherent in multi-layered structured finance deals, it is not surprising that investors underestimated risks so badly leading up to the recent crisis.

It is no use blaming the ratings agencies, which are simply responding to the incentives inherent in the regulatory use of ratings. The solution is for regulators to reclaim the power that has been transferred to ratings agencies to award ratings and determine the meanings attached to them.

How can regulatory power be reclaimed? Regulating the methods by which ratings agencies set standards is one possibility, although this would come at a huge cost, namely the ability of ratings agencies to use independent discretionary judgment. A better solution is to reform existing regulations to avoid the use of letter grades in setting standards for permissible investments by regulated institutions. In the absence of letter grades, banks and their regulators would look at the

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underlying risks of investments, not ratings. Ratings agencies sell tools to investors that permit exactly this sort of analysis. Full disclosure by regulated institutions of these new measures of portfolio risks and a greater reliance on market discipline to discourage excessive risk-taking would further improve the regulatory process.

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Ownership = Equity

CHARLES W. CALOMIRIS AND JOSEPH R. MASON†

The "democratization of finance" of the past two decades reflects improvements in the pricing of risk and the deepening of mortgage-backed securities (MBS) markets that will continue to provide greater market access for lower-income people. But some innovations should not persist. One practice that has contributed to the recent spike in subprime market defaults has been permitting mortgagors to own homes without making a significant commitment to accumulate home equity, which in many cases has resulted in home renting in the guise of home ownership.

Does it make sense to allow borrowers with poor credit history and no savings to invest in a home to buy homes with 100% or even up to 125% loan-to-value ratio mortgages? Some lenders and MBS investors did so hoping that home price appreciation would provide the equity cushion for mortgages, which would incentivize borrowers to make payments and maintain their homes and protect MBS investors from the risk of loss. This lending strategy is risky, but it often does result in the eventual accumulation of equity by the borrower.

In reality, however, future equity often did not grow, even with rising home prices. A number of borrowers were unwilling, rather than unable, to allow their rising stakes to remain invested in their homes. They obtained the same 100% to 125% loan-to-value ratio mortgages on cash-out refinancings (CORs), and were able to pocket and consume value appreciation as it occurred. From 1995 to 2005 home equity extraction through CORs increased from under $14 billion to almost $245 billion and cash available for extraction through home equity lines of credit increased from $332 billion to over $1 trillion.

There is plenty of blame to go around for the experiment in equity-free quasi-homeownership. Rating agencies (the gate-keeping stress testers in the MBS market) employed overly optimistic default scenarios that did not properly take into account important features of the current mortgage market (including the use of interest only mortgages and the understatement of default risk because of the failure to disclose mitigation practices -- more on this below). Mortgage brokers, MBS originators, the appraisal industry, mortgage servicers, and real estate developers, all of whom also gained from the excessive optimism, fed the frenzy

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with projections of never-ending price rises. Government-subsidized credit and the mortgage interest deduction stimulated demand.

Of course, risk overreach is par for the course when new products and financing structures are combined with ample market liquidity, as in recent years. Market participants are now adapting, putting hard-headed thinking back into stress tests, and requiring that homeowners have some of their own "skin in the game" in the form of a significant downpayment. Note that, thanks to existing government programs, "significant" remains quite small. The Federal Housing Administration (FHA) permits downpayments on mortgages that it guarantees of as little as 3% on new mortgages and 5% on refinancings.

Politicians, however, don't always learn from markets, and some would take us even farther into the brave new world of zero- or negative-equity mortgages. Last week, Ohio joined Maryland, Rhode Island, Massachusetts and Virginia by implementing their $100 million refinancing program to allow borrowers burdened by a "lending product that no longer meets their needs" to further increase their loan-to-value ratios. A recent House bill sponsored by Maxine Waters and Barney Frank would offer zero-downpayment loans through a "revitalized" FHA.

From a public policy perspective, it makes no sense to support zero-equity mortgages. Like renters, such borrowers purposely avoid building the home equity that forms the basis of incentives for borrowers to act like homeowners. A person's home has historically been their principal savings asset. The primary motivation for government subsidies for mortgagors (the mortgage interest rate deduction, FHA guarantees, and the panoply of other programs designed to make mortgages more affordable for lower-income people) stems from the view that home ownership and saving breed better citizens by ensuring that people are more invested in their communities. But borrowers with nothing to lose from default and no equity built up as savings are not invested in their communities, and should not be supported by government subsidies.

Some mortgagors are at risk of being unable to meet their payments, especially as interest rates rise. But there are ample private and government-subsidized means for mortgagors to refinance or renegotiate their mortgages to avoid the consequences of spikes in mortgage servicing costs. The proper policy response is not to pretend that all mortgages can be repaid, and add leverage as needed, but rather to reinforce market changes that would restore proper risk management.

Illiquid mortgagors that have a reasonable chance of meeting debt service obligations already enjoy access to many refinancing options, including through FHA programs. Beginning in the mid-1990s, Fannie Mae and Freddie Mac adopted new "mitigation" practices. Similar practices were formally adopted by the FHA in 2002. Over the past decade there has been a dramatic change in the treatment of delinquent mortgagors. In 1998, a mortgage that was 90 days delinquent had a 77% chance of being foreclosed as the result of that delinquency. By 2002, that probability was 15%. FHA, Fannie and Freddie now require originators to offer delinquent mortgagors a range of renegotiation

options, including rescheduling or forgiving interest, reducing monthly payments, and extending maturities.

One reform urgently needed is requiring disclosure of mitigation practices so that rating agencies and MBS investors can make accurate assessments of default risk. Current practice hides mitigation information by failing to identify loans that have been mitigated. This has resulted in underassessments of risk in both the subprime and prime mortgage markets, contributing to lax underwriting standards.

Combining realistic credit standards, incentives to save rather than spend home equity, and sensible mitigation standards will deliver the appropriate outcome: borrowers willing to commit wealth to own (build significant equity in) a home will be able to do so, and illiquid but long-term creditworthy borrowers will be able to renegotiate mortgage payments to avoid unwarranted foreclosures.

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January 14, 2008

The Office of the Honorable Patrick J. Leahy
United States Senate Judiciary Committee
224 Dirksen Senate Office Building
Washington, DC 20510
Att'n: Mr. Justin Pentenrieder, Hearing Clerk

Re: Response to Question from Ranking Member Specter with Regard to Dec. 5, 2007 Hearing on "The Looming Foreclosure Crisis: How To Help Families Save Their Homes"

Dear Chairman Leahy, Ranking Member Specter, and Members of the Committee:

Thank you again for allowing me to testify on this matter and to provide answers to the Members' written questions. You should already have received my letter of December 27, 2007, which responded to the initial set of written questions from the Members. Here is my response to the second set—comprising questions from Ranking Member Specter—that was enclosed with the Chairman's letter of December 17. The set included one question directed to me. Please pardon the delay in responding; I did not receive that letter until last week.

Senator Specter's Question 1 for Mark Scarberry:

"1. In your testimony, you indicate that S. 2136 would make cram down much easier to obtain [with respect to home mortgages] than it is for any other secured asset. Proponents of S. 2136 have argued that allowing cram down for mortgages would not affect interest rates or the availability of credit for mortgages by pointing to the fact that cram down is available for other secured assets such as vacation homes and second homes. Since S. 2136 will make cram down easier to obtain than for other assets, will allowing cram down increase the risk associated with home lending sufficiently to affect interest rates and the availability of credit?"

Response to Senator Specter's Question 1:

Yes, I believe that allowing cram down—what I call "strip down"—of home mortgages under S. 2136 would affect the risk associated with home mortgage lending sufficiently to affect in a material way interest rates and the availability of credit. Strip down of home mortgages in chapter 13 would eliminate the up-side potential for home mortgage holders while leaving them subject to the down-side potential. Doing so with respect to a kind of property that has been subject historically to downtrends in market values followed typically by recoveries creates a particularly substantial effect on the risk characteristics of the credit. In particular, availability of strip down is likely to affect the cost and availability of home mortgages most seriously for borrowers who have only small down payments and who do not have stellar credit. Strip down also would diminish the protection home lenders otherwise would receive in many such cases from private mortgage insurance or VA or FHA programs.

My response to the first written question that Senator Durbin directed to me explains this further. Let me quote a portion of that response from my Dec. 27, 2007 letter:

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> A chapter 13 strip down (as under S. 2136) gives the home mortgage holder the worst of both worlds. Strip down creates a one-way ratchet under which the home mortgage holder is deprived of any benefit from a recovery in the market but subject to the risks from a further drop in the market. The mortgage holder who would prefer to cut its losses would instead be required to wait and hope that the debtor makes the reduced chapter 13 plan payments called for on the stripped-down mortgage. If the market continues to deteriorate, so that the home is not even worth the amount determined by the court in the strip down process, the debtor (who starts the plan with zero equity) may choose to walk away from the home. The mortgage holder then would be permitted to foreclose, but the value that would be obtained in a foreclosure sale to a third party might be much less than the amount that could have been obtained in an earlier foreclosure. Thus a second loss could await the mortgage holder. ... But if the market recovers, the amount of the mortgage still will be based on the value at the time of strip down, and the mortgage holder will not benefit from the recovery.

Let me add that it is not quite correct to say that S. 2136 would make chapter 13 strip down of home mortgages much easier than for *any* other kind of secured debt. It remains true under current law that strip down can often be accomplished with respect to auto loans where the loan is more than 2½ years old at the time of the petition filing. Of course such a loan typically would be at least half way through its payment period, and S. 2136 contains no similar limitation on home mortgage strip down, thus treating home mortgages worse than car loans. S. 2136 does include a means test for home mortgage strip down that does not apply to auto loans, but as I noted in my prior written testimony, the means test will not accurately determine which debtors need to strip down their mortgages in order to keep their homes.[1]

It is actually an *understatement* to say that S. 2136 would make strip down easier with respect to first mortgages on homes as compared to first mortgages on vacation homes or investment real property. In fact, strip down of first mortgages on vacation homes or investment real property is simply not possible at all in the typical case.[2]

I hope this answer is helpful to the Members of the Committee. Please do not hesitate to contact me if I can be of further assistance.

Sincerely yours,

Mark S. Scarberry
Professor of Law, Pepperdine University

cc: The Honorable Arlen Specter
The Honorable Richard J. Durbin
The Honorable Jeff Sessions

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[1] It is also true that *second* mortgages on homes and other real property, including vacation homes and second homes held for investment, can be stripped entirely off in chapter 13 (though with some contrary authority with respect to homes) where the value of the real property is less than or equal to the amount of the first mortgage—that is, where the second mortgage has no value at all supporting it. And a second mortgage on a vacation home or investment real property may occasionally be stripped down under current law where there is some value supporting it (that is, where the first mortgage takes most of the value of the real property), because the debtor may be able to afford to pay the small stripped-down amount during the five year term of the plan. (Note, however, that the court might not permit the debtor to make payments on both the first mortgage and the stripped-down second mortgage in such a case.) But strip down is not, as a practical matter, available under current law with respect to substantial first mortgages on vacation homes or investment real property, which is the proper comparison.

[2] For reference to the authorities on the question whether stripped down liens may be paid over more than five years under current law—including the only circuit level authority on that question, which correctly answered "no"—see footnote 9 to my written testimony.

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December 27, 2007

The Office of the Honorable Patrick J. Leahy
United States Senate Judiciary Committee
224 Dirksen Senate Office Building
Washington, DC 20510
Att'n: Mr. Justin Pentenrieder, Hearing Clerk

Re: Responses to Questions from Committee Members with Regard to Dec. 5, 2007 Hearing on "The Looming Foreclosure Crisis: How To Help Families Save Their Homes"

Dear Chairman Leahy, Ranking Member Specter, and Members of the Committee:

I received the Chairman's letter of December 13 enclosing written questions from Committee members and asking that responses be received by the Committee no later than December 28. I appreciate very much being asked to testify at the December 5th hearing, and also being given the opportunity to respond to written questions.

There were three sets of questions enclosed with the Chairman's letter: (1) a set of questions from Senator Durbin, including six numbered questions (some with subparts) for my attention, (2) a set of questions from Senator Sessions, including two numbered questions (both with subparts) for my attention, and (3) a question (regarding pre-securitization ratings) that did note which Member had drafted it.

Apparently due to the slow pace of the mails during this holiday season, I did not receive the December 13 letter until December 21. These answers are my best effort to provide as much information as I can, given the short time frame.

Responses to Questions from Senator Durbin (D1 through D6):

D1. The question assumes several propositions with which I disagree. It assumes (1) that the means test would accurately determine which homeowners could not afford to use the current provisions of chapter 13 to kept their homes, (2) that for homeowners who could not afford to keep their homes under the current provisions of chapter 13, only a "cram down" (what I will call a "strip down") under legislation like S. 2136 (or by way of voluntary agreement) would enable them to afford to keep their homes; and (3) that a foreclosing home mortgage holder who buys the home by way of a credit bid at its own foreclosure sale could not benefit from a recovery in the market.[1] Further, the question does not take into account (4) the effects of the likely continuation, over the next year or two, of a decline in the value of homes.[2] For all of these

[1] The question also does not take into account the effect of private mortgage insurance (or VA, FHA or other government programs). This effect is discussed below in my answer to question D3.

[2] In my testimony at the hearing I did not discuss this shorter term effect of S. 2136. As a result of preparing the answers to the Committee's written questions—and research concerning the supposed provision of adequate protection to secured creditors during chapter 13 plans—I have realized that this effect may be substantial.

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reasons, I continue to believe that allowing home mortgage strip down—reducing the principal amount of the mortgage to the court-determined value of the home where that is less than the amount owed—substantially changes the risk characteristics of home mortgages.

First, some homeowners who could qualify under the means test—and thus who could strip down their mortgages under S. 2136—nevertheless would be able to cure their mortgages and retain their homes under the current provisions of chapter 13. Strip down thus would cause a loss to the mortgage holder that would not occur under current law.

The means test provisions added to the Bankruptcy Code by the 2005 BAPCPA are very ambiguous, leading to substantial litigation over their meaning, and are also very unsuited to determining whether homeowners have sufficient disposable income to make the payments that would be needed for them to keep their homes under current law. For example, scheduled payments on secured debts other than the first mortgage probably would be considered legitimate amounts to deduct from current income in determining whether the debtors have sufficient disposable income to make the payments, even if payments on those debts will not actually be made. Those debts might include junior home mortgages (which can be stripped off in chapter 13 under current law according to most courts, where the first mortgage holder is undersecured) and debts secured by a variety of other property (including, potentially, multiple or luxury automobiles, RVs, and even boats). Many such cases have been litigated under the provisions of the 2005 BAPCPA.

In addition, use of "current monthly income" as the amount from which deductions are made (as in S. 2136) will result in quite inaccurate determinations of ability to pay. "Current monthly income" is based on the six months prior to the bankruptcy filing. A homeowner who was out of work for several months before filing a bankruptcy petition but who obtained a good job shortly before the filing will have a substantially greater ability to pay than the ability suggested by the means test.

As a result, S. 2136 likely would allow a substantial number of homeowners to modify their mortgages even though their actual disposable income would be sufficient for them to use the current provisions of chapter 13 to retain their homes. Thus the assumption made in the question that a foreclosure would occur unless the mortgage were modified (beyond what is currently permitted under chapter 13) is not, in my view, correct. With respect to at least some homeowners who would be able to modify their mortgages under S. 2136 there is another option currently available: retention of their homes under the current provisions of chapter 13.

Second, even if the means test accurately determined which debtors needed to modify their home mortgages in order to avoid foreclosure, S. 2136 still would allow strip down in cases in which it would not be necessary, and thus it would unnecessarily prevent at least some home mortgage holders from benefiting from a market recovery. That is because home mortgages may be modified to reduce the required monthly payment in ways other than strip down.[3] In particular, modification of the interest rate would affect the monthly payment, and that might be all that would be needed to allow a homeowner to make the payments; in such a case strip down would not be needed.

Thus a modification of the mortgage other than by way of strip down, perhaps by way of temporary interest rate relief, could help a homeowner keep a home (whether such modification is voluntary or imposed in chapter 13 by way of provisions like those in Senator Specter's bill). I

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[3] Curiously, the only strip downs that have occurred under chapter 13—mostly between 1989 and the Supreme Court's 1993 *Nobelman* decision—never or almost never reduced the homeowners' monthly payments; the result of a strip down was simply that the homeowner paid off the loan at a faster rate, by making the same monthly payment on a mortgage with a lower principal amount.

believe that a change in the law to allow strip down should be a last resort,[4] and I do not believe that Congress needs to resort to it at this time to provide appropriate assistance to homeowners.

As a result, I cannot agree with the assumption made by the question. That assumption is that the inevitable result of a modification (whether voluntary or made pursuant to current law or the proposed bills) that prevents foreclosure is to deny the mortgage holder any benefit from a market recovery.

Third, even if a foreclosure is necessary, the mortgage holder could purchase the property at its foreclosure sale and hold the property until it appreciates. Of course that is not ideal from the lender's point of view, and thus often the lender would be willing to reduce the interest rate so that a foreclosure would be avoided. But it is a possibility, and even banks, as I understand the law (though this is not my core area of expertise), are permitted to hold foreclosed properties for five years under 12 U.S. Code section 29.[5]

Both Freddie Mac and the State of Alaska made that point in their amicus briefs opposing strip down in *Nobelman.* See Brief for Amicus Curiae Federal Home Loan Mortgage Corporation at *9-10 (available on Lexis at 1992 U.S. Briefs 641 and 1993 U.S. S. Ct. Briefs LEXIS 151); Amicus Curiae Brief of the State of Alaska at *13-14 (available on Lexis at 1992 U.S. Briefs 641 and 1993 U.S. S. Ct. Briefs LEXIS 201). I urge Committee members to read those amicus briefs. Petitioners, who sought to strip down their home mortgage, argued, according to Freddie Mac, that the Bankruptcy Code

> must be read with an eye towards life in the real world of real estate and mortgage foreclosure. Yet it is they who ignore reality. Petitioners mistakenly believe that cram-down merely replicates a foreclosure sale at which "the lienholder will receive something approximating the fair market value [of the collateral], with the balance of its claim becoming an unsecured deficiency claim". See Petitioners' Brief at p. 6. In point of fact, rather than mirror foreclosure, cram-down destroys the essence of a mortgagee's rights in a foreclosure.
>
> Faced with an undersecured loan, a mortgagee can credit-bid at the foreclosure sale and become the owner of the property. The mortgagee then holds the hope that the real estate market will improve and at least some of its deficiency can be recovered. This is the real world of bank examiners and loan officers—deciding when to and when not to credit-bid[,] i.e., on which properties should they play the market hoping for a turnaround and on which should they simply take what they can get and write off the rest. In fact, typically the lender will credit-bid its claim and become the owner of the property. This is the real world that cram-down eliminates by taking away this option from the mortgagee.

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[4] Interest rates and other provisions of a debt contract, though often very important, are secondary aspects of the debt. The principal amount is often seen as primary. A reduction in that principal amount by way of strip down strikes at the center of the obligation. And it seems unreasonable for a reduction to be based on what is likely a temporary downturn in the real estate market—a market that is known to go up and down but that ordinarily trends upward over the length of time during which a mortgage is payable.

[5] It is interesting that chapter 13 plans typically last five years, the same period for which a bank is permitted (as I understand it) to hold real property on which it has foreclosed. The two matching five-year periods suggest an interesting possibility, which I think was first suggested around 1986 with regard to the proposed chapter 12 legislation, by St. John's Law School Professor Robert Zinman.

Congress seems to have thought that banks should be able to hold properties for five years to benefit from a market recovery. Thus it could make sense, as a compromise, if some form of strip down must be enacted, to allow a reversible strip down, in which a market recovery by the end of the five-year chapter 13 plan could result in an increase in the principal amount of the debt, either fully or partially restoring the amount that had been stripped away.

Brief for Amicus Curiae Federal Home Loan Mortgage Corporation at *9-10 (footnote omitted).

Fourth, as Freddie Mac pointed out in its *Nobelman* amicus brief, under current law the mortgage holder who forecloses decides whether or not to buy the property at its foreclosure sale by considering the risks and the potential benefits. The mortgage holder may decide to cut its losses and let someone else buy the property at the foreclosure sale. Or the mortgage holder may decide to credit bid a sufficient amount to be the winning bidder, thus preserving the possibility of benefiting from a market recovery—but also taking the risk that the home's value may decline further, and that it may end up selling the home for less than it could have gotten in cash at the foreclosure sale (or in a private sale conducted shortly after the foreclosure).

A chapter 13 strip down (as under S. 2136) gives the home mortgage holder the worst of both worlds. Strip down creates a one-way ratchet under which the home mortgage holder is deprived of any benefit from a recovery in the market but subject to the risks from a further drop in the market. The mortgage holder who would prefer to cut its losses would instead be required to wait and hope that the debtor makes the reduced chapter 13 plan payments called for on the stripped-down mortgage. If the market continues to deteriorate, so that the home is not even worth the amount determined by the court in the strip down process, the debtor (who starts the plan with zero equity) may choose to walk away from the home. The mortgage holder then would be permitted to foreclose, but the value that would be obtained in a foreclosure sale to a third party might be much less than the amount that could have been obtained in an earlier foreclosure. Thus a second loss could await the mortgage holder. See Brief for Amicus Curiae Federal Home Loan Mortgage Corporation at *10-11. But if the market recovers, the amount of the mortgage still will be based on the value at the time of strip down, and the mortgage holder will not benefit from the recovery.

Many economists predict further declines in home prices. Economist Mark Zandi, with whom I had the pleasure of sharing the witness table at the December 5 hearing, expects further declines in home prices, even if there is no recession:

> It is reasonable to expect national house prices to fall by at least 10% from their peak to their eventual trough late next year. This assumes that the economy will avoid recession and the Federal Reserve will continue to ease monetary policy.

Testimony before House Judiciary Committee, October 30, 2007 (available at http://judiciary.house.gov/OversightTestimony.aspx?ID=1188). News reports suggest that Dr. Zandi may expect even larger declines. See http://biz.yahoo.com/rb/071206/usa_economy_housing.html?.v=3.

I note that the section-by-section summary of S. 2136 states that "Like any secured creditor, the mortgage holder would be entitled to adequate protection of its property interest during the Chapter 13 case." The bill does not include any adequate protection provisions, and at least some courts take the position that creditors secured by real property are not entitled, under current law, to adequate protection once a chapter 13 plan has been confirmed, so long as the debtor makes the payments required by the plan. See In re Perez, 339 B.R. 385, 401, 401 n. 18 (Bankr. S.D. Tex. 2006); In re Smith, 104 B.R. 695, 700 (Bankr. E.D. Pa. 1989).

As *Perez* notes, the 2005 BAPCPA dealt with the problem with respect to claims secured by personal property, by requiring that chapter 13 payments be sufficient in amount to provide adequate protection during the plan period. See section 1325(a)(5)(B)(iii)(II). But there is no such provision for real property secured claims. In any event, it is hard to see how adequate protection can be provided against a further drop in home values. A ten percent drop on a $300,000 home would be $30,000; the chapter 13 debtor could hardly be expected to come up with a $30,000 payment (or $2,500 per month) to provide adequate protection against an actual

or expected 10% decline in home prices. And it is precisely when prices drop further that the debtor is most likely to walk away from the home. There does not seem to be a practical way to provide adequate protection, which may be constitutionally required, particularly where there is a strip down. Enactment of S. 2136 could force resolution of that constitutional question, with potentially serious effects even on the use of the current chapter 13 process for saving home ownership.

A debtor who, in order to stay in a home, is willing to make full payments on a non-stripped-down loan—along with the amounts needed to cure during the plan any default caused by earlier missed payments—may be a good bet to continue to pay, and to stay in the home despite further drops, until the market eventually recovers. Such treatment of home mortgages under current law does not increase the mortgage holder's risk nearly to the degree that the risk is increased by strip down in a declining market, with the mortgage holder's up-side potential removed and a greater down-side risk imposed. Note that a debtor who has stripped down a mortgage due to a true or claimed inability to make full payments is probably more likely to walk away when prices decline, than is a debtor who is willing and able to make full payments and cure prior defaults.

D2. Current law does not allow mortgages secured only by principal residences to be modified, as the question recognizes (other than by giving the homeowner extra time to make up missed payments). The five-year limitation on payment of other secured debts that can be modified and are in fact modified in a chapter 13 plan prevents, as a practical matter, the modification of substantial first mortgages on real property other than the principal residence. So the point is not that first mortgages on investment property or on vacation homes are in fact paid off over five years in chapter 13 cases under current law; the payments would be too high, and no debtor who belonged in chapter 13 could afford them. My point simply is that current law does not permit what many proponents of home mortgage strip down say is permitted: it does not as a practical matter permit modification of first mortgages on vacation homes or investment real property. Thus there is not currently an imbalance in the law; it does not currently allow relatively rich debtors to modify first mortgages on vacation homes or investment property so as to keep such property, while denying homeowners such treatment on home mortgages. ***As a practical matter, neither is permitted.***

My initial reason for speaking out on this subject was that I knew this, from the work I had done fourteen years ago when *Nobelman* was pending in the Supreme Court. I thought it was important that the legislation not be enacted under the misimpression that it would just level the playing field, allowing homeowners to save their homes the same way others supposedly could save vacation homes or investment properties in chapter 13.

That is why I pointed out that S. 2136 (and Rep. Miller's bill in the House) would in fact give homeowners far longer to pay off their modified home mortgages than debtors have under current law to pay off other secured debts that are stripped down in chapter 13. S. 2136 does not just treat home mortgages the same as other secured debt. It does not just eliminate the privileged place that the language of section 1322(b)(2) provides for home mortgages; in fact, S. 2136 would allow home mortgages to be treated less favorably than other secured debt. That includes, after the 2005 BAPCPA, purchase-money car loans, which cannot be stripped down until the loan is likely at least half way to maturity.

Of course Congress may choose to enact such legislation, and the President might sign it. But it should be recognized as a rejection of policy decisions made on what I think was a bipartisan basis both in 1978 (when the Bankruptcy Code was enacted with the section 1322(b)(2) protection for home mortgages) and in 1994 (when Congress extended the protection

to chapter 11 cases following the *Nobelman* decision and following hearings held in 1991 and 1992 on strip down).[6] With that background I will now respond to the subparts of question D2.

D2(a). Some mortgages are originated with terms of five years or less, with a balloon payment due at the end. I do not know of any recent examples of fully amortized first mortgage home loans that have a term of five years or less. My point, however, is not that we should try to force homeowners to pay off their first mortgages in five years. That would be impossible, at least for homeowners who belong in chapter 13. My point, rather, is that S. 2136 would allow modification of home mortgages, with payment to be made over up to nearly thirty years, and the result is that home mortgages would be treated less favorably than other secured debt. Of course, if a bill is to be enacted to allow home mortgages to be modified in chapter 13, it should allow payment over more than a five-year period. But it should be recognized that home mortgage holders thus would be singled out for unfavorable treatment. Despite the claims of some of my academic friends for whom I have great respect, the result would not just be to allow home mortgages to be treated the same way that other secured debts presently are treated in chapter 13.

D2(b). Absolutely not.

D2(c). As I have noted above, if a bill is to be enacted that will allow modification of home loans, it must allow payment of the modified mortgage over more than five years (unless it requires that the homeowner either refinance the home or surrender it by the end of the five years). My point is that Congress should understand that such treatment would be unique to home mortgages, and uniquely unfavorable in requiring home mortgage holders to wait for completion of payments and to be subject to a court-determined (or statutorily-determined) interest rate—a rate that is likely, as Judge Bennett testified, to be below a market rate—for up to nearly thirty years.

D3. No, I am not arguing that voluntary loan modifications are a bad idea. A lender who agrees to a voluntary loan modification can take into account the benefits of avoiding foreclosure, and weigh them against the benefits that would be obtained from PMI if foreclosure occurs. Each situation may be different, and the lender who voluntarily chooses to avoid

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[6] Catholic University Law Professor (now Dean) Veryl V. Miles noted in her 1993 article that

> "During the last congressional term, both the House and Senate proposed bankruptcy reform legislation that included amendments to § 1322(b)(2) that would have prohibited the bifurcation [strip down] of such [home mortgage] claims under a chapter 13 plan. Although the proposed legislation was generally supported by both houses of Congress, it did not pass due to last minute amendments made to the bill by the Senate before the House was to vote on the bill and adjourn for the term. Nevertheless, there is great expectation that this or similar bankruptcy reform legislation will be introduced in the 103d Congress in 1993."

Veryl V. Miles, *The Bifurcation of Undersecured Residential Mortgages Under § 1322(b)(2) of the Bankruptcy Code: The Final Resolution*, 67 Am. Bankr. L.J. 207, 208 (1993) (footnote omitted). The Supreme Court's subsequent 1993 *Nobelman* decision made such legislation unnecessary with respect to chapter 13. Congress extended the prohibition on modification of home mortgages (including, per the *Noblelman* decision, a prohibition of strip down) to chapter 11 cases the following year, in 1994. Dean Miles's article includes a description of (and extensive quotes from) the Congressional hearings held in the 102d Congress. Many of the same arguments currently being made in favor of strip down were made by witnesses in those hearings, including at least one of the same witnesses, December 5 hearing witness Henry Sommer, Esq., with whom I disagree but for whom I have great respect. I would note that Mr. Sommer indicated in 1992 that there was a possible basis for distinguishing among home mortgages and perhaps not permitting strip down with respect to purchase-money mortgages that were fully secured when made.

foreclosure by modifying the loan cannot complain that it did not receive the bargained-for benefit of PMI. On the other hand, an involuntary modification that stripped down a home mortgage and prevented foreclosure—a modification such as could occur in chapter 13 under S. 2136—would prevent the lender from obtaining the bargained-for benefit of the PMI.

Voluntary modifications seldom would include a reduction of principal. Thus PMI (or other insurance, such as VA or FHA backing) would remain available with regard to the entire principal if the homeowner failed to pay the loan as modified.[7] Note that by the end of the period (before *Nobelman*) when strip-down was permitted by some courts, both the VA and the FHA took the position that, in a subsequent foreclosure, they would consider their liability to be limited to the stripped-down amount of the mortgage. See the Pepperdine Law Review article cited in my testimony (co-authored by the writer of this letter and Mr. Scott Reddie); Patricia Lindauer, *Note, Optimizing the "Fresh Start": Mortgage Cramdown under Chapter 13 of the Bankruptcy Code*, 11 J.L. & Com. 257, 279-80 (1992); Brief for Amicus Curiae Federal Home Loan Mortgage Corporation (Freddie Mac) at *42 (in the *Nobelman* case before the Supreme Court) (available on Lexis at 1992 U.S. Briefs 641 and 1993 U.S. S. Ct. Briefs Lexis 151); Brief of Mortgage Bankers Association of America [et al.] as Amici Curiae (also in *Nobelman*) at *15-16 (available on Lexis at 1992 U.S. Briefs 641 and 1993 U.S. S. Ct. Briefs Lexis 148); Brief on the Merits of Respondent American Savings Bank (also in *Nobelman*) at *41 (available on Lexis at 1992 U.S. Briefs 641 and 1993 U.S. S. Ct. Briefs Lexis 148).[8] As Freddie Mac's amicus brief put it (at *11):

> [P]rivate mortgage insurance programs require a lender to foreclose before they will pay for the lender's loss. Insurance will not cover the lender's loss following cram-down, but will only guarantee payment of the reduced balance. Thus, in foreclosure[,] insurance protects the difference between the debt and the value of the property; in cram-down it does not. Cram-down and foreclosure are worlds apart.

D4. I believe Senator Durbin is correct that the court in *Davidoff* was referring in its footnote to strip down generally rather than to strip down of home mortgages. It seems that I misread that footnote back in 1993. I have not yet been able to locate in my files the 1991 article by Michael Polk, and it does not seem to be on Lexis or Westlaw. Thus I will accept the Senator's statement that it did not include specific data, though I believe it was not mere speculation. I would note that the footnotes to the relevant paragraph in my article included another source, the Lindauer Note cited immediately above. As Lindauer stated:

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[7] I recognize that, under current law, if the debtor failed to make the required payments during the three to five year chapter 13 plan, the case most likely would be dismissed or converted to a chapter 7 case, and the mortgage lien would be restored to its full amount, per section 1325(a)(5)(B)(II). The benefit of full PMI coverage would be lost if the debtor defaulted after completion of the plan and a foreclosure took place. The benefit of the PMI coverage also is lost if the debtor pays off the stripped down mortgage, because PMI will not cover the difference between the stripped down amount and the balance the mortgage would have had absent strip down.

[8] It seems that earlier, as of 1991, the VA, FHA, and others had not made final decisions on this issue. See Michael S. Polk, *The Chapter 13 Cramdown: New Nightmare for the Lender*, 19 Real Est. L.J. 279, 296 (1991) ("Most lenders foreclosing on these loans subject to chapter 13 cramdowns have some form of claim and/or insurance backing. The question that remains unanswered is whether the lender in submitting any postforeclosure claims (e.g., to Federal Housing Administration (FHA), Veterans Administration (VA), or private mortgage insurance companies) will be paid in full, in part, or not at all. Uniform policy decisions have not yet been established in the lending industry. The most common response is that the payment on postforeclosure claims would be limited to the prorated 'secured' portion of the original loan as defined by the chapter 13 cramdown.")

> The Department of Veterans Affairs and the Federal Housing Administration have already determined they will only pay claims in the amount of the judicially-determined secured debt in a cramdown case. Thus, GNMA will hold its mortgage-backed securities issuers responsible for principal shortfalls caused by cramdowns. If cramdown becomes a readily available alternative in bankruptcy proceedings, the impact to the GNMA issuer community and to GNMA could be devastating.

11 J.L. & Com. at 279-80 (footnotes omitted). That statement was supported by the following quotes in Lindauer's footnote 142:

> "With the issuer responsible for the shortfalls, ... the issuer [could eventually be depleted of available capital] and default on its responsibilities to GNMA." Mortgage Cramdowns: Hearing of the Senate Subcomm. on Courts and Admin. Practice, 102d Cong., 1st Sess. D-705 (1991); see also [19 current developments] Hous. & Dev.Rep. (WG & L) No. 6, at 105 (June 24, 1991) (statement of Frank Keating, HUD general counsel).

11 J.L. & Com. at 280 n. 142.

I believe my statement was correct that strip down had become sufficiently widespread by 1993 to *threaten* harm to the already weak home lending industry. Consider this quote from a Sept. 26, 1990 Wall Street Journal article, which noted that there were about 300 home mortgage strip down cases nationwide as of 1990, but which cast doubt on the hopes of the chairman of a mortgage bank that strip down would not "turn into an epidemic": "Don't bet on it. Cramdowns took off in Oklahoma City only this summer, says debtors' attorney Melinda Monnet, but already her colleagues at the bar are explaining the process in solicitation letters to homeowners whose homes have been posted for foreclosure." Todd Mason, *Lenders Cringe as Judges Chop Mortgage Values*, page B1.

Whether or not strip down had become widespread by 1993, the *prospect* of widespread strip down clearly, in my view, constituted a threat. The home lending industry had recently suffered from the savings and loan crisis, and the economy was in recession. (Many of us remember the famous campaign slogan used in the fall of 1992: "It's the economy, stupid!") My 1993 article began, noncontroversially, "In these hard economic times …." As Bankruptcy Judge Cecilia Goetz pointed out, in rejecting strip down,

> In the present real estate market, adoption of the Debtors' position would bring about exactly the consequences of which Congress was warned when it drafted the Code. If by filing under Chapter 13 debtors were permitted to write down to present value their outstanding mortgages, mortgage lenders would be adversely affected, drying up, inevitably, new sources of mortgage money.
>
> Moreover, if in the present depressed market anyone with a mortgage can rewrite it down to his home's present value merely by filing a petition under Chapter 13, the real estate portfolio of banks and other lending institutions will be subjected to enormous, perhaps unbearable strain. Heavy mortgage writedowns will be available for $120, the price of filing a petition under Chapter 13, since anyone can file. No prerequisites need be met other than debts may not exceed certain limits. Lenders that are already in a precarious financial position may be pushed towards collapse.
>
> For debtors, too, the result of sanctioning bifurcation could be most undesirable. Permitting debtors to modify their mortgage obligations may have the unintended result of forcing lenders to oppose Chapter 13 plans and to opt for

> foreclosure. At the present time creditors have no reason to, and no grounds for, seeking relief from the automatic stay where arrears are being cured and current mortgage payments are being made as called for by most Chapter 13 plans. The same will not be true, however, if less is being paid. In that event, lenders may deem it in their interest to seek relief from stay so that they can repossess the property and take advantage of any future increase in real estate values.

In re Strober, 136 B.R. 614, 625 (Bankr. E.D.N.Y. 1992).

Note that Fannie Mae's amicus brief in *Nobelman* warned of serious consequences to borrowers if the Supreme Court approved of strip down:

> Fannie Mae believes that the issue of Chapter 13 cramdowns is of great importance to the residential mortgage industry. Residential mortgages are more available and affordable than other types of consumer financing, in large part because residential property is inherently reliable collateral. If a mortgage loan may be bifurcated into secured and unsecured portions in the event that a borrower seeks relief under Chapter 13, lenders' confidence in this collateral will likely diminish.
>
> Generally, the greatest obstacle to first-time home ownership is accumulating sufficient savings for a downpayment. Therefore, the key to home ownership for low- and moderate-income borrowers, in particular, is the availability of low-downpayment mortgage financing. A lender will have less incentive to make high loan-to-value ratio loans if, in addition to foreclosure losses, the lender must anticipate a borrower's reducing home mortgage debt through a Chapter 13 bankruptcy filing whenever a temporary decline in housing values eliminates the borrower's equity. Thus, the potential of home mortgage cramdown in Chapter 13 could result in higher borrowing costs to prospective home owners overall, as well as tighter credit standards, making such financing more difficult to obtain, particularly for first-time and low-income buyers.

Brief of Federal National Mortgage Association as Amicus Curiae at (available on Lexis at 1992 U.S. Briefs 641 and 1993 U.S. S. Ct. Briefs LEXIS 150).

As Freddie Mac stated in its amicus brief in *Nobelman*:

> Cram-down reduces the protection available to lenders through government home mortgage guaranty programs, for lenders who have been crammed down may look to the guarantor only for the reduced balance of the loan. Lenders will thus be required, in order to protect themselves, to seek larger down payments on home loans, especially in geographic areas of economic uncertainty, with the result that the policy of home mortgage guaranty programs—to make mortgages available even to those individuals who cannot afford a substantial down payment—will be frustrated.
>
> Cram-down of residential mortgage debt will also have a negative impact on the secondary mortgage market, in which entities such as Freddie Mac purchase home mortgage loans and resell those mortgages to investors in the form of mortgage pass-through securities which represent interests in groups of mortgages. The secondary mortgage market has been an important means of increasing the supply, and reducing the costs, of home mortgage credit, and the smooth functioning of this market depends upon a predictable flow of principal and interest from home mortgages. If cram-down is permitted, and borrowers are allowed unilaterally to reduce the balance of their mortgage loans, this

> predictability will be undermined, and the ability of entities operating in the secondary mortgage market to continue to supply low-cost and plentiful credit to America's homeowners may be adversely affected.
>
> In short, Congress has enacted pervasive and important legislative programs to foster home mortgages and home ownership in America. Congress recognized the potential harmful impact on these programs if cram-down of home loans was allowed, and it provided special protection for home mortgages in the Bankruptcy Code.

Brief for Amicus Curiae Federal Home Loan Mortgage Corporation (Freddie Mac) at *42-44 (available on Lexis at 1992 U.S. Briefs 641 and 1993 U.S. S. Ct. Briefs Lexis 151).

I believe that the same negative consequences would flow from enactment of S. 2136, due to its inclusion of home mortgage strip down. I doubt that the home lending industry is in much better shape now than it was in 1993; many mortgages would be stripped down if S. 2136 became law; and the substantial change that strip down creates in the risk characteristics of mortgages would, in my view, cause substantial difficulties both for mortgage holders and for those who would seek loans.

D5(a). My opposition to allowing chapter 13 cram down (what I have termed "strip down") rests in part on the likely harm to the mortgage markets. It also rests on the unfairness of retroactively removing statutory protection on which mortgage holders relied, and on the unfairness of removing from mortgage holders the possibility of benefiting from a recovery in the real estate market. In addition, there likely would be harm to those who would try to obtain home mortgages in the future. The increased costs and risks imposed by chapter 13 strip down would be reflected in interest rates being higher than they otherwise would be[9] and in some borrowers being denied credit. Both of those effects would likely be particularly strong in the case of borrowers with less than stellar credit who could not make a large down payment. Again, I

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[9] Professor Adam Levitin has posted on the TPM (Talking Points Memo) Café website that he has studied home mortgage interest rates in districts that allowed strip down prior to *Nobelman*, compared them to districts that did not allow strip down, and concluded that there was no significant difference. See http://warrenreports.tpmcafe.com/blog/warrenreports/2007/dec/19/the_effect_of_bankruptcy_reform_on_mortgage_interest_rates. That does not seem probative to me, for reasons I explained in a December 19 comment on the Credit Slips blog, in response to a post that was in favor of strip down. See http://www.creditslips.org/creditslips/2007/12/home-mortgage-c.html#comments, in which I noted:

> So far I haven't been able to post a comment on the TPM Cafe web page, but there are several reasons for doubting that Adam's (Adam Levitin's) observations with regard to interest rates prior to the 1993 Nobelman decision should be given serious weight. One is the point made in the prior paragraph; strip down pre-Nobelman did not allow for a reduction in the amount of the monthly payments, which is the whole point of allowing mortgage modification under the proposed legislation. Another is that until the circuit decision in Nobelman was issued, there was no dissenting circuit authority on the issue; thus the effects of the availability of strip down under the decisions that had been rendered may well have been felt relatively equally around the nation, as lenders had to consider that a mortgage originated anywhere in the nation might be subject to strip down. There also is the question whether there were a substantial number of strip downs that either occurred or were anticipated (given the requirement that the monthly payments not be reduced). John Rao raised the question with me whether there were enough strip downs to affect the lending industry. I thought there were enough that occurred or were anticipated that the still shaky lending industry was being threatened by 1993 (not long after the s&l crisis), but John is making me take a second look.

(The result of my second look is noted above in my answer to question D4.) The confused state of the law concerning whether any decision below the circuit court level is binding on a bankruptcy court may also tend to prevent any district level differences from being treated seriously by lenders.

would urge Committee members to read the amicus briefs of Freddie Mac and of the State of Alaska that were filed in the *Nobelman* case.

D5(b). I do not agree that the only other option is to allow 2.2 million foreclosures. Allowing more modest modifications of home mortgages, such as by moderating interest rates or eliminating prepayment penalties, could allow many of those potential foreclosures to be avoided. At least some of them can be avoided by using the current chapter 13 provisions. Others may be avoided by way of Secretary Paulson's initiative or by way of voluntary modifications made by mortgage holders. As I said in my testimony, Congress may be able to act to help facilitate Secretary Paulson's initiative and to make sure that some party is capable of acting on behalf of the mortgage holder or holders to make a decision with regard to voluntary modification. It is also not clear, as I noted above, how many additional homeowners could avoid foreclosure simply because of availability of strip down.

It is possible that allowing a high number of foreclosures, as painful as that would be for the homeowners involved, might be the best way to get through the home price bubble that is now in the process of bursting. I hope that there is a way to avoid that without prolonging the financial difficulties (as happened in Japan). I think a moderate approach allowing some modification of home mortgages in some chapter 13 cases, not including strip down, probably only for borrowers with income below their state's median (or perhaps below 125% of their state's median), and with a sunset date no more than two or three years in the future, could be helpful. I do not think that very low teaser rates should be locked in, but some limits on interest rate increases might be appropriate.

There is also a cost to keeping home prices artificially high: many first-time home buyers will be priced out of the market.

D6. No, I do not support the means test provisions added by the 2005 BAPCPA. Some reforms probably were needed to require debtors with substantial incomes to repay a portion of their debts rather than simply discharging them in chapter 7. However, the means test provisions that were adopted are too complex and ambiguous and do not accurately identify debtors who have the means to pay.

Responses to Questions from Senator Sessions (S1 & S2, including subparts):

S1(a). The scenario described in the question is quite realistic and highly likely to occur (if a bill is enacted that, like S. 2136, provides for strip down). Note that S. 2133 provides for strip down only with the consent of the mortgage holder. A mortgage holder will only agree to such a strip down if it is in the mortgage holder's best interest, and any benefit the homeowner might obtain in such a case should not be called a "windfall."

S1(b). I do not think any means test or income test can protect against this scenario. No matter what limits are placed on which homeowners can obtain a strip down, it will still be the case that, when strip down is imposed, the home mortgage holder is denied the benefit of the real estate market recovery that is likely to follow a downturn, and the homeowner obtains that benefit.

My answer to Senator Durbin's question D1 explains why the means test incorporated in S. 2136 would not accurately determine which homeowners are unable to save their homes under the current provisions of chapter 13. Every time a homeowner would use a strip down instead of the current chapter 13 provisions, home mortgage holders would suffer an unnecessary loss.

S1(c). If that occurs, I believe interest rates will be higher than they otherwise would have been (though I cannot say by how much), and some homeowners will be denied mortgage loans for which they otherwise would have qualified. Both of these harms will fall disproportionately on borrowers who have lower credit scores and who can make only relatively small down payments.

S1(d). I do not believe that legislation should be enacted that permits home mortgage strip down in chapter 13 cases. I would prefer to see Congress act to help facilitate Secretary Paulson's initiative and to make sure that some party is capable of acting on behalf of the mortgage holder or holders to make a decision with regard to voluntary modification. It is possible that some legislation allowing modest modifications to some home mortgages might be advisable, as noted above in the answer to Senator Durbin's question D5.

S2(a). I doubt that he meant that all 600,000 cases would be additional. Some of those homeowners probably would have sought bankruptcy relief in any event (with some of them using the current provisions of chapter 13 to save their homes). I do think most of the 600,000 would be additional cases under Mr. Sommer's scenario.

It is not clear how many of the homeowners who would qualify to modify their mortgages under S. 2136 would then be able to strip down their mortgages. That depends on the number of cases in which the court-determined value of the home is less than the amount of the mortgage.

I do not believe anyone knows how many homeowners could save their homes only if strip down is permitted; that is, we do not know how many homeowners need the extra reduction in their payment that strip down might give them above the reduction that some other modification (such as reducing interest rates or restraining interest rate increases) would give them. A bill that allowed some modification of interest rates—but not strip down—might allow nearly as many homeowners to save their homes as would S. 2136, with its provision for strip down.

A bill providing for a reversible strip down—with the mortgage amount restored to the extent the property regained value after five years[10]—probably would allow nearly as many homeowners to save their homes as S. 2136.

S2(b). No, I do not, at least not if strip down is permitted. I doubt that the bankruptcy courts could handle that number of cases in any expeditious manner, given the substantial litigation that would be involved.

S2(c). I do not favor such an approach. Homeowners who have struggled to continue to make their payments, or who have not yet defaulted because their interest rates have not yet reset, would be placed at a relative disadvantage.

S2(d). There would be several likely impacts on other borrowers. Some mortgage holders would attempt to complete foreclosures before the effective date of S. 2136. Others, in the future, might attempt to complete foreclosures before the defaulting homeowners obtained legal advice and filed chapter 13 petitions. Home mortgage interest rates, qualifying standards, and required down payments would all likely be at least somewhat less favorable for new borrowers. The largest effect probably would be denial of mortgages to potential homeowners with less than stellar credit and only small down payments. To the extent that interest rate indexes (on which ARMs

[10] See footnote 5 above.

are based) ended up higher than they otherwise would have been, existing homeowners with ARMs would face higher payments and might end up in foreclosure. (I do not know whether such indexes would be affected substantially by increased risks and costs involved with home mortgages; others will have more information on that subject.) The higher interest rates for new borrowers would probably force some of them into foreclosure at some point in the future.

Response to Question on Separate Sheet (that begins "We are learning ..."):

My expertise is primarily in the area of bankruptcy law rather than in the details of mortgage origination. To the extent that a pre-securitization rating like that suggested by the question would be helpful to investors, I think there would be a market for such a service, and there would be no need for legislation. (I also think the bond rating services will take a much harder look in the future at the quality of the mortgage collateral that backs securities; the market will demand this, as well.) To the extent that such a rating would be designed to help borrowers decide whether to enter into a particular home mortgage transaction, it could be helpful, but the cost would be high, and the historical information about a lender's experiences might not be very useful. Perhaps this could be better dealt with in the broker licensing arena, with brokers who originate a high percentage of loans that go into default being audited or asked to explain. Of course, brokers or direct lenders who work in poorer communities might originate more loans that go into default, and it would be unfortunate if such a rating system deterred them from doing so.

* * *

I hope these answers are helpful to the Members of the Committee. Please do not hesitate to contact me if I can be of further assistance.

Sincerely yours,

Mark S. Scarberry
Professor of Law, Pepperdine University, and Robert M. Zinman Scholar in Residence, American Bankruptcy Institute (Fall 2007)
mark.scarberry@pepperdine.edu

cc: The Honorable Arlen Specter
The Honorable Richard J. Durbin
The Honorable Jeff Sessions

Henry J. Sommer
Answers to Written Questions

Answer to question: "Do you believe that assigning a pre-securitization rating based upon borrower information AND lender performance to mortgages would help to decrease the future likelihood of the type meltdown we've experienced in the subprime market?

I agree with the premise of the question that consumers and investors need better information in making choices about mortgages. One of the problems of basing this information on past performance is that it sometimes (as in the last few years) takes time for problems to become apparent, especially in a rising real estate market when bad loans can be refinanced without difficulty.

In my view, many of the problems result from the proliferation of complex loan products that cannot be easily fit into standard metrics. As products become more complex, any disclosures, especially to consumers, become less and less understandable. I question whether we gain anything by allowing creditors to fashion hundreds of distinct products, rather than a far smaller number, which we had in the days of greater regulation.

If we are to continue having so many complex products, consumers (and probably investors) need some sort of rating of financial product safety, as has been proposed by Professor Elizabeth Warren, that would give grades of A to F. This rating could take into account the lender's history of defaults and foreclosures, consumer complaints, contract terms and fees unfavorable to consumers (such as prepayment penalties and yield spread premiums), and choices of good or bad loan servicers. The last factor is important because many consumer complaints arise from abuses by mortgage servicers, and consumers cannot shop for a servicer, because servicers are chosen by the ultimate holders of their loans. The agency evaluating the lenders and products would have to be a trusted and independent source, like Consumers Union, rather than the bond ratings agencies with conflicts of interest, or federal agencies, which are too close to the industry they regulate and did nothing for years as the seeds of the current crisis were planted. Otherwise we would have a situation similar to the current Community Reinvestment ratings, resembling Lake Wobegon, where all financial institutions are above average.

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Questions from Senator Durbin.

1. I believe the bankruptcy bill could save more homes than any other proposal for several reasons.

First, it does not depend on voluntary action by lenders, whether through loan modification, waiving prepayment penalties for a refinancing, or reducing principal for refinancing by a state loan fund at current value. As I described in my testimony, there are many reasons such voluntary action has not happened and will not happen in many cases. The bankruptcy proposal is the only one that gives consumers actual legal rights that will help them save their homes.

Second, the modifications available will go farther to make the loans affordable. If there has been a substantial decline in value, payments will be lower than would result from a simple freeze on interest rates. And the modification will be permanent. Temporary freezes of interest rates will, for many homeowners, simply postpone unaffordable rate increases into the future.

Third, the proposal covers far more loans. Until the last two years, most predatory and subprime loans were fixed rate loans, usually refinancing loans, and often to borrowers who qualified for better terms. This proposal would allow those borrowers who struggle to make the high payments obtain more affordable terms. Many of these borrowers are in default and would not be helped by the Paulson plan. That plan, and most of the other voluntary plans cover only mortgages with rates that are adjusting, and often only with rates adjusting during a short time-frame. They also contain other eligibility requirements, excluding those with credit scores that are too high, or too low, or increased since the loan, and those whose equity is too high or too low.

Fourth, the bankruptcy proposal does not depend on uncertain staffing of loan modification units at mortgage servicers, some of which are themselves going bankrupt, or continued funding for counseling agencies and other providers. The bill relies on a system that can easily handle the expected cases. Even with these additional cases the annual number of cases will likely be lower than the number filed in the recent past. The attorneys, chapter 13 trustees, and judges in the bankruptcy system are experienced and efficient in dealing with mortgages, modification of claims, and valuation of property.

Fifth, as discussed in question 6 below, predatory lending will not disappear. S.2136 covers future loans, so it will help borrowers in future loans.

2. I do believe that a bankruptcy restructuring of the loan is a better deal for banks and investors than foreclosure, for several reasons. Most obviously, the lender ultimately only recovers about 60% of the loan in foreclosure, after paying numerous costs and ultimately selling the property at a deep discount. The discounts in such sales further hurt lenders by depressing other real estate prices, as well as the general real estate market in which future loans could be made. Under S.2136, the lender would receive the fair market value of the property plus interest at a rate that is at least the conventional mortgage rate. Although these terms would be extended for up to thirty

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years (minus the elapsed term of the current loan), most mortgages are paid, through sale or refinancing, in much shorter time periods. Chapter 13 is a better deal for creditors for the same reasons chapter 11 is a better deal for creditors in the corporate context. The alternative is liquidation or foreclosure, and harnessing the going concern value of a business or the individual debtor's earning capacity to pay the loan can produce a higher payment than liquidation or foreclosure.

3. Allowing cramdowns is a better option than the other available options for lenders when a borrower is facing foreclosure. The disadvantages of the foreclosure option are discussed in question 2 above. If the lender permits a short sale, the most it could receive is the fair market value minus the costs of sale, including a broker's commission, which are likely to total about 10% of the value. If the lender accepts a deed in lieu of foreclosure, it must pay to maintain the property itself, and also pay all the costs of selling it, usually at a discount. And a voluntary modification, where it occurs, is likely to have costs for the servicer and/or agency that handles the transaction, possibly through multiple modifications, ultimately to reach terms similar to what the lender would receive in a cramdown. Any modification program will also have costs for all the cases where modifications are not granted.

4. I have not seen any credible independent research that proves that bankruptcy cramdowns would measurably harm the mortgage markets. As I stated at the hearing, all of the evidence we have from analogous situations is that there would be no measurable effect on the markets.

5. I believe the means test approach in S.2136 is better than a flat income eligibility cutoff for several reasons. First, the means test, while not perfect, takes into account numerous individualized factors that a flat income limit cannot, including medical expenses, childcare costs, religious tithing, expenses for elderly and disabled household members, and other special circumstances, such as a call to active duty in the Armed Forces. Second, the means test is more sensitive to local variations in expenses for housing and transportation. Thus, for example, a family in an area with higher home values and higher incomes than most of a particular state, such as Illinois, New York, Pennsylvania, or California, would be eligible despite having a somewhat higher income than eligible families in lower income areas. Conversely, the means test for eligibility could exclude debtors below a fixed income limit if they simply do not need the relief. If a debtor, after paying the expenses permitted by the means test, can afford his or her mortgage payments without cramdown, that debtor is not eligible for cramdown relief.

6. I believe that restricting the mortgages that can be modified in bankruptcy only to past loans would not offer correct incentives to the lending market and would quite possibly send a signal that Congress believes unscrupulous lending has disappeared. Unfortunately, unscrupulous lending has long been with us and is almost certain to recur in the future. Such lending tends to be cyclical, based on the real estate market. I first saw the results of such lending here in Philadelphia when FHA mortgages were abused by speculators who sold homes based on inflated appraisals that ultimately resulted in criminal prosecutions. We saw new abuses when most first lien loans were deregulated in the early 1980's. And we had the current cycle, fueled in large part of the enormous fees made by mortgage brokers, securitizers, and other players in the process. It is only a matter of time before the next "innovation" is exploited by those who make

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quick profits through abusive lending practices.

On the other hand, the availability of cramdown in bankruptcy could serve as a check on future unscrupulous practices. The knowledge that loans based on practices like inflated appraisals and unfair interest rates could be reduced to a property's actual value and to fair rates could serve as a disincentive to making such loans.

Answers to Written Questions Posed by Senator Specter

1. While delaying or prohibiting the reset of rates on adjustable rate mortgages would help many families facing foreclosure, there are many others for whom this would not be helpful or sufficient. Cramdown and relief for homeowners with fixed rate mortgages are necessary components of bankruptcy relief because the current mortgage crisis extends beyond simply the rate resets that will be unaffordable for some families who face them. The crisis was brought about by a variety of abusive mortgage practices, as well as the housing bubble they helped to create.

Adjustable rate subprime mortgages on a large scale are a relatively recent phenomenon and only the latest and worst extension of abuses that have gone on for some time. In Pennsylvania, most of the problem mortgages we've seen over the last ten years were fixed rate loans. In many cases, these fixed rate subprime loans went to borrowers, particularly minorities, who qualified for prime rates. The large majority of the loans were refinancing loans, often paying off conventional loans at lower rates, and involving very large fees and deceptive practices that masked their true cost.[1] They sometimes were based upon inflated appraisals, or were 125% mortgages for more than the home was worth. They were enabled by the same lack of regulation and the same broker practices that led to the more recent abusive adjustable rate loans, so they are very much a part of the same problem. In some ways they were worse, because they led to an immediate loss of equity due to their high fees. Collectively, these loans sucked enormous amounts of equity out of low income neighborhoods and led to a large rise in foreclosures dating back to the late 1990's. Where there has been a delinquency of some months, and foreclosure costs have been assessed, the balance on such a loan quickly builds up to an amount well over the property's value, even if the value has not declined. A bill limiting rate resets would do nothing to help these homeowners, who continue to struggle to stave off foreclosure by trying to make payments that they cannot really afford. Cramdown and rate reductions on fixed rate, as well as adjustable rate mortgages, are necessary to undo at least some of the damage these loans have caused and make it possible for these homeowners to save their homes.

2. It is true that cramdowns of mortgages on second homes and vacation homes are very infrequent for many of the reasons cited in the question. Cramdowns of mortgages on two and three family homes are somewhat more common, but still not frequent. Sometimes a plan can provide that the debtor will obtain refinancing within the five year plan period to deal with the

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[1] Such practices included 1) not making clear that the new "lower mortgage payment" did not include the escrow for insurance and taxes that was included in the old payment 2) promising a refinancing at a lower rate in a year or two (which was not forthcoming and often would have triggered a large prepayment penalty) and 3) raising the rate at closing from a lower advertised rate because of supposed deterioration in the borrower's credit (sometimes caused by following a broker's advice that they need not pay the current mortgage because the payments would be made at the refinancing.) Brokers were rewarded for the higher rates through yield spread premiums, which were not disclosed to borrowers. Lack of regulatory enforcement, lack of legal services funding, and litigation obstacles such as mandatory arbitration clauses have left these practices largely unremedied, even when they were illegal.

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fact that the entire allowed secured claim must be paid off during the plan. Or, if the mortgage is on a low value property, as in some inner city areas, it sometimes can be paid off in the five year plan. Even more common are cases in which a second mortgage is completely eliminated because the first mortgage exceeds the value of the property. And chapter 12, of course, permits cramdown of family farm mortgages and repayment over a period exceeding the five year plan period.

It is the risky lending that has occurred in recent years, by many of the same lenders who are now opposing cramdown, that has injected much greater risk into the market and has already made mortgages harder to obtain. I don't agree that giving homeowners more than five years to repay the stripped down portion of their mortgages will inject significantly more risk into the mortgage market, or make it more difficult for homebuyers to get a mortgage, for several reasons.

First, the option would be used by people who are likely to face foreclosure otherwise. Since the lenders would lose more in a foreclosure, their risk is not increased in such cases. Whatever risk they face, it is basically the risk that the borrowers will not be able to pay their loans in the future, i.e. the risk of foreclosure; they already take on that risk when they make the loans and cramdown would not add to it. Debtors who are not facing foreclosure will not want to file bankruptcy cases simply to lower their mortgage payments; even people who need bankruptcy desperately are reluctant to file. And those who can pay their mortgages are not likely to be eligible for cramdown relief under the Durbin bill's means test, even if they are willing to live under the IRS expense guidelines the means test requires.

Second, as I detailed in my testimony, the universe of mortgages that would be affected is a tiny portion of the total mortgage market. If 600,000 debtors (less than 1% of all mortgages) would be helped by S.2136, it is safe to assume that cramdown would not be available to a good percentage of them because their homes had not declined in value from the time of the loan (as opposed to the time of the home's peak value) or the loan was for less than 100% of the value of the home. The vast majority of the others would face foreclosure without that relief. And, of course, the mortgage is not eliminated by cramdown; the average reduction in principal would probably be about 10%. Taking 10% of the already tiny fraction of 1% of the mortgage market where there might not be foreclosure without S.2136 produces at most a minuscule loss for lenders from cramdown. And those figures are based on a universe that includes many risky loans that should never have been made. Assuming that lenders adopt sound underwriting practices, the risk of loss on future loans would be much less.

3. The secondary mortgage market was well-established well before the *Dewsnup* and *Nobelman* decisions that prohibited mortgage cramdown in most cases. And in any event, there is no logical reason that risk and pricing of mortgages should be any different depending on whether the mortgage is held by a bank or a securitized trust. As for the statement that rates went down after *Dewsnup* and *Nobelman*, it is simply incorrect. The later of the two decisions, *Nobelman*, which prohibited chapter 13 cramdown of mortgages in most cases, was in June, 1993. The average conventional mortgage rate in that month was 7.42%. The average rates in 1994, 1995, 1996, and

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1997 were higher.[2] I doubt that any serious economist would make the argument that these decisions, rather than broader economic trends, had any effect on mortgage rates.

4. While it is true that over the long term real estate usually appreciates in value and cars depreciate, that does not mean that cramdown is somehow unfair or that it creates a windfall. Bankruptcy law is based on the distribution of assets when a debtor cannot pay all creditors in full. In cases that would be covered by the amendments being considered, the debtor cannot pay the mortgage, so the alternative is liquidation, in this case foreclosure. The alternative of the mortgage loan being paid in full according to its terms does not exist and to compare the results of cramdown to that alternative is a debate that does not reflect reality. The homeowner will not own the home over the long term without cramdown relief so there will be no appreciation for the lender to enjoy. And lenders do not hold real estate after they foreclose. They quickly sell it at a steep discount precisely because holding and maintaining real estate is anathema to them. As in chapter 11 reorganization, cramdown permits the lender to realize more than it would in a liquidation/foreclosure because it will be paid the fair market value of the property plus a reasonable rate of interest.

Thus, both the lender and the borrower will benefit from cramdown if it averts foreclosure, because the lender will receive more than it would in a foreclosure. It does not make sense to call one benefit a windfall but not the other. The debtor is simply given a bankruptcy discharge of a debt that is in reality unsecured and treated the same as someone who purchased a home on the date of the bankruptcy with a reasonable mortgage. Windfall is a pejorative term that usually reflects the values of the user and does not advance rational argument. One could just as easily say that the lender who made an unwise investment decision and holds a debtor's home hostage, demanding payment of more than the home is worth, receives a windfall and causes hardship to the debtor if the debtor pays that amount. Moreover, if the debtor cannot pay, the hardship will be caused not only to the debtor but also to the debtor's neighbors and community. It depends on your point of view. The bottom line is that without relief there is likely to be a foreclosure with all of the negative consequences that entails. In my opinion, if more foreclosures can be prevented by S.2136, while protecting the real value of the lender's property interest, Congress should enact that legislation.

5. First, I disagree with this question to the extent it states that lenders are worse off with cramdown than with a voluntary modification. Amounts that are not paid because of voluntary modifications (which sometimes reduce the principal as well as interest) are treated the same as those not paid due to cramdown for mortgage insurance purposes. Thus, lenders making this argument are saying they are interested in nothing other than foreclosure. Second, mortgage insurance was not common on the subprime loans that would be most often affected by the legislation. The FHA and VA programs, in particular, have strict underwriting guidelines and did not insure the types of loans which are at the heart of the current crisis. (Indeed, these types of insured loans account for only a small portion of today's mortgage market.) If all lenders had adhered to such criteria, the current crisis would not exist. And private mortgage insurance does not normally pay 100% of a lender's losses in a foreclosure, so it is not at all clear lenders with

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[2] *See* http://www.freddiemac.com/pmms/pmms30.htm

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such insurance would do better in a foreclosure.

Therefore, the number of cases in which lenders would do better foreclosing because they could collect more on mortgage insurance is a tiny sliver of the already small slice of the mortgage market described in question 2. Again, assuming that lenders are using better underwriting practices going forward, I don't believe that any potential losses in that sliver would have a discernible effect on future mortgage terms. It should also be remembered that private mortgage insurance is also affected by the market. If lenders make more claims in more foreclosures, the price of such insurance would likely go up. There is no free lunch. So the greatly increased number of foreclosures apparently desired by the lenders making this argument would itself cause an increase in the cost of mortgages. (Although I have no expertise in the finances of private mortgage insurers, I understand from the media that the viability of such insurers is questionable if there are massive foreclosures, so the premise of this question that they will pay all claims may also be faulty for that reason.)

6. While it true that many, probably most, of the families now facing foreclosure will default because of unaffordable resets of adjustable rate mortgages, the problem extends well beyond that, as described in question 1 above. For that reason, S.2133, while it would help some families, would leave many others without a way out of the foreclosure crisis. Without cramdown, a mortgage may still be unaffordable for some families with adjustable rates. On a more long-term basis, if the home's value remains less than the mortgage amount, the family would be unable to sell the home or refinance the mortgage for many years. The prospect of struggling to make payments without building equity and without even a prospect of selling the home in the foreseeable future will be unattractive to some, as opposed to giving up to foreclosure, with all the community harm that entails. And, if the family later runs into economic hardship or has to relocate for some reason, it will often allow the property to go to foreclosure because it cannot be sold when there is little or no equity.

S.2133 also excludes many homeowners, even with adjustable rates, through its income cap. In some parts of the country, such as higher income areas in states like Pennsylvania, California, New York and Illinois with high property values, most homeowners would be excluded by the income test because purchasing a home in such areas requires a higher income. The income cap also does not take into account individual circumstances, such as medical expenses, child care costs, and transportation expenses, which can make it difficult for a family above the cap to pay a mortgage.

In addition, S.2133 provides no help to homeowners with fixed rate subprime loans. As described in question 1 above, a large percentage of abusive mortgages fell into this category, especially in urban and minority areas. It also will not help homeowners who obtained loans after September 26, 2007. While abusive loans have undoubtedly declined very substantially in recent month, predatory lending in various forms has been with us for decades and there is no reason to think it will permanently disappear. Limiting the bill to existing loans sends exactly the wrong signal to those who would engage in abusive lending practices in the future.

Similarly, S.2133 does not help homeowners with payment-option and interest-only loans. These products, which greatly increased the likelihood of negative equity, have been

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identified as dangerous by federal regulators because there is an artificially low payment initially on the loan, and lenders commonly underwrote only to the interest payment, not an amortizing one. Once the loan amortizes, and all loans must pay down principal at some point, the payment shock is severe because it must amortize over a shorter period than the full term of the loan.

S.2133 also does not permit reamortization of the loan over a period beyond the plan. Without reamortization, homeowners would still have to not only pay current payments, but also cure any default, including foreclosure costs and attorney's fees. This will be an insurmountable obstacle to many who can barely afford even their current payments.

And, unlike S.2136, S.2133 does nothing to deal with the widespread problem of abusive fees imposed by mortgage servicers in chapter 13 cases.[3] Section 3 of the bill amends the fraudulent transfer section of the Bankruptcy Code, which deals with transfers before the bankruptcy petition, and in any event only allows a trustee, and not the debtor, to recover funds actually transferred, as opposed to dealing with the real problem – threats of foreclosure and actual foreclosures if illegal and secret fees during the bankruptcy are not disclosed.

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[3] *See* Morgenson, Dubious Fees Hit Borrowers In Foreclosures, New York Times, November 6, 2007, p.1 (citing research by University of Iowa Professor Katherine Porter); Efrati, Judges Tackle Foreclosure Mills, Wall Street Journal, Nov. 30, 2007 (citing judges' findings of numerous illegal charges added by mortgage companies in bankruptcy cases).

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Senate Judiciary Committee
Hearing on
"The Looming Foreclosure Crisis: Helping Families Save Their Homes"
December 5, 2007

Questions from Senator Richard J. Durbin

1. Can you briefly discuss your views on Secretary Paulson's initiative and clarity why passing this bankruptcy bill is important?

Treasury Secretary Paulson's Hope Now initiative has provided some modest help to homeowners struggling to avoid foreclosure. Its' most significant success has been in facilitating communication between mortgage servicers and homeowners and establishing a clearer process for mortgage loan modification efforts. Since its inception in late 2007 through the summer of 2008, Hope Now has modified nearly 600,000 mortgage loans. While significant, this is very modest in the context of the 1.5 million homeowners that have defaulted on their first mortgages in 2007 and the close to 3 million homeowners who are on track to default in 2008. Hope Now has also become increasingly less effective in forestalling defaults as the problems homeowners face now are less related to ARM resets as interest rates have declined and more to falling house prices which is driving millions of homeowners into deep negative equity positions who when suffering a disruption to their cash flow are defaulting. Hope Now has been helpful in providing modifications that include term extensions and interest rate freezes; not mortgage writedowns. Facilitating loan modifications that include writedowns of principal would be helpful in forestalling foreclosures over the next several years.

2a. Are the industry's concerns about rising interest rates due to this bill valid?

No. Given that the bill applies to mortgage loans that have already been originated and not to loans that will be originated in the future, the bill will not materially affect future mortgage rates.

2b. Is there any objective statistical evidence available that proves the broad assertion that allowing mortgage modifications in bankruptcy will lead to higher interest rates and less credit?

No, not that I am aware of.

3. In your judgment, will banks be eager to hold on to foreclosed property in the market in the hopes that eventually these properties will appreciate? How long would the banks have to hold on to these 2.2 million homes to get that benefit?

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No, banks are increasingly eager to sell foreclosed properties. House prices are falling rapidly in most areas of the country, particularly in markets where foreclosures are high and rising. Auctions and foreclosure sales are surging nearly everywhere. Based on my projections for house prices across the nation's metropolitan areas it would take as long as a decade in some markets for banks to benefit from holding onto foreclosed property.

4. Have you seen credible independent research that proves extra cram downs in bankruptcy would measurably harm the mortgage markets in any way?

No, not if the cram downs are applied to loans that have already been originated.

5a. It appears to me that over time the mortgage market has experienced recurring periods of excessively loose underwriting and predatory practices. Is this true?

Yes, this is true. Mortgage lending was excessively loose during the 1980s contributing to the Savings & Loan Crisis of the late 1980s and early 1990s. Standards eased again in the mid and late 1990s contributing to the 1998 financial crisis. Of course, mortgage underwriting standards were substantially lowered in the boom of the mid part of this decade contributing to the current foreclosure crisis.

5b. If so, does including a sunset in a bill such as the one in S.2133 not potentially create an incentive for unscrupulous lenders to resume bad behavior the day after the sunset?

Yes, potentially. I do think however that forestalling future unscrupulous lending is best accomplished by clearer and more forceful regulatory oversight. The Federal Reserve's recent adoption of new guidelines for mortgage lenders under HOEPA will go a long way to preventing such abuses going forward. Moreover, if this legislation does not sunset, then it would likely result in somewhat higher mortgage lending rates in the future.

Questions from Senator Brownback

Do you believe that assigning a pre-securitization rating based upon borrower information and lender performance to mortgages would help to decrease future likelihood of the type of meltdown we've experienced in the subprime market?

I do not have an opinion with regard to assigning a pre-securitization rating. I do believe that better information regarding borrowers and the types of mortgage loans being originated and the loans ultimately ending up in delinquency and default would be very

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useful in preventing future housing and mortgage crisis. This could be relatively easily and at little cost be done by supplementing reporting requirements under the Home Mortgage Disclosure Act. The information that is currently available is inadequate for understanding the causes and consequences of the current crisis.

Questions from Senator Specter

1. Some critics argue that there is a conflict of interest because credit rating agencies, like Moody's, are paid by the same institutions that issue the securities they are rating. Is it possible that this conflict of interest was one of the causes of the mortgage mess?

Please let me reiterate that Moody's Economy.com is an independent subsidiary of the Moody's Corporation. My testimony to the committee represents my personal views and do not represent those held or endorsed by Moody's. I have no knowledge of a conflict of interest at the rating agencies that contributed to the mortgage mess.

2. Why do you think the approach contained in S.2133 won't help distressed homeowners?

Resetting adjustable rate mortgages are no longer the most significant factor contributing to the surging number of foreclosures. Indeed, resetting has not been a serious problem in 2008 as LIBOR has fallen sharply with the Fed's aggressive rate cutting. Most subprime loans hitting resets in 2008 are 6-month LIBOR based ARMS. Driving foreclosures this year is a combination of negative equity and a weakening job market. With national house prices now down 16% from their spring 2006 peak according to the national Fiserv Case Shiller house price index, some 9.6 million of the 52 million homeowners with first mortgages are underwater – that is the market value of their home is less than the mortgage debt they owe on the home. This is up from 4.1 million homeowners a year ago and 2.7 million two years ago.

Negative equity by itself is generally not a reason for a mortgage default. Most homeowners don't have a precise grip on the value of their home and even if they could determine they were underwater they wouldn't walk away given the hefty transaction and psychological costs involved. There is growing anecdotal evidence of increased so-called walk-aways in the most distressed areas of the country where prices are already off more than 25% from their peak such as the Central Valley of CA or Southwest FL, but these remains unusual. Mixing negative equity with a disruption to income from unemployment or even lost overtime hours, or an unexpected expense due to say a divorce or even just a leaky roof, is a catalyst for a default.

In order to help distressed homeowners with negative equity avoid foreclosure it is increasingly necessary to provide a mechanism to reduce the amount of mortgage debt they owe.

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SUBMISSIONS FOR THE RECORD

Statement for the Record
on behalf of the
American Bankers Association
before the
Committee on the Judiciary
United States Senate

December 5, 2007

The American Bankers Association appreciates the opportunity to submit a statement for the record on possible legislative changes to the bankruptcy code, particularly as embodied in the Helping Families Save Their Homes in Bankruptcy Act of 2007, S. 2136. The American Bankers Association brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $12.7 trillion in assets and employ over 2 million men and women.

There is no question that our country is going through a very difficult time as many homeowners struggle to meet their monthly mortgage payments. Changes to the bankruptcy code, while well-intentioned, are not an effective means to deal with the current situation, nor are they likely to prevent problems from repeating themselves in the future. In fact, the proposed changes are likely to raise the costs of a mortgage loan for ***every borrower***, thus hurting the very market that Congress seeks to help.

Many forces combined to create the problems we face today. After the dot-com bust, money flowed into real estate, helping to fuel a boom in home prices. As home prices rose, non-traditional mortgage products became quite popular as an avenue for real estate investment and homeownership. In many cases, individuals were purchasing homes with the intent of "flipping" them – investing money

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into upgrades and then hoping to sell quickly at a significant profit. Others purchased houses as mere investment properties with the intent of renting them out to others and then selling once the property had appreciated. In other cases, loans were being made to first-time homebuyers who may not have fully appreciated or understood the terms of their loan agreement. Still others were simply cashing-out their equity by re-financing. With the frenzy that ensued, sound underwriting practices were often sacrificed – primarily by non-bank originators – for immediate gains. In states where economic difficulties were already placing heavy financial stress on both consumers and businesses, the problems in the mortgage sector have had a particularly severe impact.

The fallout of the mortgage markets has been very troubling to the banking industry – an industry filled with institutions that have existed for decades and are committed to serving our communities for many more decades to come. The vast majority of banks were making basic mortgage loans that were underwritten on the basis of borrowers' ability to repay and with adequate documentation. Rather, it has been the actions of loosely-regulated non-bank lenders, with little stake in the subsequent performance of the loans that they have made, that have caused much of the damage for consumers and for the industry. In fact, many banks tried to warn local consumers against "toxic" types of loans, only to watch as those consumers went down the road and took on obligations they did not understand and apparently could not resist – largely from non-bank mortgage originators.

Fortunately, banks are coming forward as part of the solution to the current challenges. Banks are well capitalized and are in a position to step in to refinance loans to help borrowers avoid foreclosure. At the same time, bankers are increasing their originations of new mortgages for buyers who want to purchase houses today. Both efforts are crucial to help keep our economy growing.

If S. 2136 becomes law, it will lead to too much uncertainty and raise costs for ***all*** mortgage loans. Banks will not know the value of their collateral and, in order to manage their risks prudently, will be forced to pull back from making some mortgage loans. Simply put, this is no time to change the

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rules on the way collateral is handled. Banks are in a position to help, but cannot do so effectively if uncertainty is injected into the rules. The ABA strongly opposes the changes in the bankruptcy code that are being contemplated in S. 2136.

In our statement, we emphasize three key points:

- **S. 2136 will make it harder and more costly for consumers to obtain mortgages, which is exactly the opposite of what the mortgage market needs now.**
- **S. 2136 will encourage more bankruptcies and discourage borrowers from addressing problems early and working with lenders to facilitate a resolution.**
- **S. 2136 will eliminate required credit counseling which has helped reduce bankruptcy filings, facilitated workouts, and improved borrowers financial practices that benefit them now and in the future.**

I. S. 2136 Will Make it Harder and More Costly for Consumers to Obtain Mortgages

At the heart of the bill are provisions that would allow bankruptcy judges to alter the terms of mortgage agreements. If enacted, S. 2136 would allow judges to cramdown a portion of the outstanding mortgage balance on a primary residence, thereby converting it from secured to unsecured debt. The bill would also allow judges to modify other mortgage terms such as the applicable interest rate and repayment period. These provisions will create new lending risks that will certainly raise the costs to lenders for making any mortgage loan and inevitably lead to higher mortgage interest rates and fewer loans made to all borrowers. The impact is likely to be felt most strongly by higher-risk, but creditworthy, borrowers and may mean the difference between owning a home and continuing to pay rent to a landlord.

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The interest rate that bank's set for a mortgage loan depends on several factors, including:

- The creditworthiness of the borrower (the ability and likelihood that the borrower will repay the debt);
- The collateral backing the loan (which the borrower pledges in the event of default);
- The costs of administering the loan (e.g., monitoring, servicing, legal actions, foreclosure, and the ability to take control and sell the collateral to recoup some of the losses on the loan); and
- The cost of funding the loan (e.g., deposit and secondary market funding).

Except for creditworthiness, all of these factors will be adversely affected by the proposal and will lead to higher interest rates and reduced credit availability. While we appreciate that the bill applies only to the primary residence, lenders already typically charge a higher interest rate and require a larger downpayment for second homes – which can be crammed down in a bankruptcy under current law. This is another indication of the potential consequences on first homes should the bill be enacted.

Value of Collateral is Diminished: The difference between interest rates on unsecured versus secured loans is substantial. The reason is simple: the expected loss once a default occurs is much greater for an unsecured loan than for a secured loan where the sale of the collateral can offset a portion of the loss to the lender. One need only look at the difference in interest rates on credit cards (which are unsecured) versus auto or mortgage loans. Thus, borrowers benefit significantly from pledging the collateral, and they also have more incentive to make the payments as they do not want to risk losing that collateral.

The changes proposed in S. 2136 make the underlying collateral less valuable and raise the expected loss on ***all*** mortgages for ***every*** lender. The unpredictability regarding how loan terms might change – whether it be a cramdown in value, or a change in the interest rate or other term of the loan –

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makes valuing the benefit of the collateral practically impossible. Slight changes in any of these terms can significantly affect the potential to recoup losses in the event the borrower declares bankruptcy. Lenders simply cannot predict at the time the loan is originated what changes in terms a judge may later impose. Therefore, because the value of the collateral is less certain, the interest rate reduction borrowers enjoy from pledging the asset will be less and the interest rate paid on the mortgage will be higher.

Ability to Control the Collateral Will be Impaired: The ability to control the collateral pledged by the borrower and sell it to recover some of the losses is a critical component of secured lending. Without it, the collateral has little value and the loan will get priced more like an unsecured loan. The bill would make it more difficult for the lender (or the claim holder if the loan is sold in the secondary market) to exercise its contractual rights to modify the terms of the loan or to seize the collateral, further raising the potential for loss and extending the time for any recovery. Once again, the lender will raise interest rates to cover this uncertainty, require a larger down payment, and restrict lending to more creditworthy borrowers where the likelihood of default is much less. This means that deserving individuals who would not qualify for low-risk mortgages will find mortgage credit harder to come by and at a much higher cost – taking either a bigger bite out of their income or making the loan beyond their reach entirely.

Investors in the Secondary Mortgage Markets Will Demand Higher Returns: Another important cost that helps to determine the interest rate on any mortgage loan is the cost of funding. The low mortgage interest rates and broad availability of credit that characterize the U.S. mortgage markets are attributable to an active secondary market for mortgage-backed securities. Today, market conditions have made investors wary of mortgage-backed securities (particularly those that are not backed by prime loans). Investors have become concerned about changes in the payments being made on the underlying mortgages backing their investments. If S. 2136 were to be enacted, it would

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significantly add to the uncertainty about the performance of and expected income stream from mortgage loans. This will be particularly true of securities that are supported by pools of subprime loans where the likelihood of default, by definition, is much greater than for prime loans.

Adding yet more uncertainty for investors already made nervous by the market turmoil will delay the return of these markets. Investors do not like uncertainty. This is especially true of those with fiduciary responsibility to pension and insurance funds and others with low risk tolerances. Because the proposed change gives judges wide discretion to choose which mortgage terms to adjust and to what degree, and because this discretion is likely to be applied in different ways across the country (and even differently within the same federal court), investors will not be able to rely on consistent treatment and will have difficulty assessing the true risk. As a result, they will either not buy the asset or will require a much higher return on their investment. This will make it far more difficult to reestablish the stability and liquidity in the mortgage-backed securities sector that are essential to restore the flow of funding for healthy housing and home building markets. The higher returns demanded by investors will translate into higher interest rates for borrowers. Larger downpayments are likely to be required, which affects first-time homebuyers particularly. The result for all borrowers is higher costs of homeownership. For the economy, it adds further delay to the recovery of the housing sector, one of the most important components of national economic growth.

Simply put, all of these changes will add significantly to the risk and costs that a lender faces when making any loan. To cover this risk, the interest rate charged will certainly increase and the willingness to lend to higher-risk, but creditworthy borrowers will decrease. Moreover, since any lender will not know what loans will end up in the bankruptcy process, the rate of interest on ***all*** mortgage loans – both prime and subprime – will rise. ***This would impose a cost on all homeowners including the vast majority who meet their obligations and never file for bankruptcy.***

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It is also worth noting an asymmetry in the process. In a cramdown the creditor takes an irrevocable loss. Once home values start to appreciate again, the borrower reaps a windfall, but the creditor does not share in this gain.

Academic studies support the notion that cramdowns raise the cost of lending. For example, Columbia University professor Charles Calamaris and Drexel University Professor Joseph Mason concluded the following:

> Cram-down makes default more costly for the lender and less costly for the borrower. But ultimately the losers from cram-down are the borrowers. By removing the disincentive to default, cram-down would substantially reduce – and potentially eliminate – the gains that consumers reap from this form of lending.
>
> There is concrete evidence of the adverse effects of imposing cram-down on borrowing contracts. In response to increasing agricultural distress in 1978, Congress instituted a temporary provision for mortgage cram-downs for family farmers under Chapter 12 of the Bankruptcy Act. Bankers confirm that Chapter 12 cram-down has indeed made lending to small farmers a substantially riskier proposition, and they consequently have largely withdrawn funds from this business line.
>
> The withdrawal of agricultural lenders took place when family farmers sorely needed capital from all sources. Cram-down radically affects credit allocation and does not support orderly and efficient allocation of resources in bankruptcy. Cram-downs significantly hurt mortgage lending in agriculture in the 1980's. Cram-downs for home mortgage debt would result in the same type of credit contraction witnessed in the agricultural sector.[1]

Moreover, in studying the impact of cramdowns for farm real estate in Chapter 12 bankruptcy, the United States Department of Agriculture (USDA) estimated that cramdowns raise the interest rates on farm real estate loans by 25 basis points to 100 basis points.[2] This means as much as a 10 percent increase in the monthly mortgage payments just because of the uncertainty surrounding the collateral value.

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[1] Calomiris, Charles W. and Mason, Joseph R., "High Loan-to-Value Mortgage Lending: Problem or Cure?" AEI Studies on Financial Market Deregulation, 1999.

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II. S. 2136 Will Encourage More Bankruptcies and Discourage Borrowers From Working With Lenders To Facilitate a Resolution

Foreclosure is a losing proposition for all parties. Consumers lose their home while lenders lose money and their customers. For this reason, responsible lenders want to avoid the foreclosure process whenever possible. The industry is already taking positive steps to reach out to troubled borrowers and help them avoid foreclosure. Individual mortgage lenders and servicers are contacting customers who are behind on their mortgage payments or who may be facing adjustable rate mortgage resets. Through telephone calls, direct mail, e-mail, and interactive web sites, these companies are letting customers know of the various options at their disposal for anticipating and managing the challenges that accompany a mortgage rate reset. These options include affordable refinancing terms and payment plans that will allow borrowers to remain in their homes.

Rather than helping to facilitate refinancing or restructuring of mortgage loans to avoid foreclosure, the proposed changes embodied in S. 2136 will have the opposite effect by encouraging even more people to take the issue to the courts. In fact, the bill moves the entire bankruptcy system backwards and encourages debtors to use bankruptcy not as a last resort, but as a financial management tool.

Bankruptcy provides a fresh start for those that truly need it. This was true before Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) and it remains true today. Recognizing that the bankruptcy system had been providing billions of dollars of debt relief without ever questioning whether filers truly needed relief or to what degree, Congress enacted BAPCPA to help restore personal responsibility and integrity to the bankruptcy system. This legislation

[2] "Do farmers Need a Separate Chapter in the Bankruptcy Code?" *Issues in Agricultural and Rural Finance*, United States

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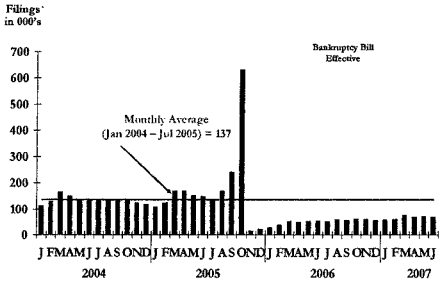
implemented an objective income/expense test designed to ensure that debtors (who earn more than the median income in their state) who can repay a portion of their debt should be required to do so. BAPCPA also requires debtors to receive credit counseling before they are determined to be eligible for bankruptcy. The purpose behind this provision is to ensure that debtors understand the alternatives to bankruptcy and the consequences of filing for bankruptcy. Debtors that do eventually file for bankruptcy are required to participate in a financial management course prior to receiving their discharge, thus helping them avoid future financial difficulties.

In the nearly two years since BAPCPA became effective, average bankruptcy filings have fallen to roughly half of what they were prior (see chart at right). This is evidence that borrowers are, in fact, employing alternatives to bankruptcy. It also indicates that debtors are reaching out to lenders to try and negotiate workable repayment plans. Moreover, it suggests that debtors are no longer looking at the bankruptcy system as a financial planning tool and abusing the protections it affords.

Pre- and Post-Bankruptcy Filing Rates



Source: Administrative Office of the U.S. Courts

The lower number of bankruptcy filings since the law became effective also verifies the notion that many debtors who seek bankruptcy protection actually have the ability to repay at least a portion of their debt. Since enactment of BAPCPA, the share of Chapter 7 bankruptcy filings relative to all filings (in Chapter 13 and Chapter 7) has also declined considerably (see chart below). In the years leading up

Department of Agriculture, Economic Research Service, October 1997.

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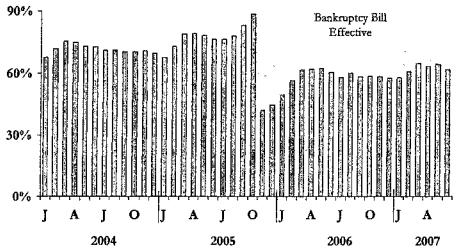
to enactment of BAPCPA, the share of Chapter 7 filings was nearly 73 percent. Since enactment of the new law, that share has fallen to just over 60 percent.

Effect of Bankruptcy Bill on Chapter 7 Filings

Chapter 7's as a Percentage of Chapter 7's & 13's



Source: Administrative Office of the U.S. Courts

If the current bankruptcy law is altered so that judges are allowed to modify the terms of home mortgages for primary residences in Chapter 13 bankruptcies, the potential for cram-downs, lowered interest rates and over-extended repayment periods will once again allow debtors to use the bankruptcy system as a financial planning tool rather than a tool of last resort. In fact, lawyers for debtors will aggressively advertise that they can significantly reduce mortgage terms for bankruptcy filers. Given that mortgages are the biggest asset for the vast majority of debtors, the promise by lawyers to reduce borrowers' housing payment obligations significantly while still being able to remain in their homes will attract not just those who are truly in need of a fresh start, but others also – including those that are current on their mortgage and "investors" that were attempting to flip houses and now want to be bailed out of a bad investment.

III. Credit Counseling is an Important Component of the Bankruptcy Process

Filing for bankruptcy remains an important avenue for debtors that truly need a fresh start. However, many individuals still do not fully realize that options other than bankruptcy are available to them – including working with lenders to find an appropriate payment plan on the debt. Many bankers

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have told us that prior to the change in the bankruptcy law, the first time they knew that a borrower was having difficulty was when they received the bankruptcy notice. These banks did not have ample opportunity to address this situation and help the borrower avoid bankruptcy.

The pre-filing counseling requirement has helped reduce the filings and facilitate workouts. While it is too soon to fully know the impact of this requirement, the early indications are the individuals, once they are aware of options, choose a path other than bankruptcy. In fact, the United States Trustee office found that between October 2006 and June 2007, 14 percent of individuals that completed the credit counseling requirement did not end up declaring bankruptcy.

Credit counseling provides an important independent source of information for debtors about the process and can confirm or deny the information provided to them by bankruptcy lawyers (who have a financial incentive to push the individual to file rather than having the debtor work out another solution). Credit counselors are well versed in housing assistance that can help a borrower save his or her home without filing bankruptcy. Many counselors are associated with a HUD-Approved Housing Counseling Agency. Moreover, to the extent that borrowers did not fully understand the terms of the mortgage that they signed, credit counseling can be the first step in helping to educate them about alternative mortgage options, ways to avoid taking on obligations beyond their means, and even to discuss whether owning or renting is more appropriate for their situation.

Thus, eliminating the credit counseling requirement would be against the interest of debtors and lenders. Furthermore, the bankruptcy code (Section 109) already allows judges to waive this requirement for "exigent circumstances" where the debtor has sought counseling from an approved non-profit counseling agency but was unable to receive such assistance within five days. Moreover, there is ample time between the initiation and conclusion of a foreclosure action to receive the required counseling.

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Conclusion

Lenders are currently working to help individuals that are experiencing difficulties meeting their mortgage payments, or will have difficulties when their adjustable mortgages reset to higher interest rates. However, should this bill be enacted, it will be much more difficult to work with borrowers to do this and it will make it harder for people to obtain new loans or to refinance their existing mortgages. Interest rates will be higher and underwriting will be tightened, making it difficult to qualify for new loans.

While we appreciate the desire of the Committee to find helpful solutions for homeowners that are having difficulty meeting their mortgage payments, the proposed changes in the bankruptcy law will make it more difficult for those homeowners in financial distress or facing higher interest rates to refinance – just the opposite of what is needed in today's market. For other borrowers, S. 2136 will end up increasing the cost of obtaining a mortgage loan and reducing the availability of mortgage credit – particularly to those with lower incomes, weaker credit and smaller downpayments.

Rather than introduce tremendous new uncertainty into the mortgage markets by eroding the value of collateral in the bankruptcy process, Congress should instead work to bring non-bank mortgage lenders up to the standards already in place for the banking industry. The ABA – and all of our member banks – wants to be part of the solution and we stand ready to work with this Committee to effect positive change.

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STATEMENT OF STEVE BARTLETT
ON BEHALF OF THE FINANCIAL SERVICES ROUNDTABLE

This hearing is about whether Congress will empower bankruptcy judges to re-write home mortgages, after the fact. Such an action would not help homeowners. Giving judges such sweeping, unchecked power will only make mortgages more risky and therefore more expensive. Those with less than perfect credit would be priced out of homeownership, and even those with perfect credit would pay higher rates. In particular, proposals to grant this power to judges for debtors who are fully current on their mortgages representing a dramatic increase in risk for lenders and investors.

Chapter 13 as it currently stands is an effective government program. One prominent bankruptcy lawyer argues on his website that Chapter 13 is effective at saving 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. 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.

Radical, risky reforms to Chapter 13 will have the effect of increasing risk for lenders to an unacceptably high level S. 2136 would authorize bankruptcy judges to unilaterally reduce the loan amount of any mortgage and covert 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. The way S. 2136 is drafted, cram down of mortgages can happen even if the debtor has projected income sufficient to pay the mortgage under its original terms. This will dry up credit for many Americans who may not be able to afford these higher rates.

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If courts can simply reduce the value of collateral, a mortgage loan can effectively become unsecured and dischargeable Lenders will accordingly 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.

Similarly, it would be highly unwise for Congress to give bankruptcy judges unlimited discretion to effectively re-amortize loans. S. 2136 could do just that by stretching payments to mortgage lenders over longer periods 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 break-through voluntary work-out programs currently being developed by the Treasury Department could be disrupted if Chapter 13 were modified to give bankruptcy judges unlimited discretion to modify loans. After all, if a borrower – any barrower, even a solvent borrower who is current on a prim and fixed-rate loan – can simply file for bankruptcy and a judge could re-write almost all aspects of the loan – as S. 2136 proposes to do – there is a greatly reduced incentive to work things out with a lender.

I am truly mystified by the idea that Congress would exempt homeowners from counseling as a pre-condition for filing bankruptcy. Counseling can help save homes. It is therefore counterintuitive to remove the counseling requirement for homeowners as S. 2136 would do. I urge the Judiciary Committee not to deprive homeowners of the financial training and education that comes with high quality counseling.

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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 dreams of homeownership. Bankruptcy law revisions must not have the effect, even if unintended, of reducing liquidity that flows from the secondary market. Mortgages are now routinely pooled and sold to third party 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. In recent times, the capital markets have been making a much larger pool of capital for home mortgages. But if enacted, S.2136 could have a de-stabilizing effect on the mortgage markets and punish innocent investors who purchased mortgage-backed securities in good faith.

The Roundtable, through its 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 hard to develop proactive strategies to prevent foreclosures. No one wins from a foreclosure.

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® America and the Homeownership Preservation Foundation known as HOPE NOW. 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 have aggressively adopted new programs and products to address the specific difficulties

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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.

In 2007, HOPE NOW counselors have already fielded over 150,000 calls from at-risk homeowners, with almost 60,000 of those completing counseling. That is, over 150,000 Americans have had the opportunity for free counseling and about 60,000 borrowers have been able to stop a foreclosure. In the last week of November alone, over 9,000 homeowners contacted HOPE NOW Care counseling. I think these numbers clearly show that the private sector is working overtime to reach troubled homeowners.

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 has worked well at saving homes while preserving access to mortgage credit and paying unsecured lenders after satisfying secured debt. S.2136 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.

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Testimony of

Hon. Thomas B. Bennett
United States Bankruptcy Judge
United States Bankruptcy Court for the Northern District of Alabama
Birmingham, Alabama

before the
Senate Committee on the Judiciary

"The Looming Foreclosure Crisis: How To Help Families Save Their Homes"

December 5, 2007

Chairman Leahy, Presiding Member Durbin, Ranking Member Specter, and Members of the Committee, I want to thank you for the opportunity accorded me today. It is with pleasure and humility that I speak. The pleasure arises not just from having one of my home state Senators, Senator Sessions, on this Committee. It also comes from the fact that Ranking Member Specter lives in the city where I attended elementary through high school at Girard College while he served as an active District Attorney for Philadelphia and Assistant Attorney General for Pennsylvania. In similar fashion, I have great affinity for Committee Member Whitehouse's Rhode Island and the welcome given to my daughter and me by the university she attends in Providence. The same is true for Member Kyl and the fact that he represents a state where I have maintained a residence for a number of years while another of my daughters strives to join the Senator as a Wildcat alumnus. There is also the status I share with Member Cornyn as an almost three decade member of the State Bar of Texas which I joined shortly after serving as a law clerk for a former chief judge of the old United States Court of Appeals for the Fifth Circuit, the late John R. Brown. There is additionally the fact that I hold undergraduate and graduate degree from West Virginia University in a discipline, economics, in common with Committee Members Cardin, Durbin, and Brownback. It is also an area that I have taught on the university level in what some refer to as a prior life and which I have continued to explore by studying its intersections with the law with the help of, among others, an economist, non lawyer, professor emeritis at the University of Virginia Law School which holds among its graduates Senators Kennedy, Cornyn, and Whitehouse. Then there is the law for which I hold another degree from West Virginia University. In this area of endeavor, one of my former professors for whom I have the greatest respect and who has had great impact on my life as a lawyer by the insights given me during his first years as a law school teacher some thirty years ago was later enticed to join the faculty of the John F. Kennedy School of Government as the Frank Stanton Professor of The First Amendment which is part of the alma mater of Senators Schumer, Kennedy, Feingold, and Kohl.

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Perhaps the greatest portion of the pleasure and reason for humbleness is that I am able to convey a few of my thoughts to a Committee composed of individuals who have dedicated a significant portion of their professional lives to the people of the United States. It is also due to the difficult challenge the issues being discussed today presents to each of this Committee's Members and the Members' bipartisan willingness to attempt to assist those in great need which is evidenced by the proposal sponsored by Senator Durbin and another put forth by Senator Specter. These are reasons why I thank each you for your service and urge others to thank all of you.

A few caveats to my remarks are warranted. I want to make clear that I am expressing my views. They are not those suggested to me by others. Similarly, I appear in my individual capacity and not as the representative, member, or officer of a group or an organization.

As you are aware, there has been an increasing number of foreclosures of residential real properties which are the homes of Americans. The current projections are that this upward trend may continue into at least the early portions of 2008. One of the perceived and real reasons for this is the number of mortgage obligations with adjustable interest rates which have and will adjust upward. Another is the fact that loans to purchase residences were made to some to whom they should not have been made. Coupled with these are the contentions–which are undoubtedly correct in some instances and wrong in others–that less than pristine lending practices were involved in some of these extensions of credit. It is in this context that this Committee is exploring ways to help some of those with the greatest financial distress, those who file bankruptcy. However, this is only a segment of the group facing foreclosures in the near future.

Reach And Effects Broader Than Possibly Desired When Viewed By The Part

Let me start my more substantive comments with an overview. I am here to urge caution and restraint in doing anything which attacks what is only a portion of a greater problem. Today, we are at or near the cusp in the slope and magnitude of the direction of what will happen in our economy. The increase in the number of mortgage foreclosures is both a symptom of a deeper rooted problem and a portion of the cause of it. What makes your task all the more difficult is the lack of complete and accurate information regarding various factors both relevant and material to the steps, if any, which should be taken to address one symptom, increasing mortgage foreclosures, without exasperating what is the perceived greater problem of a seizing in the credit market. I say perceived because it remains to be known whether this is the real problem or just another symptom. This imperfect knowledge is some of what creates difficulty in attempting to solve part of the mortgage foreclosure rise through the bankruptcy laws and has an inherent risk of aggravating a cause of the rise in a fashion that may do further harm to those you desire to assist and to many more not contemplated to be affected by the proposed legislation.

Yet another facet of your dilemma arises from the fact that conceptualization of the symptom, the cause or causes, and the solution or solutions is founded on the primary analytical tool of lawyers, judges, and legislators: words. As our counterparts in other professions have

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learned, verbal analysis has limits which we who deal in laws frequently do not take fully into account. This is especially true of those in my profession, lawyers and judges. What we do is the perverse of those who develop rules and laws using more quantitative and scientific means. We take one perceived set of fact which is a mere subset of a global set and develop a rule or law to be applied to all factual variations within the global set with no way of knowing whether it will or will not work for the majority of matters which are within the global set. When the rule or law does not work for a variant on the subset of fact, we attempt to either exclude the application of the law by distinguishing the given fact set so it is outside the global set or piecemeal alter the rule or law to make it work for more of the factual variations within the global set, but still not necessarily all of them. Rules or laws developed using quantitative methods such as econometric modeling are not by any means perfect. However, the methodologies do allow one to take into account to a greater degree more of the variations within a global set while simultaneously seeing how different treatments may affect the whole.

This highlights one of the issues confronting you today in your consideration of the proposed legislation. Each bill is believed to be designed to operate only within the context of bankruptcy. Unfortunately, this is not the case. Even if the application of these bills could be contained to be within the bankruptcy context, the focus of both bills is verbally on the relationship between bankrupt borrowers and those who own the residential mortgage secured obligations. This is only some of those impacted by the legislation. Indeed, the application of both bills is not limited to the category of mortgage debts which is a significant reason for your greater focus on foreclosures: adjustable rate mortgages mostly originated in what is called the sub-prime market. This is because both S. 2133 and S. 2136 apply to all categories of mortgages due to the fact that the determination of which mortgages may be altered in principal, interest, and/or certain fees and charges is premised on a debtor's income, not the type of mortgage. For S. 2133, it is whether one is below the applicable category of median family income. In S. 2136, the calculus is current monthly income and disposable income as determined via sections 1325(b)(3) and 707(b)(2)(A) & (B) of the Bankruptcy Code. S. 2133 limits its application to principal residence mortgage obligations for those below certain targeted amounts of median family income. This operates to exclude those who are relatively more well off than those with less income. By contrast, S. 2136 has no such limit. In fact, one with a relatively high income coupled with large non-mortgage secured debt payments would be able to utilize S. 2136's principal residence mortgage modification provisions.

Some of why both bills go beyond their targeted purpose arises from what has happened in the residential lending and borrowing market over the last thirty or so years. As the residential mortgage loan market expanded from a more local to a national and then international market aided, in part, by federal banking and interest rate/usury law alterations, the mortgage loan products were designed over time to become more and more like a commodity and then into multiple commodities by splitting the ownership of what was once one loan with a principal and interest payment into multiple ownerships of portions of the aggregate amount repayable over the life of the loan. The result for purposes of this part of the discussion is that the ownership of a residential mortgage debt claim against a bankrupt is frequently not one person or entity. Rather,

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it is many. The limit on how the various portions of a mortgage debt may be subdivided is limited only by the creativity of the person designing how it is to be divided and the market for such debt. There is the potential for multiple portions of the principal of any given debt to be held by more than one creditor and for various portions of the interest stream to likewise be owned by more than one person. At least prior to the alteration of the principal balance, S. 2133 requires agreement of the debtor and the holder of the claim being adjusted. However, it does not similarly require such an agreement on interest rate adjustments or waiver of repayment or prepayment penalties. S. 2136 has no such agreement requirement for any of the modifications allowed for principal residence mortgage debt. Thus, both will potentially affect multiple owners of such debt obligations in varying and different ways.

For instance, one owning only a portion of the interest stream will be potentially significantly, adversely impacted by any adjustment in the interest rate downward. If the downward adjustment is great enough and the portion of the interest stream is sufficiently far from the date of modification–and far need not be more than a few years, not the twenty or thirty some may think–the value of what the owner purchased could be reduced to a small fraction of what was paid for this portion of the mortgage debt even though all portions of the debt are fully secured! Given the right mix of interest rate adjustment, time attenuation from the date of the adjustment, and the portion of the interest stream purchased, it is possible that a creditor's property, its claim against a debtor, could be almost totally eliminated which would mean that the investment/purchase price paid would suffer the same fate. The import is that the implicit assumption that what is proposed will be contained within a one debtor, one creditor relationship is wrong for innumerable of the principal residence mortgage debts within the purview of each of these bills. A similar, though for some, not so dramatic impairment potential arises for those owning portions of the principal balance payment stream. What I describe as changing mortgage secured debts into multiple commodities and selling them to others is the factor which causes differing impairment of property interests of owners of portions of these types of debts and which for owners of some of these payment streams is different from and greater in degree than if the entire unpaid stream of payments were owned by one creditor. It is a matter not contemplated to the extent it should be in the makeup of each of the bills, but more so with respect to S. 2136. It is of extreme importance because the treatment of these commodities representing mortgage debt repayment streams under S. 2136 could for some be a forced diminution in value of Constitutional proportions.

More on why the S. 2136 structure of adjustable rate mortgage debt modification will have greater repercussion on creditors' property interests is that its design is to cause a permanent modification to the mortgage debt repayment stream which results in a decrease in the aggregate current value of all streams of repayment–both principal and interest. It is of necessity greater in amount than the delay and prohibition of an increase in interest contemplated by S. 2133. An example of this result is presented later in these remarks.

Although some may argue that this type of impairment already occurs in bankruptcy, this analogy is misplaced in the context of the extent to which the underlying value of what one

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purchased is impaired. This misplaced analogy compares alteration of what are shorter term vehicle and similar personal property secured loans with terms generally of no more than five to seven years to residential property secured loans with maturities of as much as thirty years and sometimes longer. The diminution in today's value of a part of it by a downward interest rate adjustment on the longer maturity portion of the residential secured debt is dramatically greater than that which occurs with the shorter term portions of the vehicle and other types of nonresidential secured debts.

To give a full view of the degree of any impairment in value which would occur, the Committee should also know that for owners of packages or pools of relatively similar streams of payment constituting portions of the ownership of mortgage secured debts, the loss which would occur from the proposals may or may not be somewhat mitigated by a given pool's makeup. Determination of whether the pool of such mortgage secured obligations lessens the degree in the lowering of property value of a creditor depends on the number of the obligations in the pool which are ultimately modified by the proposed legislation. It does not change the fact that the value will be affected.

This is an example of the external to bankruptcy effects of each bill on valuation. Another is who owns the debt and who stands to lose from modifications to such debts. All owners of the various portions of these obligations are not easy to identify. Even if one could, the fact that one is the owner is not synonymous with the person or entity who/which will ultimately bear any losses from a modification in a mortgage secured obligation through the bankruptcy process. In some cases, it will be the original lender. In others, it will be a subsequent purchaser of some or all of the debt. Still in others, it will be a person or entity which lent money to the owner of the mortgage debt. The persons and entities occupying these categories include financial institutions, retirement and pension plan trusts, individual's IRA and 401(k) accounts, money market funds, and innumerable other persons and entities, public and private. In some instances, it will undoubtedly embrace some of the bankrupts each bill is designed to attempt to help because an IRA or 401(k) or similar exempt property held, maybe unknown to the bankrupt, either directly or indirectly, an interest in such residential mortgage debts. The scope and extent this may occur is not the primary thrust of this point, nor is the impairment discussion in the prior paragraph. It is that these are factors on which we do not have sufficiently accurate or reliable information. A multitude of others exist. The next important aspect is the potential created by the imperfect nature of information we possess and what its impact may be on the relevant market.

In our economic system, the degree of information and its accuracy are factors which bear on the equilibrium between the supply and the demand for a product including mortgage secured loans. Changes in the amount and accuracy of information can have both positive and negative impact on supply and demand for a product. To the extent that the proposed legislation makes less certain and less accurate knowledge available to the market regarding various aspects of the granting of credit, each would cause a shift in the supply of credit if all other factors remain unchanged. In more technical terms, the shift in the supply curve would be to the left and

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upward which means that the supply of credit at any given interest rate will be less. Another way of looking at it is that the uncertainty is viewed as increased risk which some suppliers of credit will not take and others will not incur at, in terms of these bills, at the rate of interest or price which was the equilibrium point for supply and demand which existed before enactment of one of these bills.

Why this is important is that the implementation of the policy behind each of S. 2133 and S. 2136 is left to thousands of very bright attorneys and hundreds of equally competent judges. That there will be lack of consistency in application of these provisions is evidence by what was and remains the lack of uniformity in how confirmed Chapter 13 plans differ on what the appropriate interest rate adjustment should be for vehicle and other nonresidential secured debts. This mixed application of interest rates for vehicles and other personalty secured loans exists even after years of variation and following a ruling by the Supreme Court of the United States on the issue of what is an appropriate interest rate. At a minimum, this most likely means that there will be an extended period of uncertainty in the market regarding what will happen to principal residence mortgage loans when the bankruptcy of the borrower ensues. In other words, it creates greater inaccuracy in information and greater potential risk for the lender. Should the other factors affecting supply and demand for such credit remain unchanged, one can expect that the supply of credit will decrease and its cost increase. However and because the informational and risk factors created by enactment of either of these bills in their current formulations will have to be assessed by lenders making loans to those not in bankruptcy, but all potential candidates, the market for the assessment of those supplying credit and at what price is the broader market for credit. It is not limited to one, if such a sub-market exists, involving only bankrupts. What this represents is a potential for the decline in credit available to everyone and the prospect of an increase in the cost of obtaining credit from what it would otherwise have been. This is the risk inherent in all imposed regulation of markets for goods and services.

In times when credit markets are less skittish, the result of such bankruptcy legislation might not be as significant as it could be in the current state of the credit market. Essentially, the likelihood and cost of making a mistake may be far greater than in more stable market conditions. The question is whether such a chance should be taken by adjustment of bankruptcy laws without reference to the whole market for credit which includes non-bankrupts. This also entails the question of whether even very bright and capable lawyers and equally competent judges should be the implementors of bankruptcy laws which may involve their application to a large percentage of the current and future mortgage loan defaults using laws which give great discretion as to how each version, if enacted, would be applied. I respectfully suggest that a change, if any, focused on only a portion of a bigger market for credit should not be so undertaken and that any policy regarding how to deal with adjustments of interest rates on mortgages should in the first instance be assigned to those equally bright and capable professionals with the knowledge and training appropriate for the mission. I believe these professionals should not be lawyers and the courts. It is an unfortunate, but true, fact that the overwhelming majority, if not almost all, lawyers and judges have not had the training and education in both degree and quantity to become and remain sufficiently knowledgeable in

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virtually all technical and scientific matters, including economic ones, which is why our formalized legal system encompassing our courts is being avoided to an ever increasing degree.

As indicated an objective of this piece of my comments has been to point out that there is implicit in how S. 2133 and S. 2136 treat all mortgage debts that they are owned as a complete unit as was the case some decades ago. To a substantial degree, this is not the case today. The overarching reality is that the expansion of the market for credit has occurred in part by an alteration of how mortgage secured obligations are funded and owned. It is the failure to take this reality into account which creates many of the legal and economic problems inherent in how each of these bills may be implemented. This reality is also why in my initial comments I expressed how difficult the task is that this Committee's Members face. It is also a ground for my opinion that one should not use the insular arena of bankruptcy to propose a believed correction for the increase in foreclosures by amendments to the Bankruptcy Code, 11 U.S.C. § 101 et seq., when the result will have implications of potentially great moment beyond the context of what is trying to be achieved. Rather, and if anything in the nature of what is proposed should be done, it more appropriately needs to be from a view that is not limited by the confines of what is in and added to our bankruptcy statutes. This also highlights my point regarding verbal analysis. It is far too easy when discussing an issue in what is part of the framework to the exclusion of the whole to miss sometimes subtle, yet important details. Because of time constraints, I have limited my comments in this section to what is an overarching problem. Other equally subtle, yet consequential issues exist.

Technical Comparions: Mortgages In A More Limited Way Compared to Mortgages And More

There are other difficulties which are revealed by examination of the details of each bill. Unlike S. 2133, S. 2136 mandates that all mortgage debt be modified by the language of the enacted section 1322(a) that a plan "shall" do certain things joined with the proposed wording which would be a new section 1322(b)(11) set forth in Title I, section 101(a)(3) of the bill, calling for modifying an "...allowed secured claim secured by the debtor's principal residence..." This modification potentially includes the interest rate for and the term of the loan. Because as drafted it is a required provision of a plan where the bankrupt debtor is below the current monthly income as calculated under S. 2136 via sections 1325(b)(3) and 707(b)(2)(A) & (B), this provision may have the effect of requiring an increase in the interest rate of an adjustable rate mortgage secured loan where the loan rate is lower than that specified under the adjustment in S. 2136. Furthermore and by converting the interest rate to a fixed one, the bill prevents a future potential decrease in what was an adjustable rate. In a declining interest rate market environment such as the one we are currently in for at least the short run, this means that for some the legislation would increase the interest rate instead of what would have been a decrease. Furthermore, this interest rate increase would become the rate for the residual term of the loan. This change to a fixed, increased rate of interest under S. 2136 in one Chapter 13 would not be subject to a future modification in a subsequent Chapter 13 because once the interest rate is altered to be a fixed one it is outside the scope of S. 2136's adjustment mechanism. This happens for some mortgage secured debts due to the fact that the adjustment as proposed in S. 2136

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applies to all types of adjustable rate mortgage debts, not just those with initial teaser rates set below the prevailing market rate.

This scenario is all too likely for some because it has already happened in a similar context under existing Bankruptcy Code provisions. By way of example, the Bankruptcy Code provision which allow adjustment of the interest rate on vehicle loans, among others, to be at prime plus a so-called risk increase of some magnitude above prime has been successfully utilized by holders of motor vehicle secured debt to increase interest rates on loans that were made at zero and other rates lower than the market rate of interest. Thus, the possibility of this occurring under S. 2136 is not mere speculation. Since S. 2133 does not change an adjustable rate of interest to a fixed one and does not direct that the rate be calculated based on an indexed rate plus an upward risk adjustment, its application will not mandatorily increase the rate of interest on a mortgage debt. It allows for the stopping of a change or the delaying of a change which avoids the potential for an increase like the one which may happen under S. 2136.

Unfortunately S. 2133's design, as that of S. 2136, does not contemplate that rates may decline under the adjustable regime and, as a result of the "shall" language in section 1322(a) would require as currently drafted the delaying or prohibiting of an adjustment which would benefit a borrower. In its favor, S. 2133 does not impose a permanent fixing of the rate of interest for what could be almost thirty years. This would be of great importance should the interest rate atmosphere for credit be on a long term downward trend after the fixing of interest on a mortgage loan under the proposed legislation. One does not need to go back to the depression era of the 1930s to find examples of sustained low interest rates. More recent examples are Japan until relatively recently and the United States in the 1950s. The argument that should this occur the borrower could refinance his or her mortgage does not hold the answer. In such an atmosphere, the ability of a bankrupt debtor to quickly and at lower cost obtain refinancing is not assured. If there is a bright side to any long term downward trend in interest rates for credit, it is that the reduction in the owner's value of any portion of residential mortgage debts caused by S. 2136, and to a lesser degree by S. 2133, could be reduced and in certain instances eliminated.

These sorts of issues also demonstrate that there are almost always unintended consequences to the amendment of any statute, especially one which has become overly complex and technical by numerous amendments since its original enactment in 1978. Further changes of the sort contained in the proposed bills which make the Bankruptcy Code more complex and technical causes more uncertainty in outcomes which means greater risks to creditors and the concomitant potential for a restriction in the supply of credit to all borrowers along with increased costs to borrowers and lenders of all ilk, not just those involved in bankruptcy cases.

Although the discussion so far has been fixed on broader concerns entailed by enactment of the bills' adjustment of principal and income portions of residential mortgage debt obligations, a look at the technical aspects of each reveals important differences between the two. It also highlights problems within each, though more so with S. 2136 than in S. 2133.

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The most obvious difference between S. 2133 and S. 2136 is that S. 2133 is more constrained in its approach. It is purely limited to the adjustable interest rate mortgage debt issues and has a temporal limitation of seven years as a statutory provision and longer on the time it allows alteration of both mortgage debt principal and interest repayment. At least with respect to the adjustment of the unpaid principal balance of a mortgage secured debt, it allows it to occur only with the written agreement of the debtor and the claim holder.

S. 2136 on the other hand encompasses a far wider undertaking. It not only deals with the mortgage debt adjustments previously mentioned, it also does not have the sunset provision of S. 2133 and allows its adjustments to be spread over up to almost three decades. The mathematics of the costs to creditors and of their losses by such an extension coupled with any decrease in the contractual rate of interest is potentially far greater than that which might be wrought by application of S. 2133. Unlike S. 2133, the modifications required under the language of S. 2136 do not require the agreement of any owner of any portion of the principal or income streams of mortgage secured debt.

Both S. 2133 and S. 2136 have language designed to eliminate what are called prepayment penalties and also an early repayment penalty is within S. 2133. Although my remarks on this issue may not be a well received comment, they should be made. The dislike for these sorts of provisions in mortgage secured debt is that they can be of such a dollar magnitude that refinancing or other form of early repayment or prepayment either is prohibitive or makes no current economic sense. That these sorts of agreements have this effect is indisputable. There is another side to this type of commitment by a debtor in obtaining credit. It is that absent this agreement, she, he, or they would not in some and may not in other instances have been able to have obtained credit or credit at the price which was paid. Now recall the overarching reality that a lot of mortgage secured debt is no longer held by one owner and that it is frequently owned not just in streams of principal repayments and interest payments, each of which can be subdivided. This ownership format is an aspect of how the credit market has been able to expand and represents a reason for these types of requirements: it allows one to better assess the risk of gain and loss from ownership of a portion of a stream of payment of a debt. In other words, it is part of the calculation of what one will pay for ownership of one or more of the streams of principal and interest which in the aggregate constitute the complete mortgage secured obligation. Without this charge on early payment, the cost of what was obtained by the borrower would most likely have been greater or the borrower would not have obtained the loan in the first place. This is another of those subtle issues of importance which make your task more difficult because any unilateral ability to eliminate these provisions will make the obtaining of credit both more difficult and more costly for many beyond those who are bankrupt.

Both bills have language which may limit collection of fees, costs, and other similar charges. However, how each treats what is limited and the range of what is limited is different. S. 2133 applies to a substantial failure to disclose material terms regarding interest, late fees, or other fees related to a claim secured by a security interest in a debtor's residence. If such a significant failure to disclose has occurred, S. 2133 treats monies received for interest, late fees,

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or other fees related to the claim as a constructively fraudulent transfer under section 548(a)(1)(B) of the Bankruptcy Code. If such a significant failure to disclose has not occurred, this subsection of S. 2133 has no application to interest, late fees or other fees related to such a claim. It is broader than S. 2136 to the extent that it includes interest payments. It is narrower because it is constrained to the pre-bankruptcy period by its inclusion in section 548 governing fraudulent transfers which by the makeup of the Bankruptcy Code occur only before one files bankruptcy. By way of contrast, S. 2136 concerns only such fees, costs, or other charges for the after bankruptcy period and disallows them for all principal residence secured debt when the value of this security is less than what is owed. S. 2136 also would permit disallowance of such fees and charges for an over secured creditor if the required notice to the court is not timely given or the court makes a determination that they are not one or more of lawful, reasonable, and provided for in the underlying contract. The allowance of these sorts of items is only following an affirmative determination of the court under S. 2136 whereas S. 2133's limitation is not mandatory as is evidenced by its "may treat" language.

There is curious interpretation of the language of S. 2136 regarding the disallowance of fees, costs, and charges which might be incurred after one files bankruptcy. It is that the wording of what is to be added to section 1322(c) of the Bankruptcy Code allows the addition of these to a debtor's Chapter 13 plan's treatment of the secured debt if the proper notice to the court is given joined with the finding that they are lawful, reasonable, and provided for in the contract, but literally disallows collection of these fees, costs, and charges after the end of the bankruptcy case only for failure to give the required notice to the court during the bankruptcy case. If the required notice was given, the collection of these is not necessarily precluded.

The balance of what is Title II of S. 2136 is where other, greater deviations from the application of what S. 2133 is limited to happens. They are in the "Providing Other Debtor Protections." The one in section 202 of S. 2136 amends section 554 of the Bankruptcy Code by adding a new subsection (e). It has the effect of materially undoing section 554(d) dealing with administration of property of a bankruptcy estate which has as its correlates the legal principle of standing and the developing case law on judicial estoppel for failure of a debtor to schedule an asset.

The current status of one component of the law is that property of the estate defined under section 541 of the Bankruptcy Code which a debtor does not disclose and which is not otherwise dealt with during the pendency of his, her, or its bankruptcy case–the technical term under the Bankruptcy Code is administered--remains property of the estate after the debtor's bankruptcy case is over and closed. This causes the property which is not administered during the pendency of a bankruptcy case to be, for want of a better description, locked in a bankruptcy case and deprives one not the representative of the bankruptcy estate of standing to assert such a claim and certain types of defenses. When this happens with a claim or certain defenses which an individual debtor wishes to assert against another person or entity, the debtor lacks standing to assert the claim or defense unless and until the representative of the estate, generally the trustee, either decides to prosecute the claim or defense on behalf of the estate or to not do so. If the

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trustee decides not to prosecute known claim or defense, it is effectively administered and will revert back to the debtor. Following this, the debtor will have standing to assert the matter. This reversion may require an abandonment under or may by the provisions of section 554 be deemed to revert to a debtor. In a closed bankruptcy case, this may occur with unadministered property of the estate only after a reopening of the bankruptcy case. This formulation of what property interests a debtor may prosecute is not new to the Bankruptcy Code. Its origins and case law decisions on this issue go back at least to the Bankruptcy Act of 1898. The defense of lack of standing because a claim and certain types of defenses have not been scheduled in a bankruptcy case is frequently asserted by parties to litigation. This defensive maneuver does not without more forever bar one, maybe not the debtor, from asserting the claim against another.

The other element of the law which section 202 of S. 2136 is designed to address is a body of case law which has prevented debtors who fail to schedule a claim and certain types of defenses from ever asserting them in a court proceeding. It is the case based doctrine of judicial estoppel. For brevity and somewhat simplistically, this judicial doctrine developed to prevent a party to a court proceeding from playing fast and loose with the judicial process by taking inconsistent legal positions in different legal proceedings. Part of the recent evolution of the application of this doctrine to those who have been bankrupts occurred in the Alabama's courts and shortly thereafter in the United States Court of Appeals for the Eleventh Circuit. Since the Eleventh Circuit's holdings in recent years, other United States Courts of Appeals and lower federal courts have also used judicial estoppel to prevent a debtor who did not schedule a cause of action or similar matter on his or her bankruptcy schedules from asserting it in a subsequent lawsuit. The unfortunate aspect of some of these decisions is that the issue of judicial estoppel should never have been reached because the causes of action were barred for want of standing by the former bankrupt, now claimant who failed to have the undisclosed property interest of the estate disclosed and administered. Just why judicial estoppel was pushed by the defending litigants in lieu of the lack of standing is that the judicial estoppel bar is a permanent one against the former bankrupt while the lack of standing is generally only a temporary bar or stalling in the prosecution of the litigation. Judicial estoppel of this sort has been gaining wider application by the courts in recent years and has become a staple of the defenses asserted by opposing litigants. Because of the greater use of certain types of lawsuits by plaintiffs, both judicial estoppel and the standing defense arising from a cause of action not having been administered in a bankruptcy case have made prosecution of many lawsuits by a debtor more difficult and often impossible.

What section 202 of S. 2136 tries to do is alter the dynamics of what the current state of case and statutory law is for individual debtors who fail to disclose property interests which are those belonging to a bankruptcy estate. It imposes on the trustee of a bankruptcy estate a requirement to take action within what is called a reasonable time to join a pending lawsuit. If the trustee does not join the suit by joinder or substitution, the debtor who failed to disclose the property interest is given standing to assert the action and the doctrine of judicial estoppel is made inapplicable. Although it may be an oversight, the language of this section of S. 2136 does not encompass such causes of action which are not the subject of a pending lawsuit. It will thus leave the existing case law and statutory law unchanged until a lawsuit is filed. Although not

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delineated in section 202, the literal language deprives the representative of the bankruptcy estate of a the ability to prosecute avaluable property interest even if the trustee does not know of its existence. This is the result of not fixing the "reasonable time" to join or substitute from when the trustee learns of the existence of the claim. Additionally and when dealing with an already closed bankruptcy case, there is no trustee to join or be substituted into a lawsuit. This presents the question of whether this section applies to closed cases. If it does, there is no trustee to join or substitute until after the case is reopened and a trustee is appointed. Lastly and due to the placement of this section in section 554 of the Bankruptcy Code which is captioned "Abandonment of Property of the Estate," is the intention of this legislative language to the effect that once a trustee does not join or substitute within a reasonable time in the pending litigation that the property interest of the bankruptcy estate is abandoned to the debtor or is something else contemplated?

Section 203 of S. 2136 undoes the federal statutory enforcement of arbitration of claims and causes of action and its enforcement by courts, including bankruptcy courts, for what are defined as core proceedings in a bankruptcy case of an individual debtor with primarily consumer debts. The range of application of this section of the bill is subject to debate and will engender litigation. This is in no small part due to the fact that the jurisdictional grant to bankruptcy courts as distinguished from Article III courts has been subject to much litigation. Any provision of this nature will most likely only increase the number of cases involving jurisdiction issues.

There are two more sub-parts of S. 2136 which complete Title II's "Providing Other Debtor Protections." One is the creation of a new federal exemption for a principal residence of a debtor or dependent of a debtor. It is available to a debtor who is 55 or older who files bankruptcy and is limited to an aggregate amount of $75,000.00. It creates a new, stand alone exemption for those who are entitled to use non-section 522(d) federal exemptions along with state law exemptions. Similarly, it adds to section 522(d)(1) an identical exemption under the federal exemptions for those persons in jurisdictions which did not opt out of the federal exemptions of section 522(d). This represents a meaningful attempt, though partial in application, to bring back exemptions to where they once were. I applaud this attempt because I hold a different view for why bankruptcy case filings increased in the years prior to the 2005 enactment of the Bankruptcy Abuse and Consumer Protection Act. Part of the increase, maybe a large one, comes from the degradation of state exempt property amounts by the passage of time and the influence of inflation without sufficient–and in some cases, no–increases in the exemption amounts. In some jurisdictions, exemption sums have not been increased for over a century. In others, what did shield most, if not all, of a debtors property sufficient to ensure the ability to have at least a minimal standard of living free from interference of creditors no longer does this, let alone give one the fresh start that is one of the long standing goals of our bankruptcy system. This has left many debtors with only one workable avenue to attempt to rehabilitate her or his financial affairs: filing a bankruptcy case. To my knowledge, no one has done a quantitatively meaningful study of how the degradation of exemptions has influenced bankruptcy filings.

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I do not have a similar opinion regarding the last of the consumer protections in Title II of S. 2136. It is section 205 "Disallowing Claims from Violations of Consumer Protection Laws." It purports to allow one in bankruptcy to contest the allowance of some or all of a creditor's claim which is part of a mortgage transaction regardless of what another court may have already adjudicated. For one subset of consumer protection law founded claims and defenses, it strives to undo a basic principle of our jurisprudence, the finality of judgments of courts of competent jurisdiction, when it comes to the allowance or disallowance of any claim. Its grasp is also not just mortgage debts secured by principal residences of debtors. The reason is that although not as universally used today, a mortgage has been and may still be used as a security vehicle for non-residential personalty as well as both real and personal property interests used as one's principle residence. The undoing of the principle of finality of a judgment which includes within its swath claims known to have existed which were not raised in jurisdictions which use judicial foreclosure. These are collectively referred to under the terminology of preclusion. Adding to the problematic nature of this section is the fact that arguably there is no time limit placed on its application. When a foreclosure judgment has been rendered that there is no time limit is clear. More elusive is that fact that the language effectively makes Truth in Lending Act and all other applicable state and federal consumer protection claims in force when the offending act happened a basis for the disallowance of the creditor's claim in bankruptcy regardless of whether it could be so used outside a bankruptcy case.

The refinement in this language is that it allows offensive claims and certain defenses to a creditor's claim which are barred by a statue of limitations or similar limitation. It would at the same time do the same for purely defensive contests to claims of creditors arising from the same transaction or the same occurrence which is called recoupment. It is, however, unnecessary for preservation of recoupment as a defense to a claim. As a general rule, recoupment is not barred by a statute of limitations. So, this provision of S. 2136 is not directed at putting into play recoupment as a defense to the allowance of a creditor's claim. It already is and will remain one without enactment of this legislation. What it is designed to do is to do away with time limits placed on the offensive types of claims and defenses which a debtor may have but cannot use because of the passage of a statute of limitations or similar time bar. This also includes use of the defense of setoff/offset which technically is the setting off of claims which arise from different transactions/contracts or occurrences. It means that a time barred claim of a debtor against a creditor for, say one occurring in the making or collecting of an automobile loan, may be resurrected as a contest to an unrelated consumer mortgage or personalty indebtedness which if successful reduces this otherwise fully enforceable creditor's claim. In fairness to the drafters and in recognition of the difficulty of drafting amendments to what is a highly technical and complex statute, I suspect that the intent of section 205 of S. 2136 is to preserve offensive and defensive means to reduce or eliminate the allowance of a claim of only a creditor which is secured by and arose from a transaction involving a consumer debtor's principal residence. As drafted, though, it does more than this.

Regardless of what one may think of the propriety of what S. 2136 describes in Title II as "Providing Other Debtor Protection," these sections constitute a major difference between the

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ambit of S. 2133 and that of S. 2136. Not only do they make more complex and technical the provisions of the Bankruptcy Code, 11 U.S.C. §101 et seq., some of which have been discussed, they do the same to other federal and state laws ranging from the Truth in Lending Act and its related Regulation Z to a whole strata of other federal and state consumer protection laws and regulations. What time does not permit is discussion of the whether and how these proposals may transmute these other laws and regulations. This, too, should be investigated in advance of enactment of any version of S. 2136. To do otherwise, may create other and as complicated problems in the consumer protection laws and their resulting economic impact as those I have mentioned today from the vantage point of amending the bankruptcy laws.

Having said all that I have set forth, a final comparative comment regarding S. 2133 and S. 2136 is warranted. It is that despite my belief that neither of these bills should be enacted in their present formulations, S. 2133's reach is far less intrusive and creates far less risk of unintended, untoward consequences.

Given the extremely limited time within which I have had to prepare this written testimony, I have not been able to detail all of the problems, difficulties, and nuances presented by each of S. 2133 and S. 2136. Rather, I have attempted to spotlight two general categories for your consideration. One is what is the bigger picture viewpoint of how each piece of proposed legislation will have more far reaching ramifications than those possibly intended. The other is from a narrower perspective of the difference in the details of what each bill tries to accomplish and why each may or may not do so. Also within the narrower category is why what is being suggested does something beyond what was envisioned. I have not made these remarks to foster the adoption of one bill in favor of the other. My purpose is to highlight the very difficult and technical task you are undertaking, to suggest a different approach than contemplated by either bill, and to urge extreme caution and equally diligent restraint on what, if anything, is done. To further these ends, I am willing to further assist by review, comment, or otherwise any and all of the Members of this Committee and its staff in the task of determining how to best help those facing the financial crisis which has precipitated what is the subject matter of this hearing.

Once more, Mr. Chairman, I thank you and the other Members for allowing me to present these views. More importantly and despite any differences in views we may have, I thank each of you for your dedicated service to our Country.

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November 28, 2007

Senator Richard Durbin
United States Senate
309 Hart Senate Building
Washington, DC 20510

Dear Senator Durbin,

I understand that the Subcommittee on Administrative Oversight and the Courts of the U.S. Senate Committee on the Judiciary is considering your bill, S. 2136, the Helping Families Save Their Homes in Bankruptcy Act of 2007 (the "Durbin-Schumer bill"). Apparently an issue has arisen as to whether it is constitutional to apply these amendments to the Bankruptcy Code to existing debts. I have carefully studied this question and am convinced that there is no constitutional impediment to doing this. Throughout American history, new bankruptcy provisions have been applied to existing debts. The Durbin-Schumer bill is consistent with past practices and is clearly constitutional under well established precedents.

I am a law professor and specialize in constitutional law. I am the author of five books, including a treatise on constitutional law, and many law review articles, including several on constitutional issues in the area of bankruptcy law. I am writing because of my interest in this subject and have not been retained or paid by anyone to render this opinion.

Throughout American history, the Supreme Court has held that bankruptcy code revisions apply to preexisting contractual rights. *See, e.g., U.S. v. Security Industrial Bank*, 459 U.S. 70, 75, 80 (1982). Until the late nineteenth century, bankruptcy legislation "took the form of temporary relief measures adopted in response to specific financial crises and [were] repealed when the precipitating cause had passed." Rogers, *The Impairment of Secured Creditors' Rights in*

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Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause, 96 Harv. L. Rev. 973, 1016 (1983). There was no question of whether these acts would apply to existing debts, as this was the legislation's sole purpose. This also has been true for contemporary revisions of the Bankruptcy Code. The current Bankruptcy Code, enacted in 1978, was applied to existing debts, including mortgages, without constitutional problem. Similarly, in 1986 and 1994, the Bankruptcy Code was amended – each time adding categories of mortgages that could be modified in bankruptcy – and each time the amendments were applied to existing mortgages, always without any constitutional problems.

The Supreme Court has expressly held that Congress's power under the Bankruptcy Clause of the Constitution "has been regularly construed to authorize the retrospective impairment of contractual obligations." *See, e.g., U.S. v. Security Industrial Bank*, 459 U.S. 70, 75 (1982). The contracts clause of Article I, section 10, which prohibits states from impairing the obligation of contracts, does not apply to the federal government.

The Durban-Schumer bill impairs no property right because it would permit loan balances to be written down only to the value of the mortgaged property, but not below that value. The Supreme Court held in *Wright v. Union Central Life Ins. Co.*, 311 U.S. 273, 278 (1940), that a creditor has a constitutionally protected property right up to the value of the mortgaged property. However, beyond the value of the mortgaged property, the creditor's claim is a contractual right subject to impairment in bankruptcy without regard to whether the contractual right was created prior to the promulgation of the relevant bankruptcy law provision. Because the Durban-Schumer bill would permit loan balances to be written down only to the amount of the property's value, and because the creditor has no property right to more than that value, the bill does not violate the Constitution.

Two Supreme Court decisions from more than a half century ago clearly indicate the constitutionality of the Durban-Schumer bill. The Frazier-Lemke Act, 9 Stat. 942, 74th Cong., Sess. I., Ch. 792 (Aug. 28, 1935), Sec. 6(s)(5), was a Depression-era bankruptcy statute that provided relief to debt-burdened farmers, by providing both a three-year stay of foreclosure and giving the debtor the right to purchase the property, free and clear of the mortgage, by paying the amount of the property's appraised value – rather than the full amount of the outstanding loan. The Frazier-Lemke Act expressly provided: "This Act shall be held to apply to all existing cases now pending in any Federal court … as well as to future cases…."

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In two important cases, the Court upheld the constitutionality of the Act's provisions applying to existing debt. In *Wright v. Union Central Life*, 311 U.S. 273, 278 (1940), the Supreme Court held that the Frazier-Lemke Act was constitutional and could properly be applied to debts already existing at the time of enactment. The Court stressed: "Safeguards were provided to protect the rights of secured creditors, throughout the proceedings, to the extent of the value of the property. There is no constitutional claim of the creditor to more than that." 311 U.S. at 278.

The Court also upheld the application of the statute to existing debts in *Wright v. Vinton Branch of Mountain Trust Bank of Roanoke*, 300 U.S. 440, 466 (1937), and dismissed a creditor's challenge to the provisions that permitted the debtor to remain in possession of the property during a three-year stay of foreclosure sale. The Court said: "The legislation is designed to aid victims of the general economic depression. The mortgagor is familiar with the property, and presumably vitally interested in preserving ownership thereof .... [U]nder these circumstances, the interests of all concerned will be better served by leaving him in possession than by installing a disinterested receiver or trustee."

It is important to note that the Durban-Schumer bill is far more favorable to creditors than the Frazier-Lemke Act. Frazier-Lemke not only provided for a three-year stay of foreclosure, but it entitled the debtor to remain in possession of the property making only rental payments, and these were to be applied to the payment of taxes and maintenance of the property. Only if any amounts were left over, would they be among the creditors. In contrast, under the Durban-Schumer bill, the debtor could not retain possession of the property without repaying the loan in monthly installments, at an interest rate equal to the prevailing market interest rate plus a risk premium.

As in *Wright v. Vinton Branch of Mountain Trust Bank*, the proposed amendments are designed to assist victims of a severe housing market crisis, and the interests of all concerned are better served by enabling families to remain in their homes rather than to force them out through a foreclosure sale. This solution benefits not only the borrower, but also the neighboring homeowners, whose home values deteriorate with each nearby foreclosure sale. This, in turn, preserves the tax base, which declines both when home values decline and when foreclosed homes are left empty. These accomplishments in no way deprive the lender of any value it could obtain through foreclosure, and guarantee the lender's right to full repayment up to the value of the property.

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My conclusion is that this is not a close question of constitutional law. Quite the contrary, based on historical practice and precedent, the Durban-Schumer bill would be clearly constitutional in its application to existing debts.

Please do not hesitate to let me know if I can be of assistance to you or your subcommittee in any way.

Sincerely,

Erwin Chemerinsky

Erwin Chemerinsky

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Dear Senator Durbin:

The undersigned represent a diverse group of consumer, civil rights, labor, retiree, housing, lending and community organizations. We are writing to express our strong support for the Helping Families Save their Homes Act of 2007 (the "Helping Families Act"), which will bring desperately needed assistance to families on the brink of losing their homes because they have received a predatory subprime loan.

Predatory lending practices and declining real estate markets threaten hundreds of thousands of American families with the imminent loss of their homes to foreclosure. For many families, the precipitating event will be a catastrophic rate increase on an inappropriate "exploding" subprime adjustable-rate mortgage loan. As devastating as foreclosures have been to date, they are expected to accelerate dramatically during 2008, when a large number of loans are scheduled for a rate reset.

One important solution to this serious problem is to give consumers on the brink of losing their homes more flexibility to restructure their loans in bankruptcy. The Helping Families Act would permit bankruptcy courts to write down the principal balance of a mortgage loan to the value of the mortgaged property – but to no less than this value. This would ensure that lenders recover at least the value they could obtain through a foreclosure sale, and it would save lenders the considerable cost of foreclosing. By permitting bankruptcy courts to modify the loan in this way, or to modify the interest rate on the loan, the Helping Families Act would eliminate an inequity in the law that currently denies borrowers protections for their primary residence that the law has long granted to wealthier borrowers with respect to their vacation homes or investment properties.

The inability of courts to modify loans on primary residences dates to the enactment of bankruptcy legislation in 1978. At that time, mortgage loans were nearly all fixed-interest rate instruments with low loan-to-value ratios and were rarely themselves the source of a family's financial distress. This is no longer the case today. Preventing the modification of home loans for primary residences makes no sense in an age of subprime exploding ARMs where the mortgage itself causes financial crisis. Unless bankruptcy courts have the authority to modify such loans at reset, particularly in areas of property depreciation or where there were fraudulent appraisals, hundreds of thousands of families will be unable to keep their homes.

The Helping Families Act would help families to save their homes, without any cost to the Treasury, and ensure that lenders recover at least what they would in foreclosure.

We congratulate you on your leadership on this important issue, and urge the speedy passage of this urgently needed reform.

Respectfully,

44330.217

AARP
ACORN
AFL-CIO
Central Illinois Organizing Project (CIOP)
Center for Responsible Lending
Consumer Action
Consumer Federation of America
Consumers Union
DEMOS
International Union, United Auto Workers
Lawyers' Committee for Civil Rights Under Law
Leadership Conference on Civil Rights
National Association for the Advancement of Colored People (NAACP)
National Association of Consumer Advocates
National Association of Consumer Bankruptcy Attorneys
National Community Reinvestment Coalition
National Consumer Law Center (on behalf of its low-income CLIENTS)
National Council of LaRaza (NCLR)
National Fair Housing Alliance
National Neighborworks
National Urban League
National Women's Law Center
Opportunity Finance Network
Service Employees International Union (SEIU)

44330.218

Consumer Federation of America
1620 I Street, N.W., Suite 200 * Washington, DC 20006

December 5, 2007

The Honorable Patrick J. Leahy
Chair
Committee on the Judiciary
U.S. Senate
SD-224
Washington, D.C. 20510

The Honorable Arlen Specter
Ranking Member
Committee on the Judiciary
U.S. Senate
SD - 152
Washington, D.C. 20510

Dear Chairman Leahy and Ranking Member Specter:

The Consumer Federation of America (CFA)1 is writing in strong support of S. 2136, the Helping Families to Save Their Homes Act of 2007, introduced by Senators Durbin and Schumer. The legislative proposal embodied in this bill would give homeowners on the brink of foreclosure more flexibility to restructure their loans in bankruptcy, thus keeping an estimated 600,000 troubled borrowers in their homes. CFA is pleased the Judiciary Committee is holding a hearing today on this timely proposal. We urge quick action on its adoption.

There should be no mistaking that a foreclosure crisis of immense proportions is underway, one that promises to worsen before it improves. A large number of mortgages are scheduled for a rate reset over the next few years. Current estimates are now that two million or more families – eighteen thousand per week -- are at risk of losing their homes.

The current mortgage mess is rooted in the proliferation of reckless and irresponsible lending practices concentrated particularly in the subprime and non-traditional mortgage markets. Many unsuspecting consumers have found themselves trapped into exploding payment adjustable rate mortgages that have become unaffordable – these loans should never have been made. Declining real estate markets compound this problem and reduce the prospects that these homeowners will be able to sell or refinance. Yet because of the complexities of the mortgage securities market, lenders and servicers still have not modified troubled loans in the significant numbers needed to avert mass foreclosures.

S. 2136 would bring desperately needed assistance to families on the brink of losing their homes. The bill would do this by simply allowing bankruptcy courts to modify repayment terms on their mortgages for primary homes down to the current market value so that at-risk borrowers can continue to afford to pay-off their loans.

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[1] Consumer Federation of America (consumerfed.org) is a national non-profit association of 300 pro-consumer organizations established to advance the consumer interest through research, consumer education and advocacy.

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The bill would reverse a long-standing double standard in the bankruptcy law. Under the current code, mortgages on primary residences are the only type of secured debt that is ineligible for bankruptcy protection. Thus owners of investment properties, vacation homes, and farms can modify those loans in bankruptcy court, while the typical homeowner cannot. Preventing the modification of home loans for primary residences makes no sense given the widespread use of faulty mortgage products that spawned the current foreclosure crisis.

S. 2136 would help to keep families in their homes, without any cost to the Treasury, while guaranteeing lenders and investors at least as much, or more, than they will receive in foreclosure. Nor would it raise borrowers' costs, as some have argued, a point confirmed in recent testimony by Mark Zandi, Chief Economist with Moody's Economy.com.2

Unless Congress takes action to stem this foreclosure tide, families will lose their homes, surrounding neighborhoods will lose property value, and the entire economy will suffer. CFA urges the Committee to act quickly on this critical measure.

Sincerely,

Allen Fishbein
Director
Housing and Credit Policy

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[2] See written testimony by Mark Zandi, Chief Economist of Moody;sEconomy.com, before the House Judiciary Committee, October 30, 2007

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CONSUMER MORTGAGE COALITION

December 2, 2007

The Honorable Patrick J. Leahy
Chairman
U.S. Senate Committee on the Judiciary
224 Dirksen Senate Office Building
Washington, D.C. 20510

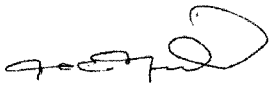
The Honorable Arlen Specter
Ranking Member
U.S. Senate Committee on the Judiciary
224 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman and Ranking Member Specter:

The Consumer Mortgage Coalition respectfully requests that our testimony be submitted for the record to the U.S. Senate Committee on the Judiciary for the December 5, 2007 hearing entitled, "The Looming Foreclosure Crisis: How To Help Families Save Their Homes."

Thank you.

Sincerely,



Anne C. Canfield
Executive Director

101 Constitution Ave., NW, 9th Floor West; Washington, DC 20001
PHONE: (202) 742-4366 FAX: (202) 403-3926

44330.079

TESTIMONY SUBMITTED BY THE:

CONSUMER MORTGAGE COALITION

BEFORE THE

COMMITTEE ON THE JUDICIARY

SUBCOMMITTEE ON
ADMINISTRATIVE OVERSIGHT AND THE COURTS
UNITED STATES SENATE

"The Looming Foreclosure Crisis:
How To Help Families Save Their Homes"

December 5, 2007

44330.080

The Consumer Mortgage Coalition (the "CMC"), a trade association of national residential mortgage lenders, servicers, and service-providers, appreciates the opportunity to submit its written testimony concerning proposals addressing difficulties in the mortgage market through changes to the bankruptcy code to the Senate Committee on the Judiciary's Subcommittee on Administrative Oversight and the Courts.

The CMC and its members strongly oppose proposals to subject mortgage loans to the cramdown provision of Chapter 13 of the bankruptcy code. While the proposals are well-meaning, they would wreak havoc on the capital markets—markets already jittery from the problems arising from the difficulties associated with subprime loans.

Further harming the capital markets will only increase the cost and decrease the availability of mortgage credit. In the long term, this will make the dream of homeownership less attainable for many would-be homebuyers, including many minority consumers. If Congress wishes to foster homeownership, it should seek to strengthen the capital markets. The pending legislation would do just the opposite.

The Home Mortgage Exception and Its Importance to the Mortgage Market

Those who wish to remove the home mortgage exception from Chapter 13's cramdown provision appear to misunderstand the vital importance of this exception to the capital markets—and, as a result, to the availability of inexpensive mortgage credit to consumers. As it current exists, the cramdown provision provides that a bankruptcy plan may:

> 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 holders of unsecured claims, or leave unaffected the rights of holders of any class of claims; . . . .

11 U.S.C. § 1322(b)(2). Pending legislation would delete the words "other than a claim secured only by a security interest in real property that is the debtor's principal residence." As a result, a bankruptcy court could modify the terms—and even delete key terms—of home mortgages.

Whatever superficial appeal such a measure might have, the Committee must not ignore the devastating impact this measure would have on the secondary market. The secondary mortgage market is one of the most important innovations of modern finance. Before the creation of the secondary mortgage market, mortgage credit was far less available to consumers. As a result, homeownership rates were far lower than they are today.[1] Mortgage lending was primarily the province of thrifts, savings and loans and savings banks, which made obtained funds from depositors. Consequently, the availability and cost of mortgage credit was closely linked to the

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[1] *See, e.g.*, LANDOL CALDER, FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT, 64-69 (1999).

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deposit levels of local institutions and the vitality of local economies.[2] Local demographic and economic conditions could create national imbalances in the availability of mortgage credit.[3] And, when the demand for housing rose (as it did in the 1960s and 1970s), this system could not satisfy that demand.[4] This led not only to a mortgage credit crunch, but to a crisis in the national economy.[5]

The creation of the secondary mortgage market provided low-cost funds to lenders, making mortgage credit more widely available than ever before. While government sponsored entities (GSEs) such as Fannie Mae and Freddie Mac initially were the main investors in mortgage loans, the Mortgage Bankers Association has reported that in 2006 the GSEs, banks and thrifts own only a minority of mortgage backed securities (MBSs). Other investors—such as foreign governments, pension funds, and state and local governments—constitute the majority of MBS owners. The market entices investors such as these to purchase mortgage loans, providing low-cost liquidity mortgage lenders then can use to make additional loans. This influx of capital not only cured this mortgage credit crunch, but it also led to the record levels of homeownership our nation has seen in recent years.[6]

Investors are enticed to purchase mortgages—and thereby provide the capital that makes mortgage credit more available and less expensive to consumers—only if they are certain they understand the scope of potential losses and liabilities. When the scope of potential losses and liabilities becomes uncertain, investors (including Fannie Mae and Freddie Mac) either refuse to purchase loans entirely or insist on forms of credit enhancement.[7] The net effect is that mortgage credit becomes more costly and less available to consumers.

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2 *See, e.g.*, Peter M. Carrozzo, *Marketing the American Mortgage: the Emergency Home Finance Act of 1970, Standardization and the Secondary Market Revolution*, 39 REAL PROP. PROB. & TR. J. 765, 767 (2005).

3 *See, e.g.*, Lewis S. Ranieri, *The Origins of Securitization, Sources of Its Growth, and Its Future Potential*, *in* A PRIMER ON SECURITIZATION 31, 31 (Leon T. Kendall ed., 1996); Anand K. Bhattacharya & Frank J. Fabozzi, *The Expanding Frontiers of Asset Securitization*, *in* ASSET-BACKED SECURITIES 1, 3 (Anand K. Bhattacharya & Frank J. Fabozzi, eds., 1996).

4 Carrozzo, *supra* note 2, at 766; *see also* Paula C. Murray & Beverly L. Hadaway, *Mortgage-Backed Securities: An Investigation of Legal and Financial Issues*, 11 J. CORP. L. 203, 205 (1986); Rudolph G. Penner, *The Housing and Finance System and Federal Policy: Recent Changes and Options for the Future*, Cong. Budget Office, (Oct. 1983), *available at* http://www.cbo.gov/ftpdoc.cfm?index=5074&type=0.

5 *See, e.g.*, Carrozzo, *supra* note 2, at 782-84, 789.

6 *See, e.g.*, *id.* at768-87; *see also* U.S. Department of Commerce, *Census Bureau Reports on Residential Vacancies and Homeownership*, at 4 (Jan. 29, 2007), *available at* http://www.census.gov/hhes/www/housing/hvs/qtr406/ q406press.pdf.

7 *See, e.g.*, Julie L. Williams & Michael S. Bylsma, *Federal Preemption and Federal Banking Agency Responses to Predatory Lending*, 59 BUS. LAW. 1193, 1201 (2004) (noting that some state anti-predatory lending laws left the scope of liability uncertain and "have resulted in some disruption of the national mortgage securitization markets").

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Recognizing the crucial role the flow of capital from the secondary markets plays in making credit affordable and available to consumers, Congress precluded the modification of mortgage loans.[8] Indeed, when court decisions in late 1980s and early 1990s threatened to undermine the home mortgage exception in Section 1322(b)(2), industry representatives and commentators warned of the disruption these decisions would cause to the secondary market.[9] If mortgage loans are subject to a cramdown, investors would absorb the loss.[10] As a result, investors will be less willing to invest in U.S. residential mortgage loans. Investors will only invest in mortgage loans if they are insured against these losses—and such insurance likely will take the form of higher rates and higher down payment requirements.[11] —not only making mortgage credit less available and less affordable, but also threatening to negatively impact the national economy. This has led one commentator to conclude that "those who view [cramdown] as a panacea for mortgagors may have badly misjudged its consequences in terms of creating a new legal environment for home mortgage lending."[12]

The home mortgage exception not only is essential to the vitality of the capital markets, but is warranted by the differences between real property and other property that secures consumer loans. Other types of property (e.g., automobiles, furniture, etc.), generally depreciate over time. If the consumer were to file for bankruptcy under Chapter 7, the secured party would recover only the depreciated value of the collateral. Because a secured party could recover only an amount equivalent to the depreciated value under Chapter 7, it makes sense to permit a bankruptcy court to modify the terms of a consumer loan under Chapter 13. In contrast, while the value of real property may increase or decrease, it generally does not depreciate like other types of property. Rather than resulting in a modification of the debt to reflect the depreciated value of the collateral, a mortgage cramdown would result in a windfall to the borrower, who in many cases will hold on to the property and will enjoy the benefits of its future appreciation. Especially given the new flexibility to stretch out payments over a period longer than five years that would be granted under Section 4 of the bill, using a cramdown unduly punishes mortgage loan investors.

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8 *See, e.g.*, Erik D. Klingenberg, *Strip Down of Home Mortgages: Undressing 11 U.S.C. § 1322(b)(2)*, 66 ST. JOHN'S L. REV. 443 (1992) (discussing the origin of the home mortgage exception).

9 *See, e.g.*, Alvin C. Harrell, *Treatment of Undersecured Claims in Bankruptcy: An Emerging Disaster for Housing Finance* , 44 CONSUMER FIN. L.Q. REP. 270 (1991); Jay A. Kroese, *Undersecured Residential Mortgage Cramdown Under Chapter 13: Receiving the Attention of the Both the Supreme Court and Congress*, 18 J. CORP. L. 737 (1993).

10 *See, e.g.*, Cramdowns of Residential Real Estate Mortgages in Chapter 13 Bankruptcies: Hearing Before the Subcomm. on Courts and Admin. Practice of the Senate Comm. on the Judiciary , 102d Cong., 1st Sess. (1991), at 48 (statement of Dean S. Cooper, Associate General Counsel for Freddie Mac) (stating that " [a]s a purchaser of residential mortgages which guarantees the payment of principal and interest to investors in our securities, Freddie Mac ultimately absorbs the cost of cramdown").

11 *See, e.g.*, Harrell, *supra* note 9, at 270-71 (noting that even a 20% or 30% down payment requirement would not be sufficient to protect mortgagees in some real estate markets).

12 *Id.* at 271.

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Moreover, in areas that may be experiencing long term declines in real property prices (e.g., areas near the traditional United States auto industry manufacturing centers that are suffering from increased unemployment and reduced wage expectations) the bill's cramdown provision could create incentives that could harm consumers. Lenders or servicers would have an incentive to rush to foreclose before the borrower declares bankruptcy, rather than trying to work with the borrower to modify or workout the loan. On a prospective basis, the additional risk that lenders would assume with respect to property value could greatly constrain lenders' and investors' willingness to make long-term loans to borrowers in areas where residential property values are declining. This will only add to the distress of the homeowners in those areas, who will increasingly become unable to tap their home equity as a buffer against the economic difficulties in their communities.

The residential mortgage capital markets are in turmoil already. The CMC respectfully suggests that any congressional action should be focused on improving the condition of the capital markets. Eliminating the home mortgage exception from Chapter 13's cramdown section will have the opposite effect. The Committee should consider carefully whether it wishes to take a chance that the bill will precipitate further turmoil in the secondary market as banks and investors are forced to re-price both the risks they have already taken on as well as for mortgage credit on a going forward basis. The reduction in confidence that investors will have could create considerable fallout on the national economy.

Our members would welcome the opportunity to discuss further with the Subcommittee how they believe the bill's proposals would affect both current mortgage investors and the price and availability of credit for the future.

* * *

Contact Information:

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Testimony of the Honorable Jacqueline P. Cox
Bankruptcy Judge for the United States Bankruptcy Court
for the Northern District of Illinois

Before the Senate Committee on the Judiciary Hearing on
"The Looming Foreclosure Crisis: How To Help Families Save Their Homes"
Wednesday, December 5, 2007

Senator Durbin, members of the Committee, I genuinely appreciate the opportunity to address the Senate on protecting home ownership and helping families deal with burdensome home mortgages. I speak for myself; I do not represent the Judicial Conference of the United States or the Administrative Office of the Courts.

Because home ownership represents economic inclusion and because of the disparate impact of the mortgage crisis on African Americans and Latinos, passage of the Durbin bill is critical. The Bankruptcy Code generally allows reorganizing debtors in Chapters 11, 12 and 13 to bifurcate secured debt. Plans strip down claims to the value of the collateral, the secured portion, which the debtor would pay in full; the balance, the amount of the claim that exceeds that value, gets treated as an unsecured claim. In the Chapter 13 context the unsecured amount would be paid under the plan by a percentage based on the debtor's income. The best efforts provision of §1325 (a)(4), a plan confirmation requirement, requires that the value of property to be distributed under the plan on account of each unsecured claim be not less than the amount that would be paid on such claim if the estate were liquidated under Chapter 7.[1]

[1] 11 U.S.C. §1325 (a)(4).

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Section 1 of the Helping Families Save Their Homes in Bankruptcy Act of 2007 will allow a debtor to modify mortgage debt if the debtor's income is insufficient to pay the mortgage. The income limitation is important; it limits this extraordinary relief to those homeowners who need it. Homeowners who can afford their payments will not receive a windfall.

Allowing the strip down of mortgage debt to the collateral's fair market value reflects the economic realities of the lenders' situation. The lender who forecloses on a loan will recover the value of the home and receive a deficiency claim when the debt exceeds the value of the home. Non-recourse states limit recovery to the value of the home.

When Americans purchase homes the most important consideration is affordability. Most of us anticipate modest future increases in income, but can not afford mortgage interest debt that increases up to 40%. The Durbin bill interest rate section allows the debtor to pay the stripped down amount at an interest rate equal to the rate published by the Board of Governors of the Federal Reserve System regarding the annual yield on conventional mortgages, with a reasonable premium for risk. Under the U.S. Supreme Court decision in Till v. SCS Credit Corp.,[2] Chapter 13 debtors now follow a similar standard when adjusting interest rates on non-residence secured debt.

[2] 541 U.S. 465 (2004).

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> "Taking its cue from ordinary lending practices, the approach begins by looking to the national prime rate, reported daily in the press, which reflects the financial market's estimate of the amount a commercial bank should charge a creditworthy commercial borrower to compensate for the opportunity costs of the loan, the risk inflation, and the relatively slight risk of default. Because bankruptcy debtors typically pose a greater risk of nonpayment than solvent commercial borrowers, the approach then requires a bankruptcy court to adjust the prime rate accordingly."[3]

I quote the Supreme Court to emphasize that interest rates are adjusted in our proceedings routinely. In fact, since the 2004 Till decision I have held only 2 or 3 hearings involving disputes over interest rate adjustments. The bar and the financial services community have very little trouble in this regard.

The Durbin bill also waives the pre-petition credit counseling requirement which was added to the Bankruptcy Code in 2005 under the Bankruptcy Abuse Prevention and Consumer Protection Act. Because most debtors facing foreclosure, probably because of fear or denial, wait until the week of a foreclosure sale to seek bankruptcy relief, credit counseling offers them no help. The briefing that debtors are required to receive outlines the opportunities for available credit counseling and assists such individuals in performing a related budget analysis.[4] Once a foreclosure action has been filed, the homeowner needs more than a briefing or help in analyzing a budget.

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[3] Till at pages 478-79.

[4] 11 U.S.C. §109 (h)(1).

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I am particularly supportive of the bill's §201 which combats excessive fees. It allows fees, costs and other charges to be added to the secured debt only if notice of such additional charges is filed with the court within a year of when they are incurred or 60 days before the conclusion of the case. Failure to give notice will be deemed a waiver of such fees and any attempt to collect them shall constitute a violation of the discharge injunction and the automatic stay.

This policy reflects the practice of the United States Bankruptcy Court of the Northern District of Illinois. Our Model Plan for Chapter 13 cases requires the case trustee at the end of the plan to notify all parties that the mortgage cure amount has been paid, satisfying all pre-petition obligations, requiring the lender to treat the mortgage as reinstated. The lender can dispute this and have the court resolve the dispute.

The bill allows a plan to waive prepayment penalties. This assists debtors who can arrange to refinance their obligations under more favorable terms. Such penalties do not compensate lenders for costs, they only serve to punish debtors.

I agree with the position of the National Bankruptcy Conference's remarks before the House of Representatives on October 30, 2007 regarding similar legislation. On behalf of the NBC Attorney Richard Levin compared the plight of homeowners with that of family farmers in the 1980s. There is clear precedent for Congress to solve the mortgage crisis by allowing debtors to bifurcate or strip down mortgage debt. In the 1980's farm values dropped dramatically

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and lenders could not renegotiate farm debt to reflect falling land prices. The good work of Senator Charles Grassley and Representative Mike Synar created Chapter 12 of the Bankruptcy Code which provided a platform for the rational court-supervised modification of farm loans. It has been a success and is now a permanent part of the Bankruptcy Code. As lenders and borrowers came to understand its operation, they were often able to modify mortgage obligations on their own, without the bankruptcy court's involvement. The Bankruptcy Code provisions provided a model for non-bankruptcy workouts in the family farmer context. Similarly, the Helping Families Save Their Homes in Bankruptcy Act of 2007 can become a model for out of court modifications.

The Chapter 12 experience provides guidance for amending Chapter 13 to address the current mortgage crisis. Chapter 12 of the Bankruptcy Code permits family farmers to modify mortgage debt on their farm land, to reamortize the debt over a period of years, and to save the family farm. Chapter 12 overcame the inability of farm lenders to negotiate terms that reflected the economic realities of family farmers in the 1980's. Many home mortgage lenders today face the same inability to deal with the economic reality regarding today's rapidly falling housing market, the decrease in home values making it difficult to secure loans because the outstanding loans exceed the value of the homes. Now, Chapter 12-style adjustments to Chapter 13 can provide the same sort of relief to homeowners trapped in impossible mortgages.

When Congress limited modification in Chapter 13 of a mortgage on the debtor's principal residence in 1978, no similar limitations were imposed on mortgages on vacation or

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second homes, on investment, rental, or business property, or on any other form of collateral. Whatever justification there might have been in 1978 for granting special protection to mortgages on a debtor's principal residence has evaporated as the marketplace has produced a baffling array of loans based more on a lender's ability to sell than on a borrower's ability to repay. Current financial conditions justify this legislation's important and needed change.

While allowing debtors to restructure their mortgages without current limitations will provide needed relief, some debtors can be expected to face unemployment and health issues after confirmation that limit their ability to meet their restructured obligations. With that in mind, I suggest that the Congress also address the situation of debtors who seek to refinance by incurring adjustable rate mortgages.

In Chapter 13 matters when debtors refinance their homes under §§ 364[5] and 1329[6] of the Code, the court has an opportunity to review and to rule on those prospective refinancing arrangements. Because of reports that borrowers have been promised fixed rate loans, but actually execute adjustable rate mortgages at closing, and because of concerns that borrowers often take on debt that they can not handle, I believe that adjustable rate financial products should be allowed only where it is shown that the debtor will be able to handle the obligation at a higher reset rate in the future.

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[5] 11 U.S.C. §364.

[6] 11 U.S.C. §1329.

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Congress should also pass legislation requiring that adjustable rate mortgages be authorized for refinancing debtors in Chapter 13 cases only after the court finds that the debtor will have sufficient additional income in the future to pay for an increase in the loan's interest rate. This is consistent with the recent statement/rule of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency and the Office of Thrift Supervision that financial institutions should make loans only to borrowers who qualify to meet loan terms even after a loan rate resets higher.[7] Bankruptcy courts are in a unique position to enforce this policy.

The following language could be added to 11 U.S.C. §§ 364 and 1329:

11 U.S.C. §364 (g):

(1) A debtor in a case under Chapter 13 of this title may incur debt secured by a lien on the debtor's residence only if authorized by the court, after notice and a hearing. Such authorization shall be granted only upon a finding by the court that the indebtedness is reasonable and will not impose an undue burden on the debtor.

(2) When the debtor seeks to incur credit by refinancing the debtor's residence, whether it is property of the estate or property of the debtor, the court must make a finding after a hearing, that the debtor will have sufficient income in the future to meet any applicable upward reset in the interest rate and other variable loan terms.

[7] Department of the Treasury, Office of the Comptroller of the Currency, Docket No. OCC-2007-0005.

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11 U.S.C. §1329 (d):

> Any modification of a plan that includes incurring debt secured by a lien on the debtor's real property may be confirmed and authorized only in compliance with §364 (g) of the title.

I note that Representative Barney Frank may sponsor a bill that requires that a refinanced loan can not be offered if it "lacks a net tangible benefit" to the consumer. I already evaluate refinancing loans for debtors on this basis.

In conclusion, I support passage of Senator Durbin's Helping Families Save Their Homes in Bankruptcy Act. I believe this bill provides sensible and much-needed modifications to the Bankruptcy Code.

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Senator Russell D. Feingold
Judiciary Committee Hearing On the Looming Foreclosure Crisis

Thank you Mr. Chairman for holding this hearing today on a critical issue facing my state of Wisconsin and the rest of the nation. The rising rate of foreclosures and its broader impact on the nation's economy is a serious issue that requires the involvement of all levels of government as well as both private and non-profit organizations.

Subprime lending and rising foreclosure rates are complicated issues to unravel and any response, whether legislative or regulatory, will bring with it a set of consequences, some intended and some unintended. We need to examine a variety of responses to the rising foreclosure rates and their consequences, including providing more housing counseling for borrowers and more effectively regulating lending practices to prevent some of the unscrupulous practices that have occurred. Some of the more egregious lending practices include high rates of predatory lending in minority communities, steering borrowers into subprime mortgage products even if the borrowers qualified for more conventional loans, and not ensuring that borrowers fully understood the terms of subprime loans.

Earlier this year, I was pleased to join a letter led by Senator Kohl asking that the Federal Reserve investigate the fair lending practices of financial institutions in response to troubling data on subprime lending in Wisconsin. The letter noted that "...sixty-one percent of all loans made in 2006 to African Americans were subprime loans. In the City of Milwaukee alone, seventy-two percent of African American borrowers had high cost loans despite the fact that over half of the borrowers may have qualified for more conventional, lower cost loans." As we move forward on legislative responses, we also need to examine ways to promote greater oversight of lending practices to help curb the disparate impact that is being felt in our minority communities throughout the country.

More counseling for borrowers and increased regulation of lenders will help future borrowers, but we also need to examine ways to provide targeted relief to Americans facing foreclosure on their homes now. It is estimated that at least two million Americans may face foreclosure on their homes, which is not only a devastating loss for those individual families, but also will have a significant negative impact on the communities in which these homes are located. I have heard from some advocates in Wisconsin about the concentration of home foreclosures in certain communities and about the damaging impact these foreclosures will have on specific neighborhoods.

Senator Durbin's legislation provides a targeted and constructive solution to homeowners currently facing foreclosure. Advocates estimate that this legislation

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could help approximately 600,000 homeowners around the country. This bill would permit qualified homeowners who have filed for Chapter 13 bankruptcy to modify the mortgage on their primary residence to make their mortgage payments more affordable. The bill only applies to borrowers who meet an income means test under the legislation, thereby helping to ensure that borrowers who can still make the monthly payments on their mortgages will continue to do so.

I understand the lending community is concerned about the implications of the Durbin legislation and I hope that we can work together in the coming weeks to address those concerns. As I stated, our response needs to be the result of cooperation at all levels of government and with the involvement of the non-profit and for-profit housing organizations. I commend Senator Durbin for promoting a measured response targeted at homeowners facing extreme hardship and I look forward to working with him to move this bill forward.

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Leadership Conference on Civil Rights

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PRESIDENT & CEO
Wade J. Henderson

December 12, 2007

The Honorable Richard J. Durbin
United States Senate
Washington, DC 20510

Dear Senator Durbin:

On behalf of the Leadership Conference on Civil Rights (LCCR), the nation's oldest, largest, and most diverse coalition of civil and human rights organizations, we write to express our strong support for S. 2136, the "Helping Families Save Their Homes in Bankruptcy Act." We greatly appreciate your efforts to craft a strong, sensible proposal that will spare hundreds of thousands of homes from the growing foreclosure epidemic that our nation is now facing. We are very grateful to Sen. Arlen Specter (R-PA) as well, for also recognizing the unique value of bankruptcy reform in addressing this crisis.

As you know, during the nationwide housing market "boom" that took place in the first half of this decade, many mortgage lenders resorted to the widespread use of reckless and predatory lending practices. These practices included so-called "exploding ARM," "interest-only," and "pay-option" mortgages, little or no verification of borrowers' incomes, and prepayment penalties. While the judicious use of subprime and non-traditional loans can serve important purposes, prudent loan underwriting standards were largely abandoned in recent years, virtually guaranteeing that many borrowers would become unable to handle their monthly payments and increasing the likelihood of default.

The consequences of these practices are still unfolding, but one thing is clear: they will be staggering. Home foreclosure rates are rapidly increasing in many areas of the nation and, according to one estimate, as many as 2.4 million borrowers – just in the subprime market alone – are likely to lose their homes.[1] This wave of foreclosures will have an especially harsh impact on racial and ethnic minority homeowners who, according to several studies, were roughly two to three times more likely to be steered into high-cost loans than white borrowers, with strong disparities persisting even *after* credit factors were taken into account.[2]

S. 2136 will give hundreds of thousands of borrowers who are in danger of foreclosure a chance to save their homes through the use of Chapter 13 bankruptcy proceedings. If

[1] Center for Responsible Lending, *Subprime Lending is a Net Drain on Homeownership*, CRL Issue Paper No. 14 (available at http://www.responsiblelending.org/pdfs/Net-Drain-in-Home-Ownership.pdf) (March 27, 2007).

[2] *See* Debbie Gruenstein Bocian, Keith S. Ernst, and Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, at 19 (available at http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf) (May 2006); National Community Reinvestment Coalition, *Income is No Shield Against Racial Differences in Lending: A Comparison of High-Cost Lending in America's Metropolitan Areas* (available at http://ncrc.org/pressandpubs/documents/NCRC%20metro%20study%20race%20and%20income%20disparity%20July%2007.pdf) (July 10, 2007).

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enacted, bankruptcy judges will be able to reduce the principal owed on a subprime or non-traditional mortgage to reflect the actual value of the home, reset interest rates to affordable-but-fair levels, and eliminate prepayment penalties and other abusive fees. .

For several reasons, we believe that using bankruptcy proceedings to avert foreclosures is one of the best and most important policy responses to the ongoing home mortgage meltdown. One key advantage is its cost. Because the public as a whole will not have to pay to save homes, it will not give the appearance of a "bailout" or raise moral hazard issues. Indeed, for people who want to utilize bankruptcy laws to save their homes from foreclosure, it will still come at a heavy enough cost – monetary and otherwise – to encourage wiser financial decisions in the future.

At the same time, S. 2136 will benefit the entire public and our economy at large. Every home that gets saved from foreclosure will help protect the value of the homes surrounding it, meaning that other homeowners will be less likely to get "upside down" on their own mortgages. In other words, it will help control the "bleeding," protecting neighborhoods and communities from even more financial harm than they might otherwise experience – and hopefully for long enough to allow the housing market to recover on its own.

Without a doubt, we believe the mortgage lending industry - the industry most responsible for providing billions of dollars in unsustainable loans in the first place - should be far more aggressive in its own efforts to modify loans that were, in many cases, destined to fail. Yet to date, the simple fact is that mortgage holders and servicers have, for the most part, done little so far to mitigate the foreclosure crisis. Only a very small fraction of loans with "payment shock" features have been voluntarily modified. While the "teaser-rate freeze" plan recently announced by Treasury Secretary Henry Paulson is undoubtedly a positive step, it will only help a small percentage of borrowers who are likely to find themselves in trouble in the coming years - and in that small number of cases, it only buys time. Homeowners, and our economy as a whole, simply cannot afford to wait.

For these reasons, we will strongly urge your colleagues to support your legislation, and we look forward to working with you to enact it. If you have any questions, please feel free to contact Rob Randhava, LCCR Counsel, at 202-466-6058.

Sincerely,

Wade Henderson
President & CEO

Nancy Zirkin
Vice President / Director of Public Policy

Testimony of

Joseph R. Mason
Associate Professor
Drexel University

To the Committee on the Judiciary
United States Senate

The Looming Foreclosure Crisis: How to Help Families Save Their Homes

December 5, 2007

Mr. Chairman, Ranking Member Specter and members of the Committee, thank you for the opportunity to be here today. I am pleased to appear before you to discuss the foreclosure crisis and possible legislative options for addressing the economic and social concerns arising from that crisis.

I am Joseph Mason, an Associate Professor of Finance at Drexel University and Senior Fellow, the Wharton School, and these are my personal views. Before joining Drexel University, I spent three years at the Office of the Comptroller of the Currency studying consumer credit, bankruptcy, and structured finance, and have since advised bank and securities market regulators as well as many industry groups on the press on the recent market and economic difficulties.

Personal bankruptcy relieves debtors and creditors of their duties and claims arising from credit mistakes, wither originating in over-borrowing or over-lending. Without such a relief valve, debts are carried throughout lifetimes and even passed through generations resulting in the debt peonage problems characteristic of America's early colonial period and the post-bellum South. Well-balanced and clearly articulated bankruptcy laws are therefore crucial to our social and economic well-being.

People only file for bankruptcy if they are first vulnerable, i.e., have debt greater than their assets, and second, only if some financial shock occurs that prevents them from keeping debt service payments current. Economic theory suggests that the population vulnerable to personal bankruptcy should be in their thirties, because debt load typically peaks as individuals approach age thirty-five or so. Growth in the number of individuals

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in that demographic has not, however, adequately explained personal bankruptcy growth in most academic and industry studies.

The reason is that debt is a necessary, but not sufficient, condition for personal bankruptcy. Rather, it takes some shock to income *in the presence of a heavy debt load* to cause a person to file for bankruptcy. The typical shocks – divorce, illness, accident, and addiction – have all increased over the last several decades and are particularly prevalent among individuals in their thirties, just when they have the highest debt burdens of their lifetimes.

With the advent of subprime mortgages, we must now add adjustable-rate mortgage payment shocks to the list of classic influences. Clearly, adjustable-rate payment shocks are having an indelible effect on housing markets. The question, however, is to what extent legislative intervention can and should insulate individuals from the payment shocks in their mortgage contracts?

To that extent, I have been asked to evaluate the economics of addressing those shocks through judicial intervention into mortgages in personal bankruptcy proceedings. I reach three main conclusions. First, mortgages and other real assets are poor candidates for bifurcation in bankruptcy because they can be fully expected to regain value later on in the life of the contract. Hence, bifurcation of a debt secured by real estate may be considered a "taking" in a sense not applicable to fully depreciable assets. Second, legislative changes to enable bifurcation of mortgage contracts will increase the cost of credit to mortgage borrowers to cover the expected aggregate value of judiciary settlements. The cost of mortgage credit can be expected to rise to levels on par with other secured non-mortgage credit (like automobile loans) and unsecured credit (like credit cards). Last, the act of bifurcating mortgage credit will increase the cost of bankruptcy to cover appraisal and other transactions costs needed to establish the "fair market value" of the underlying real estate, imposing yet another cost on filers above and beyond those imposed in the Bankruptcy Abuse Prevention and Consumer Protection Act that went into effect in October of 2005.

I. BIFURCATION OF DEBTS SECURED BY REAL ASSETS CAN BE EXPLOITED IN WAYS THAT BIFURCATION OF DEBTS SECURED BY OTHER ASSETS CANNOT

Bifurcation, commonly referred to as "cramdown," has long been applicable to non-real estate collateral. But, while the concept is sensible for non-real fully-depreciable collateral like automobiles, the idea is fundamentally flawed for assets like real estate.

The reason a bifurcation makes sense for fully-depreciable collateral is that the value of the collateral is decreasing throughout the life of the loan. If a court bifurcates a claim on an automobile loan, the automobile is not expected to ever be worth more than the current market value established by the courts.

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For real estate, even in today's market conditions, the value of the collateral can be expected to grow in the future, so that bifurcating the claim is akin to taking away real value from the lender now that will accrue to the borrower in the future. Whether that value growth is two years ahead or twenty is irrelevant. The concept is fundamentally different from bifurcating a fully-depreciating asset in that it is a taking of real property.

The concept is especially egregious in real estate markets that are highly sensitive to economic or market conditions. High-flying Houston and New England real estate markets of the early 1980s returned handsome profits for investors after the relatively brief market disruptions of the late 1980s and the recession of 1991. The Case-Shiller mortgage price index, which begins in January 1987, shows that Boston home prices hit a high of 75.53 in July 1988 and retreated thereafter, only to reach and exceed that level in May 1997. Boston now stands at 170.73. Los Angeles peaked at 100.00 in June 1990 and, after a similar hiatus, breached that level again in January 2000. Los Angeles now stands at 254.79. True homeowners obtained those gains. Speculators did not.

Furthermore, today, while California and Florida markets are expected to decline in value the most in the short-term, they are also expected to rebound sharply in the expansion that follows. In fact, it is not those markets that should be the source of concern, but markets like those of Ohio and Michigan, whose economic growth will not support timely rebounds from even mild home price depreciation, although they will rebound, nonetheless.

The point, therefore, is that real estate gains will resume and even if they are not on par with recent growth, the gains will restore value for true homeowners in the long term even if speculators lose in the short term.

II. BIFURCATING MORTGAGES WILL INCREASE THE PRICE OF CREDIT IN BOTH PRIMARY AND SECONDARY MARKETS

It is straightforward to conclude that the ability to bifurcate mortgages in consumer bankruptcy will increase the cost of mortgage credit. One only needs to look as far as other types of secured credit that is subject to bifurcation to see that the cost of credit in those markets is higher than the cost of credit on mortgages.

Worse yet, the effective price difference has led in recent years to the evolution of home equity loans and home equity lines of credit that allowed consumers to take advantage of the price difference by pledging their home as collateral while borrowing for automobile purchases, vacations, and even typical credit card expenditures.

Changing the nature of mortgage priority in bankruptcy further incentivizes the shift away from building equity in one's home by paying down the mortgage: if mortgage debt is tax-exempt and can be discharged in bankruptcy it becomes more advantageous for consumers to maximize their mortgage relative to the value of the home.

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As a result of such long-term shifts, we face a generation that stands to enter their retirement years without the historically largest retirement asset – their home equity – intact. Poorly-funded 401-k's, pension funds that will eventually have to face up to subprime mortgage losses, and Social Security will not make up for that shortcoming, which will therefore create a tremendous drag on economic growth and social well-being.

The problem, however, will also extend to secondary markets for securitized loans that have been devastated by uncertainty over the past year. Since the ability to bifurcate mortgages will extend to contracts already written and sold in securitized pools, *existing* loans will decline in value by the risk difference implied in the spread between non-real estate and real estate secured credit. That means that the value of residential mortgage-backed securities will decline further. In the event that markets will not be able to adequately ascertain the impact of judicial intervention, they will impose an additional "lemons discount," above and beyond that already imposed on the market for fundamental opacity and ratings agency malfeasance, to account for the maximum possible effect *a priori*. Knock-on effects will reverberate through resecuritization markets like those for CDOs and SIVs, making those already difficult-to-value assets even more opaque.

The point is that judicial adjustment will add further information difficulties to an already uncertain market environment. The market today is struggling to sort out information. Investors will not join back in until information about values and holdings is improved. Hence, moving the valuation target by changing the legal nature of the contract will not help end the current credit market difficulties.

III. BIFURCATING MORTGAGES WILL INCREASE THE COSTS OF PERSONAL BANKRUPTCY

In the case of bifurcating the automobile loan mentioned above, the judge need only look at Kelley Blue Book to establish a reasonable market value for the collateral asset. In the case of the mortgage, however, getting the fair market value is not so simple.

To begin with, a judge will have to order an appraisal of the property to assess a fair market value. Appraisals can cost $300 to $500 and the cost would be expected to be paid by the debtor.

To get an example of the impact of such an additional cost, filing costs under the Bankruptcy Abuse Prevention and Consumer Protection Act that went into effect in October of 2005 are estimated to have increased some 150%. Some claim that the increased filing costs, alone, have acted as a disincentive for individuals to seek relief under personal bankruptcy (see, for instance, High Foreclosures but Low Bankruptcies: Why the Disconnect? Knowledge@W.P. Carey Blog., Arizona State University).

Additionally, many have also cited the increased legal expenditures as a reason why bankruptcy filings have fallen off so dramatically since the enactment of the previous

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legislation. If that is the case, additional costs will deter even more filings, making relief for consumers more difficult to obtain.

In addition to the cost, however, the accuracy of appraisals must also be considered if appraisals are to be used in the judicial process. The fact is, appraisals have not been very accurate in the recent past. Furthermore, appraisals skewed to the high end fueled recent overborrowing and home price inflation, causing much of the present-day mortgage market difficulties.

Although proposals have recently been advanced, the appraisal industry is still unregulated and subject to gross errors and irregularities. An industry experiencing such difficulties, which has contributed so much to the recent mortgage crisis, is hardly a reliable basis for a substantial component of bankruptcy law.

CONCLUSION

In conclusion, the US economy continues to experience very real problems stemming from the mortgage crisis. The problems originate in a variety of unsafe and unsound practices in the mortgage industry, ranging from predation to speculation.

It is easy to see the need to address predation in the mortgage industry. It makes sense to seek judicial remedies that have the power to nullify contractual terms violating terms of the Real Estate Settlement Procedures Act, the Truth in Lending Act, the Home Owner Equity Protection Act, and/or other laws and regulations relating to the mortgage industry.

It is especially important that the judiciary have the power to address violations of relevant laws and regulations because it is so hard to set quantitative or easily verifiable tests to violations of those provisions. Hence, a case-by-case treatment is often necessary to identify and correct the violations that are easy to see when the parties present themselves and the relevant facts, but difficult to identify in raw loan applications and data. It will be a powerful remedy to give the judiciary the chance to correct the terms of such predatory mortgages in bankruptcy in order to avoid unnecessary foreclosures.

Giving the judiciary the power to fully bifurcate mortgage contracts, however, sets the stage for a potential abuse of the bankruptcy system to further speculative purposes and further incentivizes cashing out home equity.

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Testimony of Ms. Nettie McGee
Chicago, Illinois
Before the United States Senate Committee on the Judiciary
Hearing on "The Looming Foreclosure Crisis: How To Help Families Save Their Homes"
December 5, 2007

Senator Durbin, Members of the Committee, thank you for inviting me to speak before you today. My name is Nettie McGee, and I have lived in Chicago, Illinois for 53 years. I live in a home I waited my entire life to own. Now, the interest rate on my mortgage is going up 3% and my payments are $200 more each month. I am here to ask you to please help me save my home.

In 1997, I began renting my current home on South Aberdeen Street in Chicago. I rented it for two years with an option to buy. Then, I finally bought it, my first home, in 1999 for $80,000. I was 65 years old.

I made the payments for six years. I had a fixed rate mortgage and I knew what to expect each month -- it was $735.00 every month. I was able to make my payments and pay my taxes. I could afford all my bills.

Then, in October 2005, a sheriff came to my door to tell me my backyard was going to be sold at auction for $5,000 because of unpaid taxes. I paid the taxes on my house every year. I just didn't know that I had two tax bills, one for my house and one for my backyard. The tax bill for my backyard had been sent to an address across town for years since before I moved in.

I was desperate to keep my backyard and my beautiful trees, but I had to pay the city $5,000. I had to do something fast before I lost my yard. I didn't have $5,000 in the bank. I live on Social Security and I get rent from my daughter.

Then, I saw a commercial on TV about refinancing your home. I thought if I refinanced, I

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could get money to pay the tax bill and keep my yard. I called the number and a broker came to visit me the next day. He wrote down my personal information. A week and a half later, he called me and asked me to come downtown and sign the papers.

After I arrived at the crowded office, I was taken into a small room, handed about 40 pages, and told where to sign. The woman in charge of the closing stood over me and turned the pages as I signed them. The whole process took about 10 minutes. I thought I was signing for a fixed rate loan. Then, with no explanation of the loan, I was sent out the door.

The mortgage company paid the taxes to the county, then to my surprise they called me a few days later to come back and get a check for about $9,000. I didn't know they had me borrowing an extra $9,000, but when I asked about it, the mortgage company said that I could use it for bills. I thought it was a good idea. So, I used the money to pay some bills and fix my plumbing problems.

I started paying the loan back; the payments were about the same as my original loan. It's been difficult at times, but I have never missed a payment.

A month and a half ago, in October of this year, I got a letter from my mortgage company. It said that on December 1st, my payments were going up to $912.00 a month. I called my mortgage broker, but he doesn't work for that company anymore.

I thought I signed a fixed rate mortgage. I had no idea my payments would jump almost 25%. My interest rate went from 7.87% to 10.87%, and it could eventually go as high as 13.87%. I don't know how I'll make my payments now. They are higher than my Social Security check. The only reason I can get by for now is because my daughter pays me a little rent.

Right now, my lawyers from the Legal Assistance Foundation of Chicago are trying to help me negotiate with my lender, but we don't know if the bank will agree to lower my interest

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rate back to where it was before. But I know I'll lose the home I waited my entire life to own if I can't get my original interest rate back.

Many people who could originally afford their mortgage payments are losing their homes because they have an adjustable rate mortgage. Please help people like me, people who waited their entire lives to own a home. Please, help us keep our homes.

Statement of the

Mortgage Bankers Association

Before the

Committee on The Judiciary

United States Senate

December 5, 2007

Hearing on

"The Looming Foreclosure Crisis: How To Help Families Save Their Homes"

The Mortgage Bankers Association (MBA)[1] appreciates the opportunity to submit testimony in response to the December 5, 2007 Senate Judiciary Committee hearing, "The Looming Foreclosure Crisis: How To Help Families Save Their Homes." MBA and the mortgage industry are concerned that legislation, S. 2136, "Helping Families Save Their Homes in Bankruptcy Act of 2007," introduced by Senator Richard Durbin, would alter the treatment of home mortgages under Chapter 13 of the Bankruptcy Code and seriously disrupt the U.S. home mortgage market.

S. 2136 makes key changes to Chapter 13 of the Bankruptcy Code including:

- removing anti-modification protections afforded to all mortgages secured by principal residences ("home mortgages"), which would allow interest rates, product type, and maturity dates to be changed and allow liens to be stripped down to the fair market value of the property;
- permitting modified home loans to be repaid beyond the term of the Chapter 13 plan, which today cannot exceed five years; and
- eliminating the requirement to obtain credit counseling before the debtor can file for bankruptcy.

If these provisions were enacted, it would increase the cost and reduce the availability of mortgage credit for principal residences. For these reasons, MBA opposes the passage of this legislation.

Today, a mortgage secured by the principal residence of a debtor cannot be modified in bankruptcy. This policy has been in existence over 100 years, since the Bankruptcy Act of 1898, and is a cornerstone to an efficient U.S. residential mortgage market. The protection provided to home mortgages was not a loophole or oversight. It was a deliberate act of Congress to ensure the continued low cost and free flow of home mortgage credit. (See Legislative History, Attachment A). A shift in public policy to remove such protections and encourage debtors not to pay their contractual mortgage obligations would dramatically change the residential mortgage market. S. 2136 introduces significant new risks for home lenders, investors and loan servicers. These risks include the ability to set aside mortgage contracts and modify interest rates and

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 400,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 3,000 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

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other terms. It would also allow liens to be stripped down to the fair market value of the underlying properties.

Impact of S. 2136 on Mortgage Financing Costs and Terms

Lenders, securitizers and loan servicers would have to take various precautions to avoid or offset the significant new risks S. 2136 would impose. Such precautions would include increasing interest rates and other compensation, tightening credit standards, requiring larger downpayments and restricting credit in declining markets. Failing to take such precautions would be unsound business management.

MBA has estimated the severity of changes borrowers could face if S. 2136 were enacted as proposed. In general, we believe based on our preliminary estimates that downpayments would be required in the order of 20 percent or more,[2] as are currently required for mortgages secured by investment properties. Of course, there is some flexibility on this requirement as points are assessed in inverse proportion to the amount of the downpayment. In other words, a borrower can pay an extra point or more to make a 10 percent downpayment instead of a 20 percent or higher downpayment.

Rates and downpayment terms would no doubt vary among lenders, but it is very clear that it would be difficult for borrowers to get high loan-to-value (LTV) loans. The reason for this result is that if a lender is exposed to 95 percent of a property's value and a sizeable amount is forgiven, the lender cannot recoup that money. In addition to higher downpayments, we estimate, based on current pricing for mortgages on investment properties, that a borrower is likely to pay one to three points on the entire loan amount, depending on the size of the downpayment, and an additional 3/8 of a percent in mortgage interest rate. To explain this in terms of pure interest rate (versus a combination of rate and points/fees), we estimate that borrowers would see a 200 basis point jump in interest rates with a 5-10 percent downpayment home mortgage, with no points or fees at closing.

The need for the additional costs and higher downpayment is straightforward. Losses on any foreclosure are high and lenders are always subject to fluctuations in real estate prices for the value of any collateral recovered. For example, if the terms of the debt are subject to an appraisal conducted years after origination and the courts can strip down the lien to the current fair market value, then the security interest in the collateral and the fundamental nature of secured home lending will differ. Bankruptcy filings will no doubt skyrocket as borrowers will seek the incentives S. 2136 creates. The severity and velocity of bankruptcy cram downs will be comparable, if not higher, than rates and losses

[2] It is unclear whether mortgage insurance would be available to offset this requirement. If insurers were willing to accept the risk of strip down, the cost of mortgage insurance would increase. Mortgage insurance is not available on weaker credit borrowers.

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from foreclosure on investment properties[3] as bankruptcy attorneys will aggressively advertise to borrowers whose homes have declined in value, whether or not the borrower is in default, and when interest rates decline, advertise to all borrowers that bankruptcy provides an inexpensive method to refinance. The cost of defending these bankruptcy cases will be staggering to the industry.

It is important to understand what this bill does, to understand why it will so drastically affect the mortgage market and why MBA opposes its passage. In addition to the risk described above, other risks are introduced that are perhaps unintended, but which have serious consequences for all players in the mortgage market. We would like to discuss the full range of risks in greater detail, which will illustrate why mortgage rates and terms will change so dramatically.

Key Provisions of S. 2136 Introduce Substantial New Credit Risk

A. Permits Modifications and Strip Down of Home Mortgages

As stated above, the bill amends section 1322(b) of the Bankruptcy Code, which currently prohibits bankruptcy judges from modifying the terms of mortgages secured by "principal residences" in Chapter 13. The bill would permit bankruptcy courts to change the terms of the mortgage without the lender's consent (often referred to as a "cram down"), including modifying the interest rate, extending the maturity date, capitalizing arrearages and reamortizing the loan. In addition, judges would be granted the authority to "strip down" a secured home mortgage. A strip down (sometimes also known as a "lien strip") is a type of cram down that effectively converts that portion of the secured debt that exceeds the fair market value of the home into unsecured debt. The unsecured portion is treated like other unsecured debt, which is generally paid little or nothing through the Chapter 13 Plan, and is discharged upon successful completion of the plan.

The modification provision in S. 2136 applies to all loans secured by principal residences, not just the narrowly defined classes of abusive mortgages that members of Congress claim is the reason for this drastic change in public policy. Needless to say, this broad application of cram downs to the entire spectrum of mortgage products introduces substantial new risks into first mortgage and home equity lending on principal residences.

B. Eliminates Substantial Controls

[3] Unlike foreclosures, borrowers do not lose their assets in a Chapter 13. Rather the borrower receives a key benefit by imposing losses on the lender or investor. Because of this combination, the decision to file bankruptcy becomes significantly driven by economics (since home loss is not a factor). If the decline in property value is significant enough, the homeowner will have an incentive to seek cram down benefits comparable to an investor seeking to dispose of an underwater or financially draining asset.

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In addition to permitting cram downs of home mortgages, the bill goes farther and removes significant controls that virtually ensure that bankruptcy filings will skyrocket. S.2136 creates a quintessential moral hazard. Today, the Bankruptcy Code generally allows mortgages other than those secured by principal residences of the debtor to be crammed down. However, if such loans are crammed down, the debtor must pay the *entire amount* of the secured claim within the three-to-five-year duration of the Chapter 13 plan.[4] [5] For example, if a mortgage contract of $150,000 gets stripped down to $100,000, the debtor must pay the entire $100,000 within three-to-five years in equal monthly installments. This control limits unbridled runs on the bankruptcy court whenever property values or rates decline. This control, however, is stripped from the rights of creditors by allowing the modified debt to be paid over a term longer than the Chapter 13 plan, which currently cannot exceed five years. S. 2136 thereby ensures more borrowers will seek Chapter 13 Bankruptcy.

Of course, consumer groups argue that the bill will *not* substantially increase creditor risk or mortgage costs because cram downs of second homes and investor properties had minimal impact on rates since protections were removed on those property types in 1978. Consumer groups fail to mention the whole truth.

In addition to the restriction mentioned above, vacation homes and investment properties seldom get to the point of cram down because there is generally little reason to cram down these loans. A vacation home clearly is not necessary to provide a roof over the borrower's head and with no equity, and little or no income, is a burden on the estate. Likewise, an investor property that has no equity and a negative cash flow is not necessary for reorganization and is a burden on the estate.[6] Thus, cram down of these types of loans is seldom attempted. Instead, the lender obtains termination of the automatic stay and the property is foreclosed without stripping down the lien. Conversely, a principal residence *is essential* to the reorganization of the borrower and thus if S. 2136 is enacted, courts will not release these assets from the stay and judges will be required to impose cram downs.

Because the bill also removes the credit counseling requirement when the debtor is in foreclosure, the bill removes the final control against unfettered bankruptcy filings. Congress enacted the pre-filing counseling requirement to assure that debtors in financial difficulty had the benefit of two independent sources of information – approved non-profit counselors, and bankruptcy attorneys. Credit

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[4] 11 USC 1322(d)(2007). See also In re Enewally, 368 F.3d 1165 (9th Cir., 2004).

[5] The unsecured portion of the claim that gets crammed down gets an apportioned payment to the extent there is additional income or cash that can support those payments. If there are no funds remaining to pay unsecured creditors after paying secured and priority claims, the unsecured creditors receive nothing and the unsecured debt is discharged upon termination of the plan.

[6] Investment properties with no equity but with a positive cash flow are still subject to repayment during the 3/5 year term of the plan and thus seldom get crammed down.

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counselors are well versed in housing assistance that can help a borrower save his home without filing bankruptcy.

There is no doubt that the impact of the modification provision combined with elimination of all creditor protections will result in increased Chapter 13 filings. The considerable incentive of financial gain to the borrower will ensure that cram downs on home loans will skyrocket over the rate of existing cram downs on second homes and investor loans. Lenders will be forced to control or offset these costs through higher interest rates, points and fees; tighter underwriting restrictions; and bigger down payments. In addition, we believe that lenders and servicers would have a fiduciary duty to their stockholders to take precautions to minimize losses by avoiding declining markets. The bill has the potential to promote legal "red-lining" of distressed regions, such as the Rust Belt states. The result is counter to industry and legislative efforts to help these borrowers.

Impact of Cram Downs on Government Programs

A significant downside of the proposed bankruptcy legislation is the impact on mortgage servicers and, ultimately, on government housing programs. Today, the Federal Housing Administration (FHA), Department of Veterans Affairs Home Loan Guaranty Program (VA) and Rural Housing Service (RHS) are the prime liquidity vehicles for home purchases and mortgage refinances. FHA, for example, has seen an increase in mortgage applications recently due to the exodus of private investors. VA and RHS programs, while smaller, offer significant benefits, including 100 percent financing, to a specialized segment of consumers.

When these government programs were created, there was no risk of cram down on home mortgages. As a result, authorizing statutes and regulations of the government programs fail to deal appropriately with the risk created by the bill. Statutes were developed to deal with foreclosures, not bankruptcy modifications and strip downs. As a result, the bankruptcy legislation, when combined with existing investor accounting and claim policies, creates perverse results for mortgage servicers. These results may cause servicers to avoid administering these products. Without servicers, originators cannot offer these products.

For example, the vast majority of FHA, VA, and RHS loans are securitized into Ginnie Mae securities. Ginnie Mae guarantees the timely payment of principal and interest to investors; but, servicers are bound by contract to remit scheduled principal and interest to Ginnie Mae regardless of receipt by the borrower. If a mortgage is modified as to rate, term, capitalization or amortization, the loan must be repurchased from the Ginnie Mae security by the servicer at par (the amount of the principal balance). Servicers often have to borrow the money to buy out the loan. In order to avoid taking principal losses, servicers quickly resecuritize the modified loans into Ginnie Mae II securities. Today, there is no problem resecuritizing voluntary modifications because the borrower is brought

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current through the process. However, unlike voluntary modifications, it is unclear whether modified mortgages *in bankruptcy* will be eligible for resecuritization. Wall Street has little appetite for bankrupt debtors in securities. If bankruptcy modifications cannot be resecuritized, servicers will have to place these assets on their books, hold capital and loan loss reserves against them and take the risk of principal loss, which they do not typically do today. The servicer would also be paying the debt service on the commercial loan used to buy the loan out of the pool. Given our belief that Chapter 13 modifications will dramatically increase, the cost to the servicing industry would be substantial.

It is also important to note that servicers cannot submit an FHA insurance or a VA guarantee claim for the amount of any lien strip down. The servicer would have to advance the amount that was stripped down to Ginnie Mae security holders and absorb the principal loss. This is a substantial shift in liability servicers certainly did not contemplate when they agreed to service Ginnie Mae securities. As stated previously, servicers rarely take principal losses today. The severity of losses to which servicers would now be exposed would be comparable to what FHA and VA lose with each foreclosure – more than $30,000 per property. Yet, if those loans went to foreclosure sale, FHA insurance and VA guarantees would kick in to protect the servicer against principal loss.

The risk of uninsured losses and repurchase risk created by S. 2136 would cause existing servicing portfolios to decline in value, requiring accounting write downs of servicing assets. The velocity at which loans would enter bankruptcy could cause capital and liquidity problems for servicers. This disruption could also cause significant problems with voluntary workouts as bankruptcy cram downs would consume the servicer's financial and personnel resources. The stated objective of encouraging more voluntary workouts through S. 2136 would simply not materialize because the reward in bankruptcy is far more lucrative than what servicers could or should offer.

Going forward, servicers would bid less for servicing assets, which would drive up mortgage rates and costs for borrowers. Also, because servicers do not currently bear the primary risk of principal loss, servicers may shun these products, require significantly greater compensation, or service only loans with protections (such as higher down payments) in the future. All of these options have a direct impact on the success of the government programs and program features that make them attractive today.

Consumer groups argue that lenders will convince these entities to merely change their policies. It is not so simple. FHA, for example, is not permitted *by statute* to pay an insurance claim for the strip down amount. [7] It was simply not

[7] 12 USC 1710a (2007). FHA can only pay a claim when it receives title to the property, the mortgage is foreclosed, the loan gets assigned, there is a pre-foreclosure sale or there is a loss mitigation partial claim. A partial claim is a specialized loss mitigation tool, which allows arrearages to be subordinated into a junior lien held by HUD.

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contemplated. An act of Congress would be required to restore the 100 percent federal insurance that makes the FHA products marketable.

Impact of Cram Downs on Investors and the MBS Market

Securitization increases homeownership. Today, banks and other lenders resell mortgage debt to other investors, or "securitize" it. This frees up capital and allows banks and mortgage companies to invest more into local economies and makes home mortgage credit more widely available. As a result, homeownership has risen significantly since the mid-1990s. The share of Americans who owned homes rose from 64 percent in 1994 to 69 percent by 2005. This is the highest increase in homeownership since the surge that followed World War II.

Securitization of mortgages is based on the underlying value of those mortgage contracts. Granting bankruptcy judges the authority to retroactively modify a mortgage in Chapter 13 proceedings would have a materially adverse impact on the mortgage contract. The resulting uncertainty would mean that securitizers or investors could not assess prices or calculate the risk of how many mortgages could be modified. Such uncertainty would likely drive investment away from mortgage-backed securities (MBS) or result in overcompensating for risk through pricing. Existing MBS values could also decline as losses mount, resulting in additional downgrades of securities.

Investors such as Fannie Mae and Freddie Mac would be required to purchase the vast majority of loans out of the MBS pools if the loans are modified and absorb the principal losses.

It is unclear what would happen to investors. No doubt investors in non-guaranteed mortgages and MBS ultimately would take the principal loss and reduced yields, however, it is possible that if judges modify loans beyond the pool parameters (such as by converting a 15-year mortgage to a 30-year mortgage), the loans would have to be purchased out of the MBS pools. It is unknown if servicers would bear that cost.

Lenders Forced to Guarantee Origination Value of Properties Damaged or Destroyed by Natural Disasters or Borrower Misconduct

Another significant concern created by the bill is the windfall borrowers would obtain when the property is either 1) damaged by the borrower or 2) damaged by natural disasters such as Hurricanes Katrina and Rita or the recent wildfires of Southern California.

Borrowers in default often fail to properly maintain their property, and sometimes intentionally damage their property. In some cases, borrowers attempt significant renovations but fail to complete them, leaving the collateral significantly

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devalued. We do not believe these debtors should be rewarded through loan stripping, but S. 2136 would do just that if passed.

Likewise, we do not think borrowers should be able to wipe out the security interests of creditors when their properties are destroyed by natural disasters, but S. 2136 would do just that. To illustrate our concern, we would like to focus on properties damaged by Hurricanes Katrina and Rita. As you might be aware, lenders have offered borrowers who were impacted by the Hurricanes over two years of forbearance and/or have also modified their mortgages. Some properties have zero or negative values. Now that community development block grant money is flowing to homeowners to rebuild these properties, Congress is poised to add another devastating blow to investors and servicers: the ability for borrowers to wipe out *all or significant portions* of the debt in Chapter 13 bankruptcy. The impact of lien stripping on insurance proceeds and grant funds as secured assets is also brought into question, leaving creditors with possibly no recourse to recover the value of the debts. S. 2136 places lenders, servicers and investors in an inappropriate role of property insurers of last resort and/or guarantors of property values. Mortgage lenders and servicers are not in a position to evaluate these risks.

S. 2136 Gives Enormous Windfalls to Borrowers

What is probably one of the most inequitable results of S. 2136 is the fact that debtors in depressed real estate markets or with damaged or destroyed properties will reap a windfall at the expense of servicers, investors and borrowers who honor their debts. This windfall occurs when the borrower is permitted to reduce the debt to the depressed value of the property, retain the property, and enjoy the benefits of appreciation in value when market conditions improve (or repairs are made with insurance and government aid), while having no obligation to pay the lender the full contractually agreed upon debt. Executing a strip down based on a snapshot of value ensures borrowers will reap significant profits when the property appreciates later in time. The case in point is illustrated by In re: Enewally 368 F.3d 1165 (9th Cir., 2004).[8] While there are always pockets of declining home values, over the last 30 years home prices nationally have risen six percent per year on average.[9]

The unfair result S. 2136 would create does not occur today in Chapter 7 or when the borrower is allowed to foreclose on the property. The creditor in either case would have the right to acquire the property by bidding its claim. The creditor could then, if it chooses, hold the property until market conditions improve (and retain full insurance benefits and security interests in grant

[8] At the time of the bankruptcy court's ruling in 2001, the debtor's property had declined in value to $210,000. The mortgage debt was approximately $245,000 and the borrowers sought cram down. However by the time the United States Supreme Court rejected the Writ of Certiorari three years later, that same property was worth $600,000. Had the debtors' cram down not been overturned on appeal, the debtors would have received a significant windfall.
[9] OFHEO House Price Index.

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proceeds in the case of damaged property), thereby reducing its losses. The servicer would also receive the benefits of credit enhancements in the event of foreclosure, such as private and government mortgage insurance and hazard insurance, obtained to prevent uninsured losses. In the case of a foreclosure, the servicer could in most cases also seek a deficiency judgment for the difference between the value of the property and the contractual obligation. No such remedies are contemplated in S. 2136.

Industry Efforts to Assist Distressed Borrowers

Members of this Committee have stressed their goal of keeping people in their homes. We at the Mortgage Bankers Association absolutely share the same goal. No one wants a family to lose its home and MBA's members are trying their best to help. Servicers are providing loss mitigation to eligible borrowers in distress. These alternatives to foreclosure include forbearance and repayment plans, modifications, partial claims (FHA), short sales and deed in lieu of foreclosure. There has been a lot of criticism about the lenders' speed at modifying loans, but the industry has taken steps to speed up assistance to borrowers.

In particular, the White House announced on December 6th a voluntary industry initiative to modify mortgages by freezing introductory rates on certain subprime loans scheduled to reset in the near future. The White House estimates that 1.2 million homeowners could be helped by this initiative. Lenders also have very aggressive refinance options that they are promoting to borrowers who wish to take advantage of these opportunities.

While the press and consumer groups focus exclusively on modifications as the only source of assistance, little recognition is given to the fact that many other workout options are being offered to borrowers in significant volume – most notably repayment and forbearance agreements that allow the borrower significant time to repay arrearages and keep their homes. The industry has also made strides in clarifying accounting and tax rules to allow for more modifications.

Another problem that servicers are attempting to resolve is the low contact rate servicers have with borrowers. Historically, 50 percent of borrowers who faced foreclosure had no contact with the servicer despite multiple efforts on the servicer's part to reach out. Contact volume is still low and borrowers often simply don't know where to turn for reliable advice and assistance. Servicers have been working diligently to ensure all borrowers know about alternatives to foreclosure and to coordinate with housing counselors if borrowers are uncomfortable talking to their servicers. To help provide a coordinated and centralized approach to foreclosure prevention, the industry, with the assistance of the Department of Treasury, Department of Housing and Urban Development and the Housing Policy Council of the Financial Services Roundtable, recently

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launched HOPE NOW.[10] This effort will provide additional outreach attempts to borrowers, provide a centralized approach to managing housing counselors, centralized points of contact, and will track various metrics on housing counseling and loss mitigation activities.

Alternative Congressional and Government Actions

Congress and the Administration have done several things to help borrowers. Congress has added funds for housing counseling in the appropriations bills and the Banking Committee recently passed FHA modernization. FHA also recently announced FHASecure,[11] which allows borrowers the opportunity to refinance into FHA insured loans. What is remarkable about this program is that it would allow a borrower who is six months delinquent on an adjustable rate (ARM) loan to refinance into an FHA loan, despite his or her delinquency, provided the borrower had a good payment history prior to the ARM rate reset and he can afford the new payments. The program also allows borrowers who are upside down on their mortgages (i.e., owe more than their property is worth) to refinance a portion of their loan into non-FHA insured subordinate liens. In the past, combined loan-to-value requirements prohibited such activity. Unfortunately, passage of S. 2136 would prevent these subordinate loans from being originated, thus depriving borrowers of useful assistance.

While Congress has made strides in assisting borrowers in distress, S. 2136 goes too far. It encourages damaging behavior that will only serve to increase the cost and reduce the availability of home financing. It repudiates existing contracts, imposes mandatory buyback options or home price guarantees on all mortgages and an option to change rate terms. For proponents to argue that such options and guarantees will not come with a price is simply disingenuous.

Conclusion

MBA opposes S. 2136 because of the significant impact of the legislation would cause to the mortgage market and borrowers who seek home mortgages. The legislation would treat home mortgage debt less favorably in bankruptcy than other loans, including loans on vacation homes, investor properties and automobiles by stripping home loans of certain protections offered to other creditors. While well-intentioned, S.2136 would increase rates, tighten credit standards, and dry up investor interest in mortgage-backed securities. Our preliminary estimates indicate that mortgage interest rates could jump as much as 200 basis points per loan and down payment requirements would increase if proposed amendments to Chapter 13 of the Bankruptcy Code are enacted. Government programs also stand to be negatively impacted due to the increased costs to administer these programs. With investor appetite for U.S. mortgages waning, it is ill-advised to pass legislation that would further disrupt the mortgage

[10] http://www.hopenow.com/
[11] http://www.fha.gov/about/fhasfact.cfm

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market. We urge Senators to look deeper into the implications of S. 2136. We are convinced that upon further detailed analysis you will agree that further action on this legislation is ill-advised.

Thank you for this opportunity to share our concerns with the Committee.

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STATEMENT OF
THE NATIONAL ASSOCIATON OF HOME BUILDERS
ON
"The Looming Foreclosure Crisis: How To Help Families
Save Their Homes"

December 5, 2007

Introduction

The National Association of Home Builders (NAHB) appreciates the opportunity to submit this statement on the oversight hearing examining the recent dramatic increase in foreclosures. Founded in 1942, NAHB is a federation of more than 800 affiliated state and local building industry associations. It is the voice of the housing industry in the United States. NAHB represents over 235,000 builder and associate members throughout the country, including individuals and firms that construct and supply single-family homes, as well as apartment, condominium, multi-family, commercial and industrial builders, land developers and remodelers. NAHB's builder members will construct 80 percent of the more than 1.36 million new housing units projected for 2007.

The Need for Legislation Modifying the Bankruptcy Code

NAHB shares the alarm of the Committee about the recent explosion in foreclosures. Without question, the ballooning foreclosure rate is not only putting more pressure on the housing market, it poses a threat to the American dream of homeownership. NAHB believes Congress must take action to assist struggling homeowners and strongly supports numerous legislative responses to the foreclosure crisis, including legislation that is before the Senate to modernize the FHA program (S. 2338) and to end the taxation of forgiven mortgage debt (S. 1394). The House of Representatives has already passed FHA reform (H.R. 1852) and mortgage debt forgiveness legislation (H.R. 3648). NAHB believes these bills are the best way to address the problems in today's housing finance market and urges the Senate to pass them expeditiously.

NAHB recommends against adopting broad legislation that would change the way all primary-residence mortgages are treated in bankruptcy. In particular, NAHB opposes legislation, such as the *Helping Families Save Their Homes in Bankruptcy Act of 2007* (S. 2136), that would allow the terms of a mortgage on a primary residence to be modified during bankruptcy. Rather than changing the way all primary-residence mortgages are treated in bankruptcy, Congress should focus on the real problem, namely sub-prime adjustable rate mortgages, by passing the legislation discussed above.

By allowing bankruptcy judges to modify the terms of a primary-residence mortgage, Congress would add substantial new risks to investors in the secondary market, decreasing liquidity in the marketplace and creating new barriers to home ownership with higher downpayment requirements and mortgage rates.

The Impact of Mortgage Rate Increases on Housing Affordability

NAHB is particularly concerned about the impact of mortgage rate increases that are likely to occur if Congress passes broad bankruptcy legislation removing the protections on primary-residence mortgages. While NAHB appreciates the aim of S. 2136 and other similar bills, they will have both a short and long-term negative impact on housing in America—and may ultimately hurt more homeowners than they will help.

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Congress should not underestimate the impact even a small increase in mortgage rates has on housing affordability. Based on an analysis by NAHB's Economics Department, a modest quarter point increase in mortgage rates would price out over 1.1 million households from the marketplace. A full point increase would push over 4.5 million Americans out of mortgage eligibility on a median priced new home.

U.S Households Priced Out of the Market by an Increase in Interest Rates

Area	Mortgage Rate	House Price	Monthly Mortgage Payment	Taxes and Insurance	Minimum Income Needed	Households That Can Afford House
United States	6.00%	$243,300	$1,377	$301	$71,894	35,724,325
United States	6.25%	$243,300	$1,413	$301	$73,442	34,609,498
Difference	0.25%	$0	$36	$0	$1,548	-1,114,827
United States	6.00%	$243,300	$1,377	$301	$71,894	35,724,325
United States	6.50%	$243,300	$1,449	$301	$75,006	33,482,823
Difference	0.50%	$0	$73	$0	$3,112	-2,241,502
United States	6.00%	$243,300	$1,377	$301	$71,894	35,724,325
United States	6.75%	$243,300	$1,486	$301	$76,587	32,344,633
Difference	0.75%	$0	$109	$0	$4,693	-3,379,692
United States	6.00%	$243,300	$1,377	$301	$71,894	35,724,325
United States	7.00%	$243,300	$1,524	$301	$78,182	31,195,261
Difference	1.00%	$0	$147	$0	$6,289	-4,529,064
United States	6.00%	$243,300	$1,377	$301	$71,894	35,724,325
United States	7.25%	$243,300	$1,561	$301	$79,793	30,168,116
Difference	1.25%	$0	$184	$0	$7,900	-5,556,209
United States	6.00%	$243,300	$1,377	$301	$71,894	35,724,325
United States	7.50%	$243,300	$1,599	$301	$81,419	29,399,591
Difference	1.50%	$0	$222	$0	$9,525	-6,324,734

Calculations assume a 10% down payment and a 45 basis point fee for private mortgage insurance.
A Household Qualifies for a Mortgage if Mortgage Payments, Taxes, and Insurance are 28% of Income

At a time when the housing market is just beginning to recover from a severe credit crunch, this well-intentioned but ill-advised legislation is poised to bring renewed turmoil to the markets and further depress the market by potentially pricing out millions of buyers. Moreover, since the risk is likely to be highest in the sub-prime and alt-A market, modifying how primary-residence mortgages are treated in bankruptcy court will only further decrease the availability of credit to those borrowers these bills seek to help.

NAHB cautions against gambling with the dreams of millions of Americans seeking home ownership.

Conclusion

NAHB remains very concerned about the number of foreclosures as well as the high number of adjustable-rate subprime mortgages that will reset over the coming months. The high foreclosure rate only adds to the downward pressure on the housing market and the economy as a whole. Although the U.S. Commerce Department recently reported that sales of new homes increased in October, October's seasonally adjusted annual rate of 728,000 units was 23.5 percent below a year ago. The inventory of new homes for sale amounts to an 8.5-month supply at the current sales pace, and the downward momentum in the single-family housing market continues. Reduced residential fixed investment could retard growth in the Gross Domestic Product (GDP) growth this year by as much as 0.8 percent.

Unfortunately, legislation like S. 2136 would ultimately do more harm than good. The impact of these bills reach beyond the real problem, namely sub-prime adjustable rate mortgages, and could have far-reaching impact on the liquidity in the housing finance system. NAHB will continue to work with Congress to find appropriate ways to assist struggling home owners, but continues to urge the Judiciary Committee to reject broad changes to how bankruptcy courts deal with primary-residence mortgages.

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Determining the Number of Households Priced Out of a Market

For most people, buying a home means taking out a mortgage. According to the U.S. Census Bureau's American Housing Survey, only 19% of recent home buyers purchased their homes for cash. Thus, the ability to buy a home depends, in most cases, on the ability to qualify for a mortgage. For conventional mortgages, qualifying guidelines set by the secondary market lenders play a dominating role.

The major secondary market lenders for conventional mortgages are the Federal National Mortgage Association, or "Fannie Mae", and the Federal Home Loan Mortgage Corporation, or "Freddie Mac". About half of conventional loans are sold in the same year they are originated, so acceptability of these loans to secondary market purchasers is crucial, and institutions making conventional loans tend to follow the guidelines set forth by Fannie Mae and Freddie Mac. Even where these guidelines permit some flexibility, local lenders prefer to follow them strictly -- rather than risk being unable to sell the mortgages, or facing the prospect of selling them and later being forced to buy them back. In fact, most lenders use a standard mortgage application form developed jointly by Fannie Mae and Freddie Mac.

Standards to qualify for a mortgage are typically expressed as a fraction of the household's monthly income. In the jargon of lenders, the "front end ratio" is the percentage of monthly income devoted to "PITI" -- Principal and Interest (the mortgage payment itself), as well as property Taxes and property Insurance. For any particular set of assumptions about the mortgage, the front end ratio can be calculated for a given income. Thus, comparing household income to PITI is a convenient way to analyze the household's ability to buy a home.

Assumptions used in the "priced-out" computations are a downpayment equal to 10 percent of the purchase price and a 30-year fixed rate mortgage. For a loan with this downpayment, lenders would typically require mortgage insurance, so we also assume an annual premium of 45 basis points for private mortgage insurance. Local information about property taxes comes from Census data.[1] Average homeowner insurance rate data were compiled by the National Association of Insurance Commissioners; the data for each state were provided by the Insurance Information Institute. We then say that a particular household can afford a house if it satisfies the front-end requirement set down by Fannie Mae and Freddie Mac: PITI should not exceed 28 percent of income. Given a distribution of household income for the market area in question, this can be used to determine the number of households priced out of the market.

A detailed 2004 income distribution is available for all states and Metropolitan Statistical Areas from the 2005 American Community Survey, but must be adjusted for income and population changes in the intervening years. Income limits are adjusted annually based

[1] For greater detail, see Paul Emrath, • "Property Taxes in the 2000 Census," *Housing Economics,* December 2002; excerpts reprinted in Nation's Building News June 16, 2003, and Land Development Summer 2003.

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on the U.S. Department of Housing and Urban Development's list of median family incomes for all states. The number of households in each category is multiplied by a population growth factor -- generally determined by computing the average annual growth rate implied by the change in area population between 2003 and 2005 (available from the Bureau of Economic Analysis, which is part of the U.S. Department of Commerce) and assuming that the number of households in each income group grew at this rate every year since 2005.

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Statement of Mark S. Scarberry
Before the Senate Committee on the Judiciary

Hearing on
"The Looming Foreclosure Crisis: How To Help Families Save Their Homes"

December 5, 2007

Mr. Chairman and members of the Committee, I am Mark S. Scarberry, Professor of Law at Pepperdine University School of Law and currently the Robert M. Zinman Resident Scholar at the American Bankruptcy Institute (ABI). I am pleased to appear today to speak about pending legislation that would amend the Bankruptcy Code (the "Code") to help homeowners avoid foreclosure.

Founded on Capitol Hill in 1982, the ABI is a non-partisan, non-profit association of over 11,000 professionals involved in bankruptcy and insolvency, representing both debtors and creditors in consumer and business cases. ABI is not an advocacy group and does not take lobbying positions on legislation before Congress or advocate any particular result in matters pending before the courts. Rather, the ABI is a neutral source for information about the bankruptcy system (such as how courts are interpreting provisions of the Bankruptcy Code) and a resource for members of Congress and their staff considering changes to the Code. As an academic, and as the ABI resident scholar, I am permitted to give my views on legislation, but those views should not be taken as the views of the ABI.

At Pepperdine, I teach and write primarily in the area of bankruptcy law, including both business and consumer bankruptcy. My C.V. is attachment 1 to this written statement, but let me briefly say that after graduating from UCLA Law School and working for four years in Los Angeles for the law firm of Jones, Day, Reavis & Pogue, I joined the faculty of Pepperdine University School of Law, where I have taught for the past twenty-five years. This semester I have served as the Scholar in Residence at the ABI in Alexandria, Virginia. I am the lead author of a chapter 11 business bankruptcy casebook published by Thomson/West. I have written training materials for a pro bono consumer bankruptcy program in Los Angeles, the Los Angeles County Bar Ass'n/Public Counsel "Debtor Assistance Project," and taught in its training programs, preparing lawyers to provide pro bono consumer bankruptcy services. I recently finished a law review article for the ABI Law Review on the Supreme Court's decision earlier this year in *Travelers Casualty & Insurance Co. of America v. Pacific Gas & Electric Co.*,[1] a decision with both business and consumer bankruptcy implications. Today's subject is not new to me; fourteen years ago I published an article[2] on the topic of home mortgage strip down just as the Supreme Court was deciding *Nobelman v. American Savings Bank*,[3] which held that the Code prohibited strip down of home mortgages in chapter 13.

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[1] 127 S. Ct. 1199 (2007)
[2] Mark S. Scarberry & Scott M. Reddie, *Home Mortgage Strip Down in Chapter 13 Bankruptcy: A Contextual Approach*, 20 PEPPERDINE L. REV. 425 (1993).
[3] 508 U.S. 324 (1993).

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As the Resident Scholar at the ABI, I have studied the pending legislation introduced in both the Senate and House dealing with the mortgage crisis, including the four bills that would, to one extent or another, permit modification of home mortgages in chapter 13. I prepared a chart comparing the four bills. The chart, which I think has been widely consulted, is available on the ABI webpage, www.abiworld.org, and appears as attachment 2 to this written statement.

My testimony today will focus on the two Senate bills, S. 2133 and S. 2136. A key difference of course is that Senator Durbin's bill, S. 2136, allows a chapter 13 plan in some cases to reduce the amount of an undersecured mortgage to the value of the home without the consent of the mortgage holder, a result that is called "strip down." (Sometimes it is called "cramdown," but it is best to reserve that term for confirmation of a chapter 11 plan over the dissent of a class of claims or interests). Senator Specter's bill, S. 2133, would require consent of the mortgage holder before a chapter 13 plan could reduce the amount of the mortgage.

Thus I will begin by discussing the concept of home mortgage strip down and how the provisions of the Code presently do not permit it in cases under chapters 7, 11, or 13. Then I will explain why allowing home mortgage strip down in chapter 13, under the approach in S. 2136, would not simply treat home mortgage holders the same as other secured creditors but in fact much less favorably. Next I will explain why I prefer S. 2133's approach, allowing reduction of the amount of the mortgage only if the mortgage holder—or possibly the mortgage servicer—consents. A key reason is that strip down deprives the mortgage holder of the possibility of benefiting from a recovery in the real estate market and thus substantially changes the risk characteristics of the debt instrument.

Then I will suggest ways in which the bills might be improved. Substantive suggestions include targeting relief more precisely and also providing a clear benchmark for the setting of interest rates (so that costly, repetitive hearings with subjective outcomes can be avoided). On the technical side I will suggest that the bills address discharge issues and other issues dealt with by Representative Miller's bill, H.R. 3609.

Before getting into those areas of my testimony in detail, I would like to suggest the possibility that Congress could use its power to enact bankruptcy laws to help Treasury Secretary Paulson succeed in his attempt to provide more of a "wholesale" solution to the mortgage crisis, as compared to the one-case-at-a-time "retail" solution that might be provided by the bills before the Committee today. To the extent that mortgage servicers may lack authority to modify mortgages on a "wholesale" basis, under the process suggested by Secretary Paulson, such modifications may be unenforceable or may leave the servicers vulnerable to lawsuits filed by beneficial owners of the mortgages. Congress may wish to consider legislation that would validate such agreements when entered into under guidelines set by the Department of the Treasury and that would immunize servicers from liability for entering into such

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agreements.[4] It is not clear that the bankruptcy courts could handle enough chapter 13 cases quickly enough to deal effectively with the current problems and those on the near horizon, even if one of the bills before the Committee were to be enacted quickly. A "wholesale" solution may be necessary if any effective legislative action is to be taken. To the extent that a "wholesale" solution may require modification of the rights of the beneficial holders of mortgages, the bankruptcy power may be a particularly appropriate basis for legislation.

Home Mortgage Strip Down Under the Bankruptcy Code

When the value of a secured creditor's collateral is less than the amount of the debt secured by the collateral, section 506(a) of the Code usually divides the secured creditor's claim into a secured claim for the value of the collateral and an unsecured claim for the excess. Under nonbankruptcy law, the secured creditor has a lien on the collateral for the entire amount of the debt (even though the value is less than the debt), and the debtor generally has no right to eliminate the lien simply by paying the value of the collateral. In some cases, bankruptcy law allows the lien on the collateral to be reduced to the value of the collateral. When that occurs, it is called a "strip down" of the lien. If the lien at issue is a mortgage on the debtor's home, we would use the term home mortgage strip down.

At about the time Congress enacted the Financial Institutions Reform Recovery and Enforcement Act (FIRREA) in 1989, circuit courts began holding for the first time that home mortgages could be stripped down in chapter 13.[5] In 1992 a chapter 7 liquidation bankruptcy mortgage strip down case (not involving a home mortgage) reached the Supreme Court, followed the next year by a chapter 13 home mortgage strip down case. By that time, as I noted in my 1993 article, "strip down [was] becoming so widely used that it threaten[ed] to further damage the already weak home lending industry."[6] In the 1992 case, *Dewsnup v. Timm*,[7] the Supreme Court held that section 506(d) of the Code—a provision applicable to bankruptcy cases under all chapters of the Code (other than the new chapter 15) did not authorize strip down of liens. And in the 1993 case, *Nobelman v. American Savings Bank*,[8] the Supreme Court held that section 1322(b)(2) prohibited home mortgage strip down in chapter 13.

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[4] This approach would go further than Representative Castle's bill, H.R. 4178, which would provide immunity for servicers but apparently would not expand their authority to enter into agreements that would bind beneficial owners of mortgages.

[5] See Scarberry & Reddie, supra note 2, at 432-48. Note, however, that most of the courts that allowed strip down nevertheless required debtors to maintain their payments at the originally required level. See id. at 486. Thus the effect was not to help debtors who were unable to make their payments, but rather to allow them to pay off their stripped down mortgages years earlier than they otherwise would have. This strange approach also had the effect of maintaining the level of cash flowing to holders of mortgages for years; the full effect of strip down thus would not have been seen until years down the road. Of course the Court intervened in *Nobelman* and stopped the practice soon after it had become widespread.

[6] *See* Scarberry & Reddie, *supra* note 2, at 494.

[7] 502 U.S. 410 (1992).

[8] 508 U.S. 324 (1993).

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The Supreme Court decided *Nobelman* on June 1, 1993. Two months later Congress extended the sunset date for the chapter 12 family farmer bankruptcy provisions—originally enacted in 1986—by five years, to October 1, 1998. (Subsequently, the sunset date was extended multiple times, with only a brief lapse, until chapter 12 was made permanent in 2005.) Although, as noted below, farm home mortgage strip down is permitted under chapter 12, the extension of its sunset date does not seem to have signaled disapproval of *Nobelman*; the next year, in 1994, Congress amended section 1123(b) to ensure that home mortgage holders received the same protection in chapter 11 cases that they received under *Nobelman* in chapter 13 cases.

Why Allowing Home Mortgage Strip Down in Chapter 13 Under S. 2136 Would Treat Mortgage Holders Less Favorably Than Other Secured Creditors

It is often said that allowing home mortgage strip down in chapter 13, under an approach like that in S. 2136, would simply treat holders of home mortgages the same as other secured creditors, such as holders of mortgages on vacation homes. That is not, however, the case.

If a secured creditor's lien is stripped down under the current provisions of chapter 13, the stripped down amount must be paid off during the chapter 13 plan with interest—a period of no more than five years.[9] Thus, as a practical matter, a debtor cannot strip down a first mortgage on a vacation home, because the payments needed to pay off even the stripped-down amount over five years will be too large. The rare debtor who could afford such large payments does not deserve bankruptcy relief.

Under S. 2136, however, a debtor could pay off a stripped-down home mortgage over a period that could be as much as nearly thirty years. Not only would strip down thus become feasible only for home mortgages, but the interest rate to which the holder of the home mortgage would be entitled for up to nearly thirty years would be set by the court rather than by the contract, and the home mortgage holder would have to wait for that very long time to receive full payment even of the stripped down amount. By contrast, other secured creditors whose liens are stripped down in chapter 13 are subject to a court-determined interest rate for no more than five years and cannot be required to wait longer to be paid.

Finally, many secured creditors other than home mortgage holders no longer are subject to strip down in chapter 13 after the 2005 amendments to the Code. Purchase money automobile lenders are subject to strip down only if the loan was made more than two and a half years (910 days) before the petition filing date.[10] Home mortgages thus would be treated worse than the most common debt secured by personal property, even

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[9] *See* 11 U.S.C. § 1325(a)(5)(B); Enewally v. Wash. Mut. Bank (*In re* Enewally), 368 F.3d 1165 (9th Cir. 2004); Scarberry & Reddie, *supra* note 2, at 468-73; Helping Families Save Their Homes in Bankruptcy Act: Section by Section Summary, page 1 (Dec. 4, 2007 version); cf. Ann E. O'Donnell, *Modification of Secured Claims: How to Reconcile Apparent Conflicts Within the Plain Language of § 1322*, CHAPTER 13 ANALYSIS, ABI 12th Annual Northeast Bankruptcy Conference, available on Westlaw at 071405 ABI-CLE 13 (2005) (discussing *Enewally* and several district court and bankruptcy court decisions that split on the issue whether payments must be completed within the five years permitted for a plan). In my view, the Code is clear on this point; *Enewally* was correctly decided.

[10] *See* 11 U.S.C. § 1325(a) (final sentence—the "hanging paragraph"—added in 2005).

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though Congress historically has recognized the importance of protecting real property secured lenders, and particularly home mortgage lenders.[11]

Why the Code Should Not Be Amended To Provide for Home Mortgage Strip Down in Chapter 13

I believe home mortgage strip down should not be permitted in chapter 13. Permitting home mortgage strip down would likely cause difficulties in the secondary mortgage market that is so important to the availability and affordability of home mortgages. In addition, permitting home mortgage strip down would cause unjustified harm to the holders of home mortgages and home mortgage related securities, with a negative effect on investors, including investors of modest means. These views are based mainly on two conclusions. First, as noted above, home mortgages would move from being protected to being treated less favorably than most other secured consumer debts. Second, home mortgage strip down would substantially change the risk characteristics of home mortgages, largely because of the likelihood that strip down would occur during a real estate market downturn when prices are depressed.[12]

Under the approach in S. 2136, home mortgage holders would not benefit from the upturn in the real estate market that ordinarily follows a downturn. Congress attempted, wisely in my view, to prevent such consequences in chapter 11 cases with regard to all kinds of collateral, by repealing former section 1124(3) (which permitted cashing out of a mortgage at a depressed market value) and by creating the section 1111(b)(2) election (which permits an undersecured creditor to elect to be treated as fully secured, though perhaps without much of the protective effect that Congress intended). At least some financially-distressed debtors who could, perhaps with difficult belt-tightening, afford to make their mortgage payments, will instead opt to strip down the mortgage in chapter 13. The later upturn then will provide equity for the debtor rather than a restoration of value to the mortgage. Under current law, after foreclosure the mortgage holder has the option hold the property and wait for it to appreciate. Home mortgage strip down eliminates that upside potential.

In addition, it seems likely that private mortgage insurance would not compensate home mortgage holders if the debtor strips down the mortgage in chapter 13 and avoids foreclosure. At least in the short run, strip down would deprive home mortgage holders of the benefit of the credit enhancement they bargained to receive, by way of private mortgage insurance.

Changing the risk characteristics of home mortgages retroactively in this way not only would likely depress further the value of the existing home mortgages. Increased risk would mean increased interest rates to compensate for the risk, and denial of mortgage credit to some who presently would qualify under appropriate underwriting

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[11] In addition to the protection of home mortgages in chapters 11 and 13, consider section 722, which permits redemption of certain property from liens by payment of amount of the debt or the value of the property, whichever is less, but which excludes real property from its operation.

[12] Valuation issues also would create much litigation under the approach in S. 2136, not only because of the difficulties in valuing real property but also because the approach to be taken to valuation—foreclosure sale value vs. what it would cost the debtor to buy a similar home—may be contested. The latter type of valuation would seem to be required by Assocs. Comm'l Corp. v. Rash, 520 U.S. 953 (1997), but that might be questioned, and footnote 6 in *Rash* creates ambiguity.

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standards. There also would be a shadow cast on the trustworthiness of American mortgage-backed securities. The implications are disturbing given that such securities are held worldwide by investors who count on the protection of property and contract rights under American law. Note that inclusion of a sunset provision might provide little comfort; the main lesson to be learned from inclusion of farm home mortgage stripdown in chapter 12[13] is that provisions thought to be temporary often turn out to be permanent.

Substantive Suggestions with Regard to S. 2133 and S. 2136

Whether a mortgage modification bill is needed at all depends on whether the market will handle this crisis without Congressional intervention and on whether the homeowners who may lose their homes should be protected even at the risk of causing oher harm (such as making it more difficult and more expensive for future would-be homeowners to obtain mortgages).

Should Congress decide to move forward with a bill, my substantive suggestions would be:

(1) not to include home mortgage strip down;
(2) to target relief carefully under clear and objective standards, such as the income standards in S. 2136, standards that do not require subjective, fact-intensive considerations (such as whether the debtor has sufficient current income per S. 2136);
(3) not to allow extension of the term of a home mortgage;
(4) to provide clear standards for the interest rate to be applied, in the event the contract rate is modified, which should probably be something like 2% over an appropriate national thirty-year conventional prime mortgage rate (rather than allowance of an appropriate risk premium, which would lead to subjective results after costly and repetitive hearings, and rather than locking in existing teaser rates);
(5) to provide both clear mortgage origination dates for eligibility for mortgage modification (e.g., mortgages originated between January 1, 2003 and September 26, 2007) and a firm sunset date (preferably one much shorter than the seven years provided for in S. 2133); and
(6) to delete the provision of S. 2136 providing for forfeiture of the mortgage lien and debt for various violations of law.

Technical Suggestions with Regard to S. 2133 and S. 2136

Allow me to refer the Committee to the chart that is Attachment 1 to this written statement for a discussion of some of the technical aspects of the bills. Technical provisions similar to those in H.R. 3609 should be included. They would make clear (1) that the mortgage holder's lien is retained despite the provisions of section 1325(a)(5)(B)(I)(bb), (2) that any personal liability on the mortgage is not discharged, and (3) that the debtor's discharge of other debts need not await completion of all payments on the modified mortgage. I would also suggest that some mechanism other

[13] The impact of chapter 12 farm home mortgage stripdown on that specialized market, even if it were researched, likely would tell us little about the impact of chapter 13 home mortgage stripdown on the much larger home mortgage market that is so dependent on the secondary market.

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than fraudulent transfer law be used if it is desirable to allow recovery of excessive interest. Finally, it should be made clear that the $75,000 homestead exemption provided by S. 2136 is a floor amount rather than an amount to be added to existing state law exemptions.

* * *

Thank you again for the opportunity to appear today. Please do not hesitate to call upon me or the ABI if we can be of further assistance on this or any other bankruptcy policy issue.

Attachment 1

Attachment 2

Detailed Chart Comparing Provisions of Current Bankruptcy Bills Dealing with Modification of Home Mortgages, as of October 17, 2007

Prepared by Mark S. Scarberry
Professor of Law, Pepperdine University School of Law
Robert M. Zinman Scholar in Residence, American Bankruptcy Institute

	Durbin Bill, S. 2136	Specter Bill, S. 2133* Chabot Bill, H.R. 3778* (identical except as noted in row for "Allows strip down ...")	Miller Bill, H.R. 3609
Eliminates or limits § 1322(b)(2) prohibition on modification of mortgage on principal residence	Yes, if debtor has insufficient current income to make mortgage payments and cure arrearages, after deducting other expenses permitted under § 707(b)(2)(A) & (B).	Yes, in certain cases, but only in specified ways described below. To modify a mortgage, the debtor must have current monthly income (including spouse's income) less than 150% of median per as determined under § 1325(a)(4)(A)(ii) (I)-(III). (Bill could be read to apply 150% multiplier only to debtors in households of one person.) Modification is limited to mortgages "initiated before September 26, 2007."	Deletes prohibition in § 1322(b)(2).
Allows strip down of mortgage lien to value of home in chapter 13	Yes, if modification of mortgage is permitted. Strip down is not addressed specifically but would be permitted under the general authorization to modify the mortgagee's claim.	Specter Bill: Yes, if modification of mortgage is permitted, ***but only if debtor and mortgagee so agree in writing***. Chabot Bill: Yes, if modification of mortgage is permitted ***with no requirement of agreement by mortgagee***.	Yes. Strip down is not addressed specifically but would be permitted under the general authorization to modify the mortgagee's claim.

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Allows payment of modified mortgage beyond duration of chapter 13 plan	Yes, if modification of mortgage is permitted. Unclear whether it provides exception to § 1325(a)(5)(B)(I)(bb) to allow mortgagee to retain lien after debtor receives discharge. Does not provide expressly for discharge to be granted on completion of payments other than mortgage payments. Does not expressly provide for mortgage not to be discharged as personal liability of debtor.	Apparently yes, if modification of mortgage is permitted, because allowed modifications do not include changes in payment schedule. Unclear whether it provides exception to § 1325(a)(5)(B)(I)(bb) to allow mortgagee to retain lien after debtor receives discharge. Does not provide expressly for discharge to be granted on completion of payments other than mortgage payments. Does not expressly provide for mortgage not to be discharged as personal liability of debtor.	Yes. Provides expressly for mortgagee to retain lien after debtor receives discharge despite provisions of § 1325(a)(5)(B)(I)(bb). Also provides expressly for discharge not to be delayed until completion of mortgage payments, and for mortgage obligation not to be discharged.
Allows chapter 13 plan to provide for extension of mortgage payments beyond term of mortgage	Yes, if modification of mortgage is permitted. Mortgage term can be extended to thirty years from origination of mortgage.	No.	Yes, without any express limitation on term.
Allows or requires court to determine mortgage interest rate for home mortgage modified in chapter 13 plan	Yes, if modification of mortgage is permitted. Court must set mortgage rate at most recent annual Fed figure for yield on conventional mortgages plus risk premium.	No.	Yes. Ordinary rules for determining interest rate needed to provide full present value of secured claim apparently would apply. No further guidance given in bill.
Allows chapter 13 plan to determine home mortgage interest rate.	No (except to extent that plan proponent must include appropriate interest	Yes, to a limited degree. If modification permitted, plan may	No (except to extent that plan proponent must include an interest rate that court

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	rate in plan).	modify right of holder of adjustable rate mortgage by "prohibiting or delaying adjustments to the rate of interest applicable to the debt on and after the date of filing of the plan or voiding any such adjustments that occurred during the 2-year period preceding that date of filing."**	will find to be sufficient to provide full present value of secured claim).
Limits post-petition fees and charges imposed by oversecured home mortgagee where debtor is in chapter 13	Only lawful and reasonable fees provided for in the mortgage agreement may be added, and only if mortgagee gives court notice.	Not clear. Same treatment as interest in cases of substantial failure to disclose material terms regarding fees. See footnote **.	Requires timely notice of fees to debtor and trustee.
Allows waiver of prepayment penalty in chapter 13 plan	Yes, whether or not mortgage may be modified otherwise, and without regard to income and expenses.	Yes, in chapter 13 plan, but only if modification of mortgage is permitted.	Yes (not specifically but as part of general authorization to modify mortgagee's claim in chapter 13 plan).
Disallows mortgage claim for violations of law	Yes. Applies generally to allowance of claims under all chapters of Bankruptcy Code. Entire mortgage claim is disallowed (and mortgage lien is voided) if mortgage is subject to any damages or rescission claim for any violation of TILA or any other state or federal consumer protection law in effect when noncompliance occurred, even if	No.	No.

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	mortgagee obtained foreclosure judgment.		
Waives pre-filing credit counseling requirement where home is in foreclosure	Yes, if mortgage foreclosure sale has been scheduled, and regardless of which chapter of the Bankruptcy Code the filing is made under.	Yes, as a pre-filing requirement, but debtor must obtain such counseling after the filing, apparently in addition to the required pre-discharge financial management course. Waiver applies only in chapter 13 cases.	Yes, if mortagee has initiated judicial or nonjudicial foreclosure on debtor's principal residence. Waiver applies only in chapter 13 cases.
Allows debtor (or trustee, upon timely intervention) to pursue claims (or defenses) held by debtor but not scheduled as asset of debtor (or as defense, presumably by way of scheduling creditor's claim as disputed).	Yes. Defendant cannot avoid liability by claiming that debtor is not real party in interest or by asserting judicial estoppel. Applies generally, not just in chapter 13 cases.	No.	No.
Allows court to refuse enforcement of arbitration agreement in core matters involving consumer debtor	Yes. Applies generally, not just in chapter 13 cases.	No.	No.
Creates $75,000 federal bankruptcy homestead exemption for debtors over 55	Yes. Applies generally, not just in chapter 13 cases. A $75,000 exemption is added to §§ 522(b)(3) and 522(d). Could be read to be in addition to whatever homestead exemption is provided under state law, where state law exemptions are used.	No.	No.
Requires study to be performed	No.	Yes. Comptroller General must conduct a study "to determine the impact of allowing bankruptcy	No.

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		judges to restructure principal residence mortgages on the secondary market for mortgages"and submit a report to Congress within 180 days of enactment.	

* S. 2133 and H.R. 3788 would apply only to chapter 13 cases, and only to such cases filed before the sunset date, seven years after the date of enactment.

** Apparently this would allow lock-in of teaser rates (or of adjustable rate below market rate for non-adjustable rate mortgages) for full term of mortgage. Voiding of increases might entitle debtors to refunds of some interest paid pre-petition. The bills also explicitly allow court to order recovery (in chapter 13 cases only) of pre-petition interest payments as fraudulent transfers if there was a substantial failure to disclose material terms regarding interest. Under § 548(a), up to two years of pre-petition interest could be recoverable. Section 548(a) apparently would not allow recovery of post-petition interest paid by debtor during the plan (though this is not clear), and the bills do not characterize the obligation to pay interest going forward as a fraudulently incurred obligation.

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Testimony of Mr. Henry J. Sommer
President, National Association of Consumer Bankruptcy Attorneys
Before the Senate Committee on the Judiciary
Hearing on "The Looming Foreclosure Crisis: How To Help Families Save Their Homes"
Wednesday, December 5, 2007

Mr. Chairman and members of the Committee, thank you for inviting me here to testify before you today. My name is Henry J. Sommer and I am an attorney specializing in bankruptcy and consumer law matters. For over 33 years, I have represented families and individuals in Philadelphia who have sought my help for serious debt problems, often involving mortgage foreclosure. I am the President of the National Association of Consumer Bankruptcy Attorneys (NACBA), an organization of attorneys who represent consumers in bankruptcy. Our members, numbering over 2700, represent a large proportion of the individuals who file bankruptcy cases in the United States Bankruptcy Courts. I am also Co-Editor in Chief of Collier on Bankruptcy, I have had the honor of testifying several times before this Committee over the past 25 years, and I am a former member of the Judicial Conference's Advisory Committee on Bankruptcy Rules and the Federal Reserve Board's Consumer Advisory Council.

It is now quite clear that our country is facing approximately two million home mortgage foreclosures over the next few years. While there may have been some doubt about this when I first testified about this issue in the House last April, the dimensions of the problem are now becoming evident to almost everyone. These foreclosures are already having widespread effects in neighborhoods across America, as well as in the financial markets, and those effects will get much worse in the months to come. Not only will millions of people lose their homes, but other homes in the vicinity will decline in value as a result of nearby foreclosures, causing a significant loss in wealth to most American homeowners.

It is also clear that it is within the power of Congress to prevent hundreds of thousands of

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these foreclosures, and the ripple effect they will have throughout the economy. Senator Durbin's Helping Families Save Their Homes in Bankruptcy Act (S.2136), which would make modest changes to the Bankruptcy Code to treat home mortgage debts more like all other secured debts, could save as many as 600,000 families from losing their homes. Allowing homeowners to file chapter 13 plans that modify their mortgage debts and reduce their payments would utilize an existing, efficient, well-established, and predictable template to prevent foreclosures, and it would not require the use of government funds to bail out either homeowners or lenders. No other legislative proposal has the potential to save nearly as many homes.

The basic principle underlying the bill -- that liens are reduced to the extent they exceed the value of the collateral and the payment terms are modified to reflect a fair rate of interest -- is popularly known as "cramdown". The concept is one of longstanding use and importance in bankruptcy law, and has applied for decades to almost every other kind of asset in chapter 11 (commercial real estate and all other assets), chapter 12 (all assets, real and personal), and chapter 13 (almost all assets, including second homes, multifamily homes, and commercial property, but not a debtor's principal residence.) Essentially, it simply permits the debtor to "buy back" an asset from a creditor's lien at the current market value anyone else would pay for it, and pay that amount over time with a fair rate of interest. Moreover, the unsecured portion of the debt remains as an unsecured claim in the bankruptcy case.

This principle is fundamental to the way that bankruptcy laws reflect economic reality and provide an orderly system for resolving the rights of debtors and creditors. Among creditors, it is unfair to pay a secured creditor more than the value of its collateral at the expense of unsecured creditors. And making bankruptcy more difficult for debtors does not mean they will pay debts they cannot afford to pay. If cramdown is not permitted for debtors who cannot pay

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their mortgages, debtors and creditors have several other alternatives, none of which is more favorable to the mortgage creditor:

(1) Foreclosure, in which the creditor would receive liquidation value which is usually much less than current market value (some sources estimate that a foreclosing creditor receives an average of 60% of market value after all foreclosure costs[1]);

(2) Short sale, in which the debtor sells the home privately and pays the creditor what it would receive in cramdown (usually, minus a realtor's commission and other costs of sale);

(3) Deed in lieu of foreclosure, in which the creditor receives the home, worth only the cramdown amount, and must pay the costs of maintaining and selling the property;

(4) Voluntary modification, which lenders rarely agree to, in which an arrangement similar to cramdown results.

In light of the fact that cramdown is at least as favorable to a creditor as foreclosure, it is not surprising that the price and availability of mortgages were not affected over the years when four circuits permitted cramdown of home mortgages in chapter 13 prior to the Supreme Court ruling otherwise.[2] Indeed, prior to the Supreme Court's *Dewsnup* decision, many courts permitted cramdown of undersecured liens in chapter 7.[3] Also, chapter 13 debtors still have the ability to cram down mortgages on investment properties, commercial real estate, vacation

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[1] *See* Fitch Smartview: "170 U.S. Subprime RMBS Transactions Placed Under Analylsis" (Jul. 12, 2007), available at http://www.marketwatch.com/news/story/fitch-smartview-170-us-subprime/story.aspx?guid=%7b65699D03-9AFB-468F-86D5-D9272BFBEAE4%7d&print=true&dist=printTop - "First lien loan loss severity assumptions reflect the performance to-date, resulting in projected lifetime loss severity averaging approximately 40%, with a range of 30%-65% by transaction."

[2] *See* In re Bellamy, 962 F.2d 176 (3d Cir. 1992); In re Hart, 923 F. 2d 1410 (10th Cir. 1991); Wilson v. Commonwealth Mortgage Corp., 895 F2d 123 (3d Cir. 1990); In re Hougland, 886 F.2d 1182 (9th Cir. 1989).

[3] *E.g.*, Gaglia v. First Federal Savings & Loan Assn., 889 F.2d 1304, 1306-1311 (3rd Cir. 1989).

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homes, and two and three family homes,[4] with no resulting difference in credit cost or availability of such loans.

The fundamental underlying fact in these cases is that bankruptcy does not cause a loss to the creditor. The debtor's inability to pay, combined with inability to refinance or sell the asset and pay off the loan, has caused the loss. The loss already exists, as a matter of economic reality, whether or not the creditor has recognized it on its books. Bankruptcy, whether in a corporate chapter 11 case or an individual's chapter 13 case, recognizes that reality and moves forward from there to restructure the debtor's finances according to rules designed to rehabilitate the debtor financially and share the pain fairly.

I understand that industry lobbyists have been arguing that such legislation is unnecessary because 1) lenders will solve the problem through voluntary modifications and 2) the legislation would cause interest rates to increase dramatically. As I will discuss, neither of these arguments has merit. But I must first point out that these arguments contradict each other. The bankruptcy legislation would allow courts to impose terms similar to those that would be needed to save homes in voluntary modifications. If lenders were actually granting such modifications to homeowners who need them, those homeowners would not need to file chapter 13 cases to obtain those terms.[5] In addition, the resulting modified loans would have the same economic effect that they would have if a bankruptcy court imposed the modifications. It makes no sense to argue that the same types of modifications, on the same loans, would have totally different effects on the mortgage market.

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[4] *E.g.*, In re Scarborough, 461 F.3d 406 (3d Cir. 2006).
[5] In fact, bankruptcy legislation such as S. 2136 would be likely to cause an increase in voluntary modifications because it gives some bargaining leverage to the homeowner. When chapter 12 farm bankruptcy, permitting modification of farm loans, was passed in 1986, it led to a substantial increase in voluntary workouts outside of bankruptcy.

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But the truth is that voluntary modifications are not being made in any significant numbers. Although there have been many press announcements by lenders and regulators that such modifications will be granted, our experience in the field, as well as press reports, reveal that this is not happening in many cases. When I testified in the House eight months ago, a witness representing the industry testified that such efforts were well under way, yet months later it was reported by Moody's that modifications were being granted in only 1% of subprime mortgage cases.[6] And not all "modifications" even saved the family's home; some lenders count as successful modifications resolutions such as "short sales" in which the borrower sells the home and the lender forgives the remaining debt.

Industry representatives claim that borrowers are just not responding to their offers of help, but borrower after borrower, as well as many housing counselors and attorneys trying to negotiate with lenders, report that when they do call they are subjected to endless phone chains, constant changes in the people they are dealing with, enormous paperwork requests, and ultimately denial of necessary modifications. To the extent modifications are being offered, many are inadequate, such as delaying an interest reset for a year or two, or increasing the negative amortization of the loan, which would simply push the problem into the future.[7]

So far, the primary responses to the problem have been to beef up government and nonprofit resources for counseling debtors and negotiating with lenders. But if lenders are unwilling to offer significant modifications, no amount of resources put into those programs will prevent the massive wave of impending foreclosures. In a dramatic example, it was recently

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[6] Michael P. Drucker and William Fricke , 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.").

[7] *See* Cohen, "Citigroup Feels Heat to Modify Mortgages – Nonprofit Groups Press for Subprime Relief; Deciding Who Gets Help," *Wall Street Journal*, Nov. 26, 2007.

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reported that when state housing finance agencies sought to help borrowers by asking lenders to modify loans so the agencies could then refinance them, they had no success because lenders would not make the modifications.[8] If mortgage companies will not modify loans even when they will receive an immediate payoff through refinancing, they certainly will not modify them in cases where they will be paid over a long period of time. In short, the problem is not that borrowers are spurning the lenders' generous offers of help. It is that the public relations efforts about mortgage modification have not been matched by real, concrete action. It defies logic that borrowers would not respond to meaningful offers to help them save their homes if such offers were actually being made.

And it is not surprising that modifications are not happening on a large scale. In some cases, modifications are flatly prohibited or severely restricted by the mortgage pooling and servicing agreements, so servicers do not even have discretion to grant them. Even when they are not prohibited, obtaining a loan modification is difficult for many 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 or with the trust that actually owns the loan. 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, or there are multiple owners who all would have to agree to

[8] *See* Appelbaum, "Refinancing Programs Omit Many Borrowers; Mass., Other States Limit Their Focus," *Boston Globe*, Nov. 21, 2007.

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modification; the loans have been sliced and diced so many times that all of the owners cannot be found and brought into the process.

• 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 and are simply not set up to negotiate modifications. The magnitude of the crisis has 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 of trying to foreclose as quickly as possible. They know how to foreclose, and the foreclosure process has been increasingly automated to maximize the fees the servicers receive. These servicers are not disposed to postponing foreclosure or equipped to handle case-by-case negotiations. What happens most often is that, at best, the servicer goes through the motions of looking into modification, while the foreclosure proceeds full speed ahead. Only when the foreclosure sale is imminent does the borrower realize that no modification will be forthcoming. Further, many of these servicers are affiliated with lenders who are themselves going bankrupt or facing severe financial stress, and therefore are cutting back just as the demands are increasing significantly.

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• 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.[9] 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.

With respect to the contention that the legislation would raise interest rates by one to two percent on all mortgages, there is simply no basis for this conclusion. The argument that consumers' costs will rise, and that credit will be less available, is made every time consumer protection legislation is proposed and it has never proved to be true. For example, after the 1978 Bankruptcy Reform Act, which significantly expanded debtors' rights, consumer credit continued to grow dramatically and did not become more expensive. After the 2005 bankruptcy bill, which restricted debtors' rights, credit did not become less expensive. The fact is that legislation such as this has no measurable impact because the debts which are discharged in bankruptcy are overwhelmingly debts that would not be paid in any event. Bankruptcy laws are not the cause of the loss; the debtors' inability to pay is the cause of the loss. In the current mortgage situation, as I discussed previously, the lenders will take a loss, perhaps a greater loss, even if this bankruptcy legislation is not enacted.

[9] Somewhere between one-third to one-half of 2006 subprime borrowers took out "piggyback second" mortgages on their home at the same time as they took out their first mortgage. *See* Credit Suisse, "Mortgage Liquidity du Jour: Underestimated No More," March 12, 2007, p. 5.

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Moreover, the arguments made by the lenders do not make sense as a matter of simple arithmetic. Even if it were not true that the losses have already occurred, and would not be caused by bankruptcy legislation, even if lenders did not already account for the risk of default in their mortgage rates,[10] and even if they continued to make the same kinds of loans in the future that created this catastrophe, the amount of interest rate increase they are predicting is 10 to 20 times the amount that could possibly occur.[11]

Industry lobbyists have also argued that enactment of legislation like S.2136 would bring uncertainty to the financial markets. Like the losses that they claim will be brought about by the legislation, that uncertainty already exists. It would be hard to imagine how this bill could bring even a small fraction of the uncertainty the lenders themselves have caused. No one knows how many mortgages will be modified to prevent foreclosures, or what the terms of those modifications would be, to the extent they occur. If anything, allowing modification in chapter 13 will foster more certainty and stability because it will create a predictable template for dealing with defaulted mortgages, based on long-recognized bankruptcy principles that will permit a large number of families to avoid foreclosure and the more unpredictable losses foreclosure will cause.

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[10] Obviously lenders did not adequately account for risk, but that problem is already correcting itself with respect to future loans.

[11] The number of mortgages that would likely be affected by the legislation is about one percent of the total number of mortgages in the country. Even if the legislation caused an average reduction of ten percent in these mortgages, that would amount to one tenth of one percent of the total market. Lender projections that rates would increase by a full one to two percent for all mortgages are 10 to 20 times that amount. Also, one would hope that going forward lenders would not make the kinds of risky loans that comprise most of those that could be modified, so even the tenth of a percent would be a substantial overestimate for the future mortgages. Indeed, enactment of S. 2136 on a permanent basis, applicable to all loans, would be another deterrent to the types of risky and unsound loans that caused the current crisis. Without such a deterrent, it will only be a matter of time until there is another cycle of market excesses.

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I also hope Congress will remember that those who are making these projections are the same people who not long ago told Congress that there were no problems with abuses or excesses in subprime mortgage lending that needed regulatory or statutory action.

The people who now say they are so concerned about risk are the same people who saw no problems when it was repeatedly pointed out they were giving loans without even determining whether borrowers could pay those loans and, in fact, were offended by the idea they should be required to determine whether a borrower could repay the loan.

In other words, these are the people who created this mess and are now suffering billions of dollars of losses, not because of any bankruptcy laws, but rather because of their poor predictive abilities. It is hard to understand why Congress should listen to predictions about the mortgage market from those who have been so wrong, rather than from those who predicted that the current crisis would happen.

The industry has also argued that the legislation will help speculators and that it will be used by those who do not need it. But S.2136 will not help speculators, because it only applies to a debtor's principal residence. Ironically, under current law, investors can already modify the loans on the properties they buy.

S. 2136 also will not help those who bought a more expensive house than they could, even with a reasonable mortgage, afford. The existing feasibility standard for confirmation of a chapter 13 plan will prevent such debtors from obtaining relief under this bill.

The mortgage modification remedy in S.2136 will not be used where it is not needed; there are strict eligibility requirements based on the stringent means test expense formula, based on IRS collection standards, enacted in the 2005 bankruptcy legislation. If debtors can pay their living expenses as determined by those standards, and still have enough money remaining to cure

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their mortgage defaults under the standard chapter 13 methods, they will not be eligible for modification.[12] And, in our experience people do not file bankruptcy unless they have no alternative. (Some will not do so even then.)

S.2136 also will not allow judges to simply reduce mortgage amounts and interest rates without any standards. Supreme Court precedents guide bankruptcy courts in both valuation and setting of interest rates, and S.2136 itself sets standards that incorporate those precedents. Loans would not be reduced below a property's fair market value (more than the lender would receive in foreclosure) and interest rates would not be reduced below conventional rates, usually increased by an adjustment for risk.

S.2136 *will* help the many families who refinanced their homes with predatory mortgages, often because they were deceived into refinancing an affordable mortgage into one they could not afford, especially the many families who, in fact, qualified for better terms. And it will help their neighbors, whose homes will not lose value because of foreclosures on their block, as well as their mayors and local governments, who will not suffer a precipitous loss in their property tax base

In conclusion, Congress has an opportunity to prevent hundreds of thousands of families from losing their homes, if it acts soon. Providing resolution in such cases is more likely to rationalize and stabilize the market, rather than destabilize it.

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[12] The use of the means test is a better way to determine need than the flat percentage of median income test in S.2133. The means test was carefully crafted in the 2005 bankruptcy legislation to take into account local variations in costs for housing and transportation, as well as variable expenses like child care and medical expenses, which could not be accounted for by a rigid income cutoff. This difference is particularly important in areas like parts of California where living expenses are far higher than in other parts of the same state, and where most homeowners need a higher income to pay for even modest housing in very high-priced markets.

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Statement of Eric Stein
Center for Responsible Lending

To the U.S. Senate Judiciary Committee

"The Looming Foreclosure Crisis: How To Help Families Save Their Homes"

December 5, 2007

Chairman Leahy, Presiding Member Durbin, Ranking Member Specter, and members of the Committee, thank you for holding this hearing on how we can avert foreclosures on families in financial distress. I appreciate the opportunity to submit comments.

Every day it appears, the problems in the subprime market have become more evident and have grown even worse. However, one hopeful sign is that we now have an active bipartisan effort to address this situation. I commend Senator Durbin for his current bankruptcy proposal, and I also want to commend Senator Specter for his leadership in recognizing bankruptcy reform as a necessary tool for addressing the massive home losses families are experiencing today. A collaborative approach to this problem is essential, and it is heartening to see consensus on the need for action.

In this statement, I will emphasize these four points:

- There is a serious subprime foreclosure crisis that will get even worse in the future.
- Voluntary modifications by lenders and servicers are not enough. The private sector is stymied by competing financial interests and the sheer magnitude of the problem.
- The most effective solution, both for investors and homeowners, is a small change to the bankruptcy code that would impose no cost on the U.S. Treasury, have no negative impact on home credit, and prevent 600,000 needless foreclosures.
- The failure to prevent a significant proportion of the coming foreclosures will severely impact whole communities – including the millions of homeowners who continue to pay their mortgages on time, but who will suffer the effects of foreclosures in their neighborhoods – and risks pushing the economy into recession.

First, a bit of personal background. I have direct experience as a mortgage lender, since 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 (www.responsiblelending.org), which is a not-for-profit, non-partisan research and policy organization dedicated to

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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.

I. The Subprime Crisis Worsens and Spreads

The epidemic of subprime foreclosures keeps growing, and the ripple effects continue to extend wider. For example, First American CoreLogic (CoreLogic), a private firm with expertise in risk management, has highlighted how quickly risks are escalating in the mortgage market.[1] During the past month alone, roughly 150,000 households have experienced interest rate resets on subprime exploding adjustable rate mortgages (ARMs), meaning that these families are facing monthly payment increases ranging from 20% to 40%.[2] According to CoreLogic, up to 75,000 of these families will lose their homes to foreclosure. **In fact, every week that passes without Congressional action, some 18,000 families will lose their homes to foreclosure.**

Homeowners aren't the only ones who are hurting; problems are accelerating for lending institutions and financial markets. Virtually every financial institution with a stake in subprime lending has reported high losses and layoffs. Some notable examples: Countrywide Financial Corp. posted a $1.2 billion loss in the third quarter and has seen its stock lose 60% of its value and 12,000 of its employees lose their jobs so far this year. Merrill Lynch announced it lost $8.4 billion in the 3rd quarter—its worst loss in 93 years—with $7.9 billion of these losses on subprime and CDO assets. Citigroup recently wrote down $1.3 billion in subprime assets, paid $2.6 billion to cover credit losses and increased reserves, and is reportedly considering layoffs for 45,000 employees. Last week, Wells Fargo announced a $1.4 billion hit for mortgage-related charges. Similarly,

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the Office of Thrift Supervision said third-quarter profits at the nation's 831 savings institutions plunged 84 percent due to increased reserves for losses on housing-related assets.

Overall, banks and brokers may have to write off as much as **$130 billion** in subprime assets this year, according to Deutsche Bank AG, and Lehman Brothers predicts **another $250 billion** in losses over the next five years.

And in yet another twist, subprime's financial tsunami is moving beyond Wall Street and now reaching Main Street in our communities. A significant number of state- and county-run investment pools—used by thousands of school, fire, water and other local districts—hold interests in structured investment vehicles (SIVs) backed by subprime loans. Losses on SIVs will impact many states, include Connecticut, Florida, Maine, Montana and Washington. "Nobody knows how much more pain is coming. State funds could lose hundreds of millions of dollars" says Lynn Turner, chief accountant of the U.S. Securities and Exchange Commission from 1998 to 2001. Similarly, the subprime SIV problems may soon cause losses in money market mutual funds—called "the bedrock investment of ordinary Americans" and currently holding about $3 trillion in assets.

With such widespread repercussions from subprime foreclosures, it's no surprise that consumers have ranked the subprime crisis above global warming and the federal deficit among their most pressing concerns, according to a recent survey by TNS North America.[3] It is notable that subprime lenders—who should have known better in the first place—have yet to act on the widespread public understanding that recent lending is excessively dangerous. As Friedman Billings Ramsey reports in a recent study: "We find scant evidence that the risk characteristics of subprime loans originated in 2007 differ significantly from those of subprime loans originated in 2006 and 2005. Therefore, we cannot conclude that lenders have reversed the liberal underwriting criteria of 2007, limited exceptions to these criteria, and strengthened quality control procedures for newly originated subprime loans."[4]

II. Voluntary Loan Modifications Will Not Solve the Problem

A. Obstacles to Modification

Opponents of this bankruptcy tweak often claim that the mortgage market is "self-correcting" and, therefore, can adequately address the current foreclosure crisis without government interference. However, the magnitude of this problem simply overwhelms the private sector response to it.

First of all, lenders are not modifying loans in any significant numbers.[5] Moody's Investors Service recently surveyed servicers representing 80 percent of the market through July of this year and found that only about one percent of subprime loans experiencing rate resets were being modified.[6] Given up to half of the 450,000 families facing subprime resets in the next three months will lose their homes to foreclosure,[7] even if industry modification efforts increase ten-fold—an extraordinary increase under

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any circumstances—only 10 percent of subprime loan-holders facing reset would receive modifications.

Second, many of the loss mitigation activities that lenders are pursuing are not resulting in loan terms that are sustainable in the long term. For example, most of Countrywide's foreclosure prevention activities consist of simply capitalizing arrearages, or taking the borrower's home before the foreclosure proceedings are completed.[8] Others simply delay the rate reset for six to 24 months.

Third, the interests of loan servicers and investors are misaligned. As reported in *Inside B&C Lending*, "Servicers are generally dis-incented to do loan modifications because they don't get paid for them but they do get paid for foreclosures." In fact, "it costs servicers between $750 and $1,000 to complete a loan modification."[9] And for servicers that have affiliates who receive payments for foreclosure-related services, such as appraisals and foreclosure trustee services, foreclosure is economically beneficial.[10] Since servicers decide whether to modify, the fact that a modification rather than foreclosure would be in the interests of investors as a whole is irrelevant. So, even when a loan modification would better serve investors and homeowners, loan servicers typically have economic incentives to skip solutions and proceed as quickly as possible to foreclosure.

Finally, even those servicers who genuinely wish to help homeowners in distress, or who recognize that investors as a whole would fare better under a modification than through foreclosure, face significant obstacles to modifying loans. The following are three main obstacles:

- Fear of Investor Lawsuits. Servicers have obligations to investors who have purchased mortgage-backed securities. Modifying loans typically affects various tranches of securities differently, which raises the specter of investor lawsuits when one or more tranches lose income.[11] For example, a modification that defers loss rather than immediately writing down principal will favor the residual holder if the excess yield account is released after a certain period of time, generally three years, but will hurt senior bondholders since the residual, or equity, will not be there to absorb losses anymore. Under circumstances where different tranches would be impacted differently by modification, the least risky course for the servicer is to pursue foreclosure – even though this may be the least economically beneficial for investors as a whole.

- Dilemma of Piggyback Seconds. Between one-third and one-half of 2006 subprime borrowers took out so-called "piggyback loans", that is, simultaneous first and second lien mortgages.[12] When there is a second mortgage, 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; rather, the holder of the second is better off waiting to see if a borrower can make a few payments

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before foreclosure. Beyond the inherent economic conflict, negotiating with two servicers is an insurmountable challenge to most borrowers.

- Servicers Overwhelmed by Demand. The magnitude of the crisis has simply exceeded the capacity of servicers to effectively respond. Hundreds of thousands of borrowers are asking for relief from organizations that have traditionally had a collections mentality, have been increasingly automated, and whose workers are simply not equipped to handle case-by-case negotiations. Many of these servicers are affiliated with lenders who are going bankrupt or facing severe financial stress, and therefore they are cutting back on staff just as the demands are increasing significantly. In addition, housing counselors and attorneys have observed that even when top management expresses a desire to make voluntary modifications, the word does not filter to the front-line staff.

For the various reasons listed above, servicers are not modifying loans and these loans are proceeding to foreclosure in unprecedented numbers. Thus, Congressional action is needed to enable bankruptcy courts to order loan modifications, thereby removing the threat of investor lawsuit and leading to voluntary modifications on a much larger scale than has occurred to date. This legislation would be in the interest of borrowers and investors alike.

B. The Paulson Plan

Given estimates that there will be 3.5 million defaults over the next three years,[13] the plan announced by President Bush for targeted loan modifications for some subprime borrowers is a positive, but very limited, step. There are two reasons that the plan, on its own, will not be commensurate to the scale of the problem.

First, eligibility for the streamlined modification plan is extremely narrow:

- 2005 loans. The plan does nothing to help hundreds of thousands of subprime borrowers who received "exploding" 2/28 adjustable-rate mortgages in 2005.
- Delinquency due to reset. The plan excludes those who have fallen behind because the interest rates on their loans have already reset to unaffordable levels. Some lenders have told borrowers they cannot get a modification unless they are delinquent.
- Improved credit scores. To qualify, the borrower needs to have had good payment history on the loan, but the plan then excludes those whose credit scores improved significantly. These criteria are mutually exclusive.
- Cannot refinance. Even if the borrower's loan balance exceeds the value of the borrower's house, or their credit score started low but improved by 10%, they would not be eligible for streamlined modification, even though they cannot refinance.
- PO ARMs. The plan will not cover "payment option" ARM loans, which are not typically considered subprime loans but also face significant rate resets in 2008 and beyond.

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Second, the plan relies on voluntary decisions by individual mortgage servicers and investors, does not remove the strong financial and legal incentives servicers have to foreclose on loans rather than modify them, and does not address the obstacles caused by the "piggyback" second mortgages. Recent experience shows that the likelihood of widespread modifications is small under this "business as usual" approach. Finally, servicers and lenders have made repeated announcements throughout 2007 that they will modify large numbers of loans, but because of the substantial obstacles, this hasn't happened. The plan lacks a reporting mechanism to provide accountability that, this time, servicers are living up to their commitments.

The plan will help some borrowers, but in light of its limited impact, it is imperative that Congress complement it with this tweak to the bankruptcy code.

III. Bankruptcy Relief is Needed as a Last Resort

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 other 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.

A. Benefits of the Bankruptcy Solution

Bankruptcy targets those who truly need help, without affecting interest rates. Interest rates already reflect the lender's assessment of the risk that some proportion of loans will end in a foreclosure sale. Because bankruptcy modifications under the proposed reforms would occur only for those loans that would otherwise end in foreclosure, and because, such modifications will net the lender at least as much or more than could be recovered in foreclosure, interest rates on new loans should not be affected.

Bankruptcy reform would affect only a fraction of all mortgages. We estimate that the proposed changes to the bankruptcy law would allow 600,000 families who are facing foreclosure to keep their homes (see **Appendix A, Homeowner Savings**). While this number would significantly reduce the severity of the current foreclosure epidemic, it only represents 1.4% of all homeowner households with outstanding mortgages.

Investors receive more from loan modifications than foreclosures. For the 600,000 families whom we expect this legislation to help, the alternative to a loan modification is

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foreclosure. This outcome is worse, not only for borrowers, but for lenders as well. Chapter 13 would guarantee at least the market value of the property that the lender took as collateral and would mandate that the borrower make regular payments over three to five years on the difference between market value and the loan balance. Conversely, under foreclosure, lenders receive only liquidation value, not fair market value, with any remaining balance written off altogether.

In addition, there are significant expenses associated with foreclosure that would not arise under judicial modification: lenders face one-to-two year delays and incur high legal expenses, not to mention the costs related to the maintenance and sale of the property. Thus, subprime lenders or investors lose approximately 40% of the principal balance of a loan that defaults.[14] Finally, foreclosures have significant negative impacts on surrounding property values. Therefore, to the extent a lender holds liens on other properties in the area, loan modifications help protect the value of other collateral

B. Stabilizing the Market

While it is clear that greater accessibility to bankruptcy relief could provide a boost to the housing market, some industry groups continue to assert that judicial modifications will negatively impact the market.[15] There is irony to this claim given that the current credit squeeze is caused by the *lack* of adequate regulation. Absent such regulation, reckless lending practices flourished, causing lender bankruptcies and investor losses. Investors reacted abruptly (and belatedly) to stem further losses, causing a sudden, unplanned-for, and highly disruptive liquidity crisis.

There is strong evidence that the proposed reform will not adversely affect the availability of credit and, in fact, will help stabilize the housing market. Such evidence includes the following:

Experience shows that past primary mortgage modifications worked well without adversely affecting the availability of credit. For the fifteen years between the enactment of the 1978 Bankruptcy Code and the Supreme Court's 1993 *Nobleman* decision interpreting the Code to disallow modification of loans on primary residences, numerous bankruptcy courts did allow modifications of mortgages on primary residences by placing the portion above the market value of the house on par with other unsecured debts. There is no evidence that the cost or availability of credit for mortgages on primary residences was negatively impacted in these jurisdictions during this time, either compared to jurisdictions that did not allow modifications or compared to lending patterns after 1993.[16]

Bankruptcy modifications work well for other types of assets. The claim that allowing modifications of home mortgages will adversely impact the cost or availability of credit is similarly belied by decades of experience in which bankruptcy courts have been modifying mortgage loans on family farms in chapter 12,[17] commercial real estate in chapter 11,[18] and vacation homes and investor properties in chapter 13,[19] with no ill effects on credit in those submarkets. Debt secured by all of these asset types, plus credit

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cards and car loans, are easily securitized even though they can be modified in bankruptcy.[20] In addition, as Richard Levin, Vice Chair of the National Bankruptcy Conference, testified in October, the success of Chapter 12, in which loans on family farms can be modified, has actually led to a *decrease* in its use. As lenders and borrowers have come to understand how the law operates, they are increasingly able to reach agreements on their own, without intervention from the courts.[21]

Some industry groups have argued that allowing bankruptcy judges to modify mortgages on primary residences, would cause "major disruption in the financial markets." Specifically, these groups claim that loans on investment properties have higher interest rates and higher down payment requirements because they can be modified in bankruptcy, and that would be the fate of all mortgages. I must say, in over a decade dealing with housing finance, I have never heard this argument before. As Self-Help has recognized through our commercial lending operation and as the Wall Street Journal concludes,[22] these loans carry higher rates simply because they are riskier than loans on owner-occupied houses, since investors are much more likely to walk away than homeowners.

To review other arguments against the bankruptcy solution and why they are not persuasive, please refer to **Appendix 2, "Myth v. Reality."**

C. The Durbin Bill

The Durbin bill is specifically structured to make bankruptcy modifications available only for those borrowers whose homes would otherwise be lost in foreclosure. Moreover, to qualify for relief, a homeowner must not have sufficient income to pay their mortgage after applying the strict expenditure limits imposed by the 2005 amendments to the Bankruptcy Code. The proposed bill addresses concerns that I've heard about changing chapter 13.

The first set of concerns is that families with sufficient income to pay their mortgage should not benefit. In other words, people should not file for a chapter 13 modification if their property has lost value but they are able to continue paying their underwater mortgage; they should only use the bankruptcy option if their only alternative is foreclosure. Otherwise, they will be obtaining a windfall; bankruptcy should be the last option, not the first.

In fact, the Durbin Bill imposes a strict means test to ensure that only people who otherwise face foreclosure are eligible for a loan modification on their principal residence under chapter 13.[23] In addition, the good faith requirement already applies, so someone who meets the means test but can still afford mortgage, somehow, could be excluded by lender objection. Finally, the existing $1 million loan limit for secured debt still applies as well.

The second concern I heard was that allowing judicial modification would give bankruptcy judges unfettered discretion to modify loan terms so that any loan could be made affordable, even when the borrower has simply purchased too much house for their

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income. A judge might add 30 years to a loan that has already been outstanding for 15 years, reduce interest rates to one or two percent to make the loan maximally affordable, and strip down the principal to a 50 percent loan-to-value ratio. Such terms would be unfair to lenders, and the uncertainty created by lack of guidance will have a chilling effect on the market.

The Durbin bill actually provides guidance to bankruptcy judges to generally leave the remaining term of the loan the same as it currently is and establishes that the benchmark interest rate will be market rate—i.e., the prevailing 30-year fixed rate plus a risk premium. Such a rule is consistent with a holding in the *Till* case to use a customary index and require the judge to add a risk premium; the prime rate used in *Till* is customary for car loans but is not used to set the interest rate on first mortgages. In addition, the principal can only be stripped down to the fair market value of house. The amount over value would become unsecured debt paid to extent family is able during three-to-five years of the plan. If a family fails in completing the chapter 13 plan, the loan returns to its original terms and cramdown is undone.

Because the Durbin bill is so prescriptive about how a loan otherwise heading into foreclosure can be modified judicially, the parties will have every incentive and sufficient information to come to agreement outside of bankruptcy. Families have no desire to enter bankruptcy, given the stigma, 10-year damage to their credit report, court supervision of every expense for 5 years, and cost. Servicers would have a perfect defense to investor lawsuits, since they can negotiate outside of bankruptcy for more favorable terms than what they would receive in chapter 13. This move toward voluntary modification because of the bankruptcy availability is exactly what occurred for family farms in chapter 12.

IV. The Risks of Failing to Prevent a Substantial Proportion of the Anticipated Foreclosures are Great

While some will point out risks of enacting a change to chapter 13 to allow judicial modification of primary residences, the risks of not making this change are far greater. A family doesn't need to be holding a subprime mortgage to be hurt by it. Recently we at the Center for Responsible Lending found that, for subprime home loans originated in 2005 and 2006, 44.5 million neighboring homes will experience devaluation because of subprime foreclosures that take place nearby. The decline in house values and tax base resulting from these nearby foreclosures will add up to $223 billion—losses that are completely outside the direct losses associated with foreclosures.[24]

As described in Appendix 1, we believe that the Durbin bill would avert 600,000 foreclosures, saving $72.5 billion in wealth lost by American families *not* facing foreclosure.[25] This in turn will save local governments property tax revenues, as well as the significant costs of police and administrative support that foreclosures require.[26] According to the Joint Economic Committee, every new foreclosure can cost all stakeholders $80,000.[27]

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Recognizing the massive scale of the foreclosure crisis and the fact that current efforts to address this crisis are insufficient, a number of prominent, independent housing economists have recognized that judicial modification under chapter 13 is an essential part of the solution. Three preeminent professors that I spoke with who specialize in real estate economics and finance support the proposal: William Apgar, Senior Scholar at Harvard's Joint Center for Housing Studies, a former FHA Commissioner; Karl E. Case, a highly respected Professor of Economics at Wellesley College; and Roberto Quercia, Director of the Center for Community Capital at UNC-Chapel Hill. In addition, this Committee has received a letter to this effect from Robert Shiller, Professor of Economics and Professor of Finance at Yale University and a principal in creating the Standard & Poor's Case-Shiller® Home Price Index, which is, according to S&P, "the leading indicator on the overall health of the U.S. housing market." Finally, the written testimony of Mark Zandi, Chief Economist and co-founder of Moody's Economy. com, for the hearing states that "there is no more efficacious way to short-circuit this developing cycle [of foreclosures and falling housing prices] and forestall a recession than by passing this legislation."[28]

The negative cycle that Mark Zandi spoke of—that is, of foreclosures leading to depreciation of home values, which consequently, increase foreclosures—is hard to break. Concentrations of foreclosures can devastate communities in ways that may be irreparable. The impact of the foreclosure epidemic on the economy as a whole could be similarly devastating. We therefore need to use every means at our disposal to stem this crisis. Treasury Secretary Paulson's plan will help some borrowers. But bankruptcy reform could save the homes of hundreds of thousands of the families who will not be helped by that plan.

Conclusion

Let me end by reiterating some of the major benefits of making bankruptcy accessible to homeowners who are struggling with subprime loans:

- There would be no cost to the U.S. Treasury, and experience shows there would be no negative impact on home credit.
- This solution narrowly targets families who would otherwise lose their homes.
- This solution also helps families who live in the vicinity of potential foreclosures by minimizing the amount of value lost in surrounding properties.
- And, finally, this solution not only helps homeowners, it is also better for investors as a whole. Chapter 13 loan modifications are less expensive for lenders and investors than the cost of foreclosures, and modifications would guarantee at least the value of the property that the lender took as collateral. Moreover, a loan modification ensures a continued stream of income—the borrower continues to pay—and, to the extent the lender is involved with other properties in the area, it prevents the further decline of overall property values.

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By tweaking the bankruptcy code, Congress has an opportunity to help homeowners all over the country, and the ripple effects emanating from that action will have positive implications for families, local governments and the economy as a whole. I urge you to take this crucial step to help homeowners struggling with abusive subprime mortgages and thereby minimize the impact of the subprime crisis that ultimately will affect us all.

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1 See, eg., Christopher L. Cagan, Mortgage Payment Reset: The Issue and the Impact, First American CoreLogic (March 19, 2007), available at http://www.facorelogic.com/uploadedFiles/Newsroom/Studies_and_Briefs/Studies/20070048MortgagePaymentResetStudy_FINAL.pdf; See also First American CoreLogic: Core Mortgage Risk Monitor Q4, 2007 (October, 2007), http://www.facorelogic.com/uploadedFiles/Newsroom/Innovations_Newsletter/Core_Mortgage_Risk_Monitor_Q3_2007.pdf; and First American CoreLogic: Core Mortgage Risk Monitor Q3, 2007 (Sept. 2007), http://www.facorelogic.com/uploadedFiles/Newsroom/Innovations_Newsletter/riskmonitor_Q4-07_3.pdf

2 See Christopher Cagan, cited in Ivry, Bob, "Subprime Borrowers to Lose Homes at Record Pace as Rates Rise" (Sept. 19, 2007), Bloomberg, available at: http://www.bloomberg.com/apps/news?pid=email_en&refer=finance&sid=akOEPec30TR4.

3 "Public Perceptions," American Banker (October 11, 2007).

4 "Changing Credit Performance of Subprime RMBS," FBR Capital Markets Structured Finance Insights, (Sept 27, 2007).

5 See generally "Modified Mortgages: Lenders Talking, Then Balking," San Francisco Chronicle, 9/13/07 ("Lenders are uniformly unwilling to make loan modifications for homeowners whose interest rates are resetting higher, said Rick Harper, director of housing at Consumer Credit Counseling Services of San Francisco, which talks to about 1,000 delinquent borrowers a month."); 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/.

6 Michael P. Drucker and William Fricke , 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.").

7 Christopher Cagan, cited in Ivry, Bob, "Subprime Borrowers to Lose Homes at Record Pace as Rates Rise" (Sept. 19, 2007), Bloomberg, available at: http://www.bloomberg.com/apps/news?pid=email_en&refer=finance&sid=akOEPec30TR4.

8 Gretchen Morgenson, Can These Mortgages Be Saved?, The New York Times (Sept. 30, 2007), available at http://www.nytimes.com/2007/09/30/business/30country.html.

9 Inside Mortgage Finance Reprints, Subprime Debt Outstanding Falls, Servicers Pushed on Loan Mods (Nov. 16, 2007) (Quoting Karen Weaver, a managing director and global head of securitization research at Deutsche Bank Securities).
10 Gretchen Morgenson, Can These Mortgages Be Saved?, The New York Times (Sept. 30, 2007), available at http://www.nytimes.com/2007/09/30/business/30country.html.

11 Sam Garcia, "Group Warns on Large Scale Modifications: Consumer Mortgage Coalition Sends Letter to FDIC," MortgageDaily.com (October 9, 2007) (servicer doing widespread modifications "faces potential legal action from the securitization trustee and even from the securities holders themselves"); Harris Terry, ARM Workout Calls Trigger Fierce Debate, American Banker (Oct. 9, 2007) ("Servicers are 'scared to death' of being challenged by investors for making too many modifications, [Citigroup

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Managing Director Tim] Bolger said. 'Talking about getting modification rates up, they're probably going to err on the conservative [side] if they think any investor is going to come after them.'")

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

13 Mark Zandi, "A Step Behind", Dismal Scientist, Moody's Eoconomy.com., December 6, 2007.

14 Fitch Smartview: 170 U.S. Subprime RMBS Transactions Placed Under Analylsis (Jul. 12, 2007), http://www.marketwatch.com/news/story/fitch-smartview-170-us-subprime/story.aspx?guid=%7b65699D03-9AFB-468F-86D5-D9272BFBEAE4%7d&print=true&dist=printTop -"First lien loan loss severity assumptions reflect the performance to-date, resulting in projected lifetime loss severity averaging approximately 40%, with a range of 30%-65% by transaction."

15 Sloan, Steven."Bankruptcy Reform 2.0? Subprime Ills Raise Odds." American Banker, October 9, 2007. (http://qa.cujournal.com/$nocookies$/article.html?id=2007100590M4RK4L)

16 CRL reviewed data on homeownership rates, for the years 1984 to 2000, from the United States Census Bureau, as well as data on mortgage interest rates for the same period, from the Federal Housing Finance Board's Monthly Interest Rate Survey, comparing both states that permitted modifications in bankruptcy and those that did not, as well as trends in "modification states" before and after the 1993 Nobleman decision. The data revealed no observable connection between the modification of home mortgages by bankruptcy courts and either homeownership rates or the cost of mortgage credit.

17 See, e.g., Hon. Greg Zerzan, Deputy Assistant Secretary for Financial Institutions Policy, Dep't of the Treasury, Congressional Testimony Before the House Committee on Agriculture (June 2, 2004) ("There are many providers of credit to farmers and ranchers, including commercial banks, insurance companies, the Farm Credit System, and specialized agricultural credit providers. ... Farmer Mac is providing a secondary market outlet for lenders to dispose of loans, much the same way that other financial institutions would purchase or participate in agricultural real estate mortgage loans from one another."); Peter J. Barry, Paul N. Ellinger and Bruce J. Sherrick, Valuation of Credit Risk in Agricultural Mortgages, American Journal of Agricultural Economics (Feb. 1, 2000) ("Agricultural mortgage markets in the United States are experiencing a major transition toward greater institutional lending, wider geographic dispersion, larger lending systems, increased standardization of financing arrangements, greater reliance on nondeposit funding, and expanded potential for securitized loan pools.").

18 Stacey M. Berger, Does anyone (other than the borrowers) care about servicing quality?, Mortgage Banking (July 1, 2005) ("The commercial real estate finance industry has been reshaped by the strong influence of global capital markets. ... A high proportion of fixed-rate loans are now securitized."); Kenneth P. Riggs, Jr., A new level of industry maturity: commercial real estate has earned its place in the pantheon of stable and attractive investment classes, Mortgage Banking (Jan. 1, 2005) http://www.encyclopedia.com/doc/1G1-127789084.html; Amos Smith, Lenders are renewing their interest in real estate, Los Angeles Business Journal (Oct. 16, 1995) ("Investors and developers are once again being courted by lenders and mortgage bankers seeking to finance commercial property. ... Real estate lending is also providing attractive yields relative to other investments.")

19 While interest rates are generally higher on investment properties than on primary residences, this is because "[e]xperts say such properties are higher foreclosure risks than homes lived in by their owners." "The United States of Subprime: Data Show Bad Loans Permeate the Nation; Pain Could Last Years" by Rick Brooks and Constance Mitchell Ford. Wall Street Journal, Page A1. October 11, 2007.

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20 See http://www.riskglossary.com/link/securitization.htm (All sorts of assets are securitized: auto loans, mortgages, credit card receivables); http://jobfunctions.bnet.com/whitepaper.aspx?docid=105734 ("credit card ABS market has become the primary vehicle by which the card industry funds unsecured loans to consumers").

21 http://judiciary.house.gov/media/pdfs/Levin071030.pdf (page 4-5).

22 See Rick Brooks and Constance Mitchell Ford, The United States of Subprime - Data Show Bad Loans Permeate the Nation; Pain Could Last Years, Wall Street Journal (Oct. 11, 2007) ("Experts say such properties [i.e., those not occupied by the owner] are higher foreclosure risks than homes lived in by their owners.")

23 The means test would exclude from relief any debtor whose monthly income exceeds the sum of: (a) monthly living expenses allowable under the chapter 13 means test that incorporates IRS living expense standards, plus (b) amount due on the mortgage. If a borrower has enough income left after living within the IRS's strict expense limitations to pay their mortgage, modification is not available. If there is not enough income left to do so, the family would otherwise lose their home in foreclosure, and relief is available. However, if the debtor does not have sufficient income even to pay a reasonable market-rate mortgage on a loan equal to the fair market value of the house, modification would not be available either.

24 "Subprime Spillover: Foreclosures Cost Neighbors $223 Billion; 44.5 Million Homes Lose $5,000 on Average," CRL issue paper (November 13, 2007), available at http://www.responsiblelending.org/pdfs/subprime-spillover.pdf.

25 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/. Assuming the median house value equals $212,000 (National Association of REALTORS® Median Sales Price of Existing Single-Family Homes for Metropolitan Area, 2007 Q2, http://www.realtor.org/Research.nsf/files/MSAPRICESF.pdf/$FILE/MSAPRICESF.pdf, $212,000 value per home * 1.14% value lost per foreclosure* 50 homes per block = $121,000 value lost per foreclosure * 600,000 foreclosures avoided = $72.5 billion in home value saved.

26 See Jim Rokakis, The Shadow of Debt – Slavic Village Is Fast Becoming a Ghost Town. It's Not Alone, (Sept. 30, 2007) http://www.washingtonpost.com/wp-dyn/content/article/2007/09/28/AR2007092801331.html?hpid=opinionsbox1; 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.

27 http://www.jec.senate.gov/Documents/Reports/subprime11apr2007revised.pdf

28 http://judiciary.senate.gov/testimony.cfm?id=3046&wit_id=6807.

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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

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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

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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).

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Appendix B – Objections to the Durbin/Schumer Bill – Myth v. Reality

Some industry representatives have raised objections to the Durbin/Schumer bill, claiming that it will harm the market, or harm borrowers, or unfairly impact lenders or investors. These objections are refuted by the factual record, as discussed below.

Myth No. 1: The Durbin/Schumer bill will make credit less available, or more expensive.

Reality: Three compelling data-points refute this claim.

First, decades of experience in which bankruptcy courts have been modifying mortgage loans on family farms in chapter 12,[1] commercial real estate in chapter 11,[2] vacation homes and investor properties in chapter 13,[3] with no ill effects on credit in those submarkets. Debt secured by all of these asset types, in addition to credit cards and car loans, are readily securitizable even though they can be modified in bankruptcy.[4]

Second, from 1978 (when the current Bankruptcy Code was enacted) until 1993 (when the Supreme Court decided *Nobleman v. American Savings Bank*, 508 U.S. 324 (1993)), many courts across the country believed that bankruptcy judges had the authority to modify home mortgages (by treating them as secured up to the value of the property only). Lending experience during this 15 year period showed that those jurisdictions that permitted cramdowns experienced no adverse effects on the cost or availability of credit, either as compared with jurisdictions that did not permit cram-downs, or as compared with the period after 1993, when cram-downs were no longer permitted.[5]

Third, and dispositively, the cost of credit and its availability already reflect the risk that some loans will end in the loss of the home to foreclosure. Because the Durbin/Schumer bill provides for modifications only in those cases where without it the home will be lost to foreclosure, and because modification is economically preferable to the lender/investor than the cost and loss associated with foreclosure, the Durbin/Schumer bill imposes no additional risk, and hence, no further cost.

There is irony to this claim; the current credit squeeze is caused by the *lack* of adequate regulation. Absent such regulation, reckless lending practices flourished, causing lender bankruptcies and investor losses. Investors reacted abruptly (and belatedly) to stem further losses, causing a sudden, unplanned-for, and highly disruptive liquidity crisis.

Myth No. 2: The Durbin/Schumer bill will cause an increase in the cost of credit by 2% because it will increase the risk of non-payment, or because current credit pricing models do not capture the risk of bankruptcy modifications, according to the MBA.

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Reality: The Durbin/Schumer bill adds no further risk of non-payment, and does not add any risk or cost that isn't already captured in the current pricing models.

As noted above, credit pricing models already capture the risk and cost of a loan ending in foreclosure. The Durbin/Schumer bill will allow bankruptcy modification only for those loans that would have ended in foreclosure. **The loss will be caused not by the chapter 13 provision, but rather by the borrower's inability to repay the debt according to its terms; the alternative to judicial modification isn't full repayment, but nonpayment.** Because bankruptcy modification under the Durbin/Schumer bill is *less costly* to the note-holder than foreclosure, the cost of bankruptcy modification is a subset of the total cost of foreclosure already captured by current pricing models. Therefore, existing pricing models already account for all risk and cost associated with the Durbin/Schumer bill.

Myth No. 3: (According to SIFMA):[6] If mortgages on primary residences are subject to modification just like mortgages on secondary residences (e.g., vacation homes and investment properties), mortgages on primary residences will be harder to securitize. "Roughly only 9 percent of second home mortgage originations are securitized. By comparison, roughly 84 percent of primary home mortgage originations are securitized."

Reality: SIFMA has confused mortgages on second homes with junior (second position) mortgages. The latter stand behind the first mortgage on the property at issue, and, for obvious reasons, are far riskier than the first position mortgage. This has nothing to do with first position mortgages on second homes, the point SIFMA purports to address.

Here is the full quote from a document that SIFMA circulated to members of the House on October 18, 2007:

> "How dramatic would such a change be? Unlike mortgages on primary residences, mortgages on second homes and investment properties can be modified during bankruptcy proceedings. As a result, mortgages on second homes and investment properties generally require greater down payments and have higher interest rates. **Roughly only 9 percent of second home mortgage originations are securitized.[1] By comparison, roughly 84 percent of primary home mortgage originations are securitized.**[2]"
>
> [1] Seconds include home-equity lines of credit and closed-end seconds; some second mortgages are also securitized in subprime and other MBS products. "Securitization Rate Slips in Second Quarter Despite Lag in Nonprime MBS Process," Inside MBS & ABS (September 7, 2007)

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[2] Including subprime, prime jumbo, conforming, FHA/VA in the first half of 2007. Inside MBS & ABS (September 7, 2007)

Moreover, most second liens are secured by primary residences, and so are not subject to modification in bankruptcy. SIFMA's data points thus do not say what SIFMA claims they do, and have absolutely no connection to the points for which they are cited.

SIFMA also claims that mortgages on vacation homes and investment properties have higher interest rates and larger down-payments because they are riskier due to their potential for modification in bankruptcy. This also is false. Loans on vacation and investment homes are considered riskier because people are more likely to walk away from their second homes than their primary residence. People need to live somewhere, so they are far more reluctant to lose the home they live in than other properties they may own.[7]

Myth No. 4: The Durbin/Schumer bill will let speculators and investors off the hook for bad investments.

Reality: The opposite is true: The Durbin/Schumer bill will benefit ordinary homeowners only. It *will not have any impact at all on speculators or investors.*

Current law – not the Durbin/Schumer bill – allows mortgage loan modifications by speculators and investors. The Durbin/Schumer bill would apply to ordinary homeowning families only, and would extend to these families the protections that have long existed for all other debtors and for all other debts.

Myth No. 5: The Durbin/Schumer bill will benefit wealthy homeowners, and could provide a windfall to the rich.

Reality: The Durbin/Schumer bill is drafted so as to prevent this: It applies *only* to debtors who meet a *strict means test* and adhere to a budget with *severe limitations* on living expenses.

The only families who are eligible are those whose monthly income is less than the limited monthly living expenses allowable under the existing Chapter 13 means test, plus payments required to cure and pay the mortgage. Thus, relief is available only to debtors who, despite living within the strict expense limitations established by Chapter 13 and IRS rules, still do not have enough income left to save the home.

Further, a debtor must abide by strict expense guidelines for the life of the plan, which is generally five years, with all income above these minimum provisions being dedicated to repaying debts. In addition, declaring bankruptcy creates an unwanted stigma and harms an individual's credit, making all other debts unavailable or more expensive. As a result, no one who can afford to pay their mortgage would take advantage of this provision.

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Myth No. 6: It is unreasonable or unfair to expect lenders to modify the interest rate, amortization or principal balance of outstanding loans.

Reality: To the contrary: The Durbin/Schumer bill is designed so that lenders will recover *more* from the modification than from the lender's available alternative (foreclosure). Moreover, these modifications are called for both by Senator Dodd's May 2007 Homeownership Preservation Principles (endorsed by industry leaders), and by President Bush, as well as all of the federal banking agencies and the Conference of State Banking Supervisors.

The widely endorsed Homeownership Preservation Principles[8] call upon lenders to modify loans to "ensure that the loan is sustainable for the life of the loan, rather than, for example, deferring the reset period," including, as appropriate, one or more of:

- "Switching from an adjustable to a fixed rate loan at an affordable rate"
- "Reducing the interest rate"
- "Reducing the principal in order to ensure affordability"
- "Reamortizing the loan."[9]

Similarly, announcing a White House initiative to help homeowners facing foreclosure, the President said, "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."[10] Federal and state regulators have urged the same actions for lenders they regulate.[11]

Moreover, the Durbin/Schumer bill has two guarantees to ensure that lenders recover at least what they would from their best available alternative to a loan modification – and probably more: *first*, as noted above, the only borrowers eligible are those who otherwise could not afford to save the home from foreclosure; and *second*, the bill permits the write-down of loan balances to the fair market value of the home. In foreclosure, the lender would recover only liquidation value, not market value, and would incur substantial costs of foreclosing – which, by industry estimates, typically amount to 40% of the principal balance.[12] Finally, in foreclosure, the portion of the loan that exceeds the proceeds of the foreclosure sale is generally lost to the lender forever. Under the Durbin/Schumer bill, the excess of the loan over the home's fair market value will be treated as unsecured debt, and paid back at the same rate as other unsecured debts during the three to five years of the plan.

Myth No. 7: The bill is unnecessary as lenders and servicers are already working with borrowers to help them save their homes.

Reality: Industry data establishes that these modifications are hardly happening at all.

A recent Moody's survey of the modification practices of subprime servicers constituting 80% of the total market revealed that, "most servicers had only modified

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approximately 1% of their serviced loans that experienced a reset in the months of January, April and July 2007."[13] Moreover, many of those few modifications that are being made do not comply with the objective of long-term sustainability. Indeed, most of Countrywide's foreclosure prevention activities consist of simply capitalizing arrearages, or taking the borrower's home before the foreclosure proceedings are completed.[14]

There appear to be several reasons for industry's failure to modify loans to any meaningful extent: One relates to the interplay between first and second lien holders.[15] When there is a second mortgage, 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; rather, the holder of the second is better off waiting to see if a borrower can make a few payments before foreclosure.

A second concerns a mismatch of incentives between servicers and investors. As noted above, foreclosures are costly. But these costs are borne by investors, not servicers. As reported in Inside B&C Lending, "Servicers are generally dis-incented to do loan modifications because they don't get paid for them but they do get paid for foreclosures." Further, "it costs servicers between $750 and $1,000 to complete a loan modification.[16] In addition, servicers often charge fees by affiliates for appraisals and other foreclosure-related services, and so can be economically incentivized to proceed to foreclosure, even where a loan modification would be better for investors.[17]

Finally, many servicers have said that they want to modify these loans, but are afraid that this exercise of discretion will lead them to be sued by investors.[18] Thus, even where foreclosure is a worse outcome for the investors, it is the least risky for servicers.

Empowering bankruptcy judges to order these modifications will address the problems that may make it harder for servicers and lenders to modify these loans.

Myth No. 8: The bill is unnecessary because Secretary Paulson's loan modification plan will accomplish the same things that the bill would do.

Reality: The Paulson plan is entirely voluntary, and will have an impact only to the extent lenders and servicers agree to modify the loans. The Paulson plan does not address or alleviate any of the problems that have prevented lenders and servicers from modifying loans to date (see point 7 above). Moreover, it expressly excludes borrowers who have already defaulted on their loans, and so would exclude from relief several hundred thousand borrowers now on track to lose their homes in foreclosure. It also excludes all borrowers whose rates reset prior to January 1, 2008, and so excludes most loans originated prior to 2006.

Myth No. 9: Lenders and servicers are prevented from modifying these loans by securitization vehicles, and the objections of the holders of second liens.

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Reality: This is true only some of the time; in most instances, where a borrower has defaulted or default is reasonably imminent, servicers have authority to modify these loans. But those servicers who do not have such authority are exactly why the Durbin/Schumer bill is necessary. Bankruptcy judges can order modifications where lenders and servicers cannot not make them voluntarily.

Myth No. 10: Lenders should be given the opportunity to approve (or veto) any proposed cram-down.

Reality: This is sometimes not possible, for the reason noted in point 7 above. Moreover, as noted above, even where lenders or servicers have the authority to approve these changes, many are reluctant to do so out of fear that any discretion they exercise will give investors a basis for suing them. Empowering bankruptcy judges to order these changes will provide lenders and servicers with the "cover" they need. Finally, leaving this to lenders' discretion does not alter the status quo – in which hardly any modifications are being made.

Myth No. 11: Borrowers should have understood the risks involved in the subprime loans they got. They should not have relied upon mortgage brokers' assurances.

Reality: Even the senior management of the world's leading banks and hedge funds found it difficult to properly assess the factors that made subprime exploding ARM loans so destructive – i.e., underwriting that necessitated refinancing prior to rate reset, prepayment penalties that guaranteed a substantial loss of equity with each refinancing, and the consequence that the loans were wealth-destroying while home prices were rising, and were guaranteed to fail once home price appreciation slowed. It is unreasonable to expect the average borrower to have understood the risks better than did the banks and Wall Street.

As recently reported in *The New York Times*, Klaus-Peter Muller, the CEO of Commerzbank, the major German lender, observed that, "Bankers … did not adequately understand these [subprime MBS] investments and relied too heavily on high-grade credit ratings from agencies that helped put together the products, then rated them. This ignorance of the risks extended to the top echelons of the banks."[19]

These sophisticated bankers, well-versed in interest rate risk, housing market risk, anticipated home price appreciation trends, and underwriting norms, had access to independent economic and trading advice, as well as teams of experienced lawyers, investment bankers, and accountants advising them on every one of these transactions. They also owed fiduciary duties of care to their shareholders, and so presumably exercised care in investing in these loans. Nevertheless, even they misunderstood the risks.

The average subprime borrower is not represented by a lawyer at the closing of the loan transaction, let alone a team of advisors, and so is left to rely on the mortgage

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broker to explain the significance of any loan terms that seem confusing, and to help assess the significance of the relevant risks. Many borrowers were deliberately misled. Most were offered products that were doomed to fail even though they qualified for better, more sustainable loans. (See point 13 below). For most borrowers, the home purchase or refinancing is the largest financial transaction they have ever entered into. Without significant prior experience or access to independent economic or investment advice, they stood little chance against the market forces that incentivized mortgage brokers and originators to push them into products they could not sustain.

Myth No. 12: Bankruptcy modifications are inappropriate because they would shield borrowers from the impact of their poor decisions, thereby creating a moral hazard.

Reality: Historically, and currently, regulators, Congress and senior members of the administration have organized assistance to failing lenders, investment banks, and private investors, sometimes with taxpayer funding, sometimes by using governmental influence to raise private funds. The moral hazard is deemed outweighed by the need to avoid a broader crisis that would harm innocent victims, even if the solution entails helping those who are responsible for the crisis. Similar reasoning mitigates any concerns about moral hazard associated with helping families save their homes. Widespread foreclosures devastate not only the defaulting borrowers, but their innocent neighbors as well.[20] And individual borrowers' responsibility for the crisis is hardly greater than the responsibility of the brokers, lenders and investors who designed and promoted loan products for sale to borrowers who could not afford them.

For example, Treasury Secretary Paulson has encouraged the creation of a $100 billion fund to support the value of Wall Street's investment in subprime mortgage backed securities. The administration is pursuing this course notwithstanding subprime lenders having indicated that the subprime lending practices most responsible for the current crisis were largely investor-driven. This was frankly acknowledged by the chief executive of Ownit Mortgage Solutions, a state-licensed non-bank mortgage lender that filed for bankruptcy protection after investors asked it to buy back well over one hundred million dollars worth of bad loans. Ownit's chief executive, William D. Dallas "acknowledges that standards were lowered, but he placed the blame at the feet of investors and Wall Street, saying they encouraged Ownit and other supbrime lenders to make riskier loans to keep the pipeline of mortgage securities well supplied. 'The market is paying me to do a no-income-verification [i.e., "no doc"] loan more than it is paying me to do the full documentation loans,' he said. 'What would you do?'"[21]

One final irony: Bankruptcy courts have the authority to assist lenders like Ownit by modifying the debts that Ownit cannot repay. Opponents of the Durbin/Schumer bill would deny this relief to the hundreds of thousands of borrowers who are losing their homes because of investor-driven, inappropriate loans they received from Ownit and lenders like it.

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Myth No. 13: The real problem is that borrowers were buying homes they could not afford.

Reality: In most instances, it is not the home but rather the loan that the borrower cannot afford. Mortgage brokers and loan originators pushed subprime borrowers into loans they could not afford, and steered them away from the sustainable loans for which they qualified. Had they received the latter, most of the foreclosures in the current crisis would never have happened.

The industry itself has stated that borrowers placed in subprime hybrid ARMs could have received sustainable, thirty-year fixed-rate loans, for at most 50 to 80 basis points above the teaser rate on the unsustainable exploding ARM loan they were given.[22] Worse, borrowers who were needlessly placed into "no doc" loans typically paid at least 50 to 80 basis points for the privilege. This means that borrowers placed into a no doc exploding ARM loan could have received a thirty-year fixed rate loan for less than the teaser rate on the no doc 2/28 exploding ARM loan they were given. Moreover, a recent study for the Wall Street Journal found that of the subprime loans originated in 2005 that were packaged into securities and sold to investors, fully 55% "went to people with credit scores high enough to often qualify for conventional [i.e., prime] loans with far better terms." That number rose to 61% by the end of 2006.[23] Had these borrowers received the sustainable loans they qualified for, the foreclosure crisis we now face would not have occurred. The crisis can be mitigated if the terms of these loans are modified to make them reasonably sustainable – like the loans these borrowers qualified for and should have received. Finally, the borrower would need to be able to afford the modified loan under chapter 13, which would be a market-rate interest loan, at the same term, on a loan at the full value of the house; if this is more house that the family could afford, chapter 13 would not be able to help them.

Myth No. 14: It would be unconstitutional (according to SIFMA) to apply Bankruptcy Code changes to existing loans.

Reality: To the contrary, throughout this country's history, and continuing to the present, bankruptcy law changes have been applied to existing loans. Supreme Court authority is clear that this is constitutional.

The application of newly enacted bankruptcy legislation to existing debts has been the norm both historically, in the case of the Depression era statutes, and with modern bankruptcy laws. The Family Farmer Bankruptcy Act of 1986 is useful precedent. There, in response to the farm financial downturn of the early 1980s, Congress did for family farmers precisely what the Durbin bill would do for ordinary homeowners today: it empowered bankruptcy courts to modify farmers' secured and unsecured debts – including all mortgage debts.[24] (In fact, the Family Farmer Bankruptcy Act provided much broader relief than would the Durbin bill; it allowed for modification of mortgage loans for *all* family farmers; the Durbin bill applies only to those who satisfy a strict means test.) The Family Farmer Bankruptcy Act was applied to existing loans without any constitutional impediment.

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The Durbin/Schumer bill avoids constitutional challenge because it would permit loan balances to be written down only to the value of the mortgaged property, but not below that value. As the Supreme Court unequivocally held in *Wright v. Union Central Life Ins. Co.*, 311 U.S. 273, 278 (1940), a creditor has a constitutionally protected property right up to the value of the mortgaged property. However, "[t]here is no constitutional claim of the creditor to more than that."[25] SIFMA's claim ignores this authority, and relies instead on the earlier case of *Louisville Joint Stock Land Bank v. Radford.*[26] *Radford* has no bearing here, because in *Radford*, the relevant statute provided the lender with "*much less* than the appraised value" of the property.[27] The Durbin/Schumer bill avoids this impediment entirely, and so *Radford* has no bearing here.[28] The constitutionality of the Durbin/Schumer bill is not subject to serious dispute.[29]

December 5, 2007
For further information call Eric Stein or Ellen Harnick (919-956-4400).

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[1] *See, e.g.*, Hon. Greg Zerzan, Deputy Assistant Secretary for Financial Institutions Policy, Dep't of the Treasury, *Congressional Testimony Before the House Committee on Agriculture* (June 2, 2004) ("There are many providers of credit to farmers and ranchers, including commercial banks, insurance companies, the Farm Credit System, and specialized agricultural credit providers. ... Farmer Mac is providing a secondary market outlet for lenders to dispose of loans, much the same way that other financial institutions would purchase or participate in agricultural real estate mortgage loans from one another."); Peter J. Barry, Paul N. Ellinger and Bruce J. Sherrick, *Valuation of Credit Risk in Agricultural Mortgages*, American Journal of Agricultural Economics (Feb. 1, 2000) ("Agricultural mortgage markets in the United States are experiencing a major transition toward greater institutional lending, wider geographic dispersion, larger lending systems, increased standardization of financing arrangements, greater reliance on nondeposit funding, and expanded potential for securitized loan pools.").

[2] Stacey M. Berger, *Does anyone (other than the borrowers) care about servicing quality?*, Mortgage Banking (July 1, 2005) ("The commercial real estate finance industry has been reshaped by the strong influence of global capital markets. ... A high proportion of fixed-rate loans are now securitized."); Kenneth P. Riggs, Jr., *A new level of industry maturity: commercial real estate has earned its place in the pantheon of stable and attractive investment classes*, Mortgage Banking (Jan. 1, 2005) http://www.encyclopedia.com/doc/1G1-127789084.html; Amos Smith, *Lenders are renewing their interest in real estate*, Los Angeles Business Journal (Oct. 16, 1995) ("Investors and developers are once again being courted by lenders and mortgage bankers seeking to finance commercial property. ... Real estate lending is also providing attractive yields relative to other investments.")

[3] While interest rates are generally higher on investment properties than on primary residences, this is due to the increased credit risk associated with lending to investors (an owner-occupier has to live somewhere, and the amount that otherwise would have gone to rent can be applied to the mortgage; in contrast, an investor who cannot find a tenant and lacks sufficient resources to cover the mortgage payments from resources other than revenues generated by the property is at greater risk of default). For example, Genworth Mortgage Insurance's "A-Minus Rate Sheet" dated December 1, 2005 shows a 0.5% premium for investor loans for coverage on 90% LTV A minus loan with credit score of 600-619.

[4] See http://www.riskglossary.com/link/securitization.htm (All sorts of assets are securitized: auto loans, mortgages, credit card receivables); http://jobfunctions.bnet.com/whitepaper.aspx?docid=105734 ("credit card ABS market has become the primary vehicle by which the card industry funds unsecured loans to consumers").

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[5] CRL reviewed data on homeownership rates, for the years 1984 to 2000, from the United States Census Bureau, as well as data on mortgage interest rates for the same period, from the Federal Housing Finance Board's Monthly Interest Rate Survey, comparing both states that permitted modifications in bankruptcy and those that did not, as well as trends in "modification states" before and after the 1993 *Nobleman* decision. The data revealed no observable connection between the modification of home mortgages by bankruptcy courts and either homeownership rates or the cost of mortgage credit.

[6] Securities Industry and Financial Markets Association.

[7] *See* Rick Brooks and Constance Mitchell Ford, *The United States of Subprime - Data Show Bad Loans Permeate the Nation; Pain Could Last Years*, Wall Street Journal (Oct. 11, 2007) ("Experts say such properties [i.e., those not occupied by the owner] are higher foreclosure risks than homes lived in by their owners."

[8] Homeownership Preservation Summit Statement of Principles (May 2, 2007), http://dodd.senate.gov/index.php?q=node/3870/print (The Principles were announced by Senator Dodd, and endorsed by the Mortgage Bankers Association, CitiGroup, Chase, Litton, HSBC, Countrywide, Wells, AFSA, Option One, Freddie Mac, and Fannie Mae).

[9] *Id.*

[10] White House press release, August 31, 2007. See also the Interagency Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages, http://www.federalreserve.gov/newsevents/press/bcreg/20070904a.htm (Encouraging lenders to address subprime hybrid ARM resets by pursuing "appropriate loss mitigation strategies designed to preserve homeownership. . . . Appropriate loss mitigation strategies may include, for example, loan modifications, deferral of payments, or a reduction of principal.")

[11] Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages http://www.federalreserve.gov/boarddocs/srletters/2007/SR0716.htm

[12] Fitch Smartview: 170 U.S. Subprime RMBS Transactions Placed Under Analylsis (Jul. 12, 2007), http://www.marketwatch.com/news/story/fitch-smartview-170-us-subprime/story.aspx?guid=%7b65699D03-9AFB-468F-86D5-D9272BFBEAE4%7d&print=true&dist=printTop - "First lien loan loss severity assumptions reflect the performance to-date, resulting in projected lifetime loss severity averaging approximately 40%, with a range of 30%-65% by transaction.

[13] See also, "Modified Mortgages: Lenders Talking, Then Balking," San Francisco Chronicle, 9/13/07 ("Lenders are uniformly unwilling to make loan modifications for homeowners whose interest rates are resetting higher, said Rick Harper, director of housing at Consumer Credit Counseling Services of San Francisco, which talks to about 1,000 delinquent borrowers a month."); 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/. Michael P. Drucker and William Fricke , 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.").

[14] Gretchen Morgenson, Can These Mortgages Be Saved?, The New York Times (Sept. 30, 2007).

[15] Somewhere between one-third to one-half of 2006 subprime borrowers took out "piggyback second" mortgages on their home at the same time as they took out their first mortgage. *See* Credit Suisse, Mortgage Liquidity du Jour: Underestimated No More, March 12, 2007, p. 5.

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[16] Inside Mortgage Finance Reprints, *Subprime Debt Outstanding Falls, Servicers Pushed on Loan Mods* (Nov. 16, 2007).

[17] Gretchen Morgenson, Can These Mortgages Be Saved?, The New York Times (Sept. 30, 2007).

[18] Harris Terry, *ARM Workout Calls Trigger Fierce Debate*, American Banker (Oct. 9, 2007) ("Servicers are 'scared to death' of being challenged by investors for making too many modifications, [Citigroup Managing Director Tim] Bolger said. 'Talking about getting modification rates up, they're probably going to err on the conservative [side] if they think any investor is going to come after them.'")

[19] Mark Landler, European Banker Sees More Bad News Ahead from Lending Crisis, *The New York Times* (Nov. 27, 2007) at C1.

[20] *See* Center for Responsible Lending, *Subprime Spillover* (Nov. 13, 2007), showing that available at http://www.responsiblelending.org/issues/mortgage/research/subprime-spillover.html

[21] Vikas Bajaj and Christine Haughney, *Tremors At the Door -- More People with Weak Credit Are Defaulting on Mortgages*," The New York Times (Fri. Jan. 26, 2007) C1, C4.

[22] January 25, 2007 letter from CFAL to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner, at 3.

[23] David Cho and Neil Irwin , "Bush Unveils Mortgage-Relief Plan," *Washington Post* (Dec. 6, 2007).
[24] Jim Monke, Agricultural Credit, Congressional Research Service Agricultural Policy Briefing Book, http://www.cnie.org/nle/crsreports/briefingbooks/Agriculture/Agricultural%20Credit.htm

[25] *Id.*, 311 U.S. at 278 (*emphasis supplied*).

[26] 295 U.S. 555 (1935).

[27] *Radford* , 295 U.S. at 591 (under the Frazier-Lemke Act, "a sale at much less than the appraised value is prescribed") (emphasis supplied). This critical aspect of the Radford decision was highlighted by the Supreme Court in the 1982 case of *U.S. v. Security Industrial Bank*, 459 U.S. 70, 76 n. 7 and text (1982) (emphasis supplied). ("The Frazier-Lemke Act, which by its terms applied only retrospectively, permitted the debtor to purchase the property for less than its fair market value." (emphasis supplied)). The Court explained that, as originally enacted, the Frazier-Lemke Act (48 Stat. 1289, 73d Cong., Sess. II., Chs. 868-69 (June 27-28, 1934) (s)(3)) gave the debtor the right to purchase the property through deferred payments made in installments over five years, paying only one percent interest. "Given the interest rate of 1%, the present value of the deferred payments was much less than the value of the property." *Security Industrial Bank*, 459 U.S. at 76 n.7. *Security Industrial Bank* involved a creditor's challenge to the retroactive application of the lien avoidance provision of the 1978 Bankruptcy Act (Bankruptcy Code section 522(f)(2)), which permitted debtors to avoid the liens on certain types of property. Although the Court decided the question on statutory, rather than constitutional grounds, it stated in *dicta* that because the provision would void the entire lien -- not just the creditor's right to recover the excess over the value of the mortgaged property -- thereby resulting in "a complete destruction of the property right of the secured party," the constitutionality of its retroactive application was in "substantial doubt."459 U.S. at 75, 78 (emphasis supplied).

[28] Moreover, whatever Radford's continued viability for propositions not in issue here, in light of SIFMA's reliance on the case, it merits note that, while never expressly overturned, the Supreme Court itself later cited Radford as an example of Supreme Court error. *See* Rogers, 96 Harv. L. Rev. at 981 n. 33 (noting "the Supreme Court itself once admitted that it may have fallen into error in *Radford* and corrected itself in *Vinton Branch*," and citing *Helvering v. Griffiths*, 318 U.S. 371, 400-01 & n.52 (1943), in which the court observed that, "this Court may fall into error," citing *Radford* as an example of error,

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and *Wright v. Vinton Branch* (in which the Court upheld the amended Frazier-Lemke Act), as the correction of that error. Both decisions were authored by Justice Louis D. Brandeis)).

[29] For further details on the analysis of the constitutional law question, see http://www.responsiblelending.org/pdfs/constitutionality-of-applying-bankruptcy-changes-to-existing-debts.pdf

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Written Testimony of Mark Zandi
Chief Economist and Co-Founder
Moody's Economy.com
Before the Senate Committee on the Judiciary
Hearing on "The Looming Foreclosure Crisis: How To Help Families Save Their Homes"
Wednesday, December 5, 2007

Mr. Chairman and members of the Committee, my name is Mark Zandi; I am the Chief Economist and Co-founder of Moody's Economy.com.

Moody's Economy.com is an independent subsidiary of the Moody's Corporation. My remarks represent my personal views and do not represent those held or endorsed by Moody's. Moody's Economy.com provides economic and financial data and research to over 500 clients in 50 countries, including the largest commercial and investment banks, insurance companies, financial services firms, mutual funds, manufacturers, utilities, industrial and technology clients, and government at all levels.

I will make six points in my remarks. First, the nation's housing and mortgage markets are suffering an unprecedented downturn. Housing activity peaked over two years ago, and since then home sales have fallen by over 30%, housing starts by 40%, and house prices by 7%. Over half of the nation's housing markets are currently experiencing substantial price declines, with double-digit price declines occurring throughout Arizona, California, Florida, Nevada, the Northeast Corridor and the industrial Midwest. Further significant declines in housing construction and prices are likely into 2009 as a record amount of unsold housing inventory continues to mount given the impact of the recent subprime financial shock and its impact on the mortgage

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securities market and thus mortgage lenders. There is now a broad consensus that national house prices will fall by between 10% and 15% from their peak to their eventual trough.[1] Even this disconcerting outlook assumes that the broader economy will avoid recession and that the Federal Reserve will continue to ease monetary policy.

Second, residential mortgage loan defaults and foreclosures are surging and without significant policy changes will continue to do so through the remainder of the decade. Falling housing values, resetting adjustable mortgages for recent subprime and Alt-A borrowers, tighter underwriting standards, and most recently a weakening job market are conspiring to create the current unprecedented mortgage credit problems. Even if mortgage loan modification efforts soon measurably increase, I expect approximately 2.8 million mortgage loan defaults (the first step in the foreclosure process) in 2008 and 2009. Of these, 1.9 million homeowners will go through the entire foreclosure process and ultimately lose their homes. The impact on these households, their communities, and the broader economy will be substantial. Foreclosure sales are very costly after accounting for their substantial transaction costs, and serve to significantly depress already reeling housing markets, as foreclosed properties are generally sold at deep discounts to prevailing market prices. In much less stressful times, these discounts are estimated to be between 20% and 30%.[2]

Third, there is a substantial risk that the housing downturn and surging foreclosures will result in a national economic recession. The stunning decline in housing activity and

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[1] See "Aftershock: Housing in the Wake of the Mortgage Meltdown," Moody's Economy.com, December 2007.
[2] See "The Value of Foreclosed Property," Anthony Pennington-Cross, Federal Reserve Bank of St. Louis, September 2004. http://research.stlouisfed.org/wp/2004/2004-022.pdf. For an estimate of the impact of foreclosures on property values, see "There Goes the Neighborhood: The Effect of Single Family Mortgage Foreclosures on Property Values," Woodstock Institute, June 2005. http://www.woodstockinst.org/content/view/104/47/.

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prices when combined with rising gasoline prices are crimping consumer spending, and the job market appears increasingly weak as it struggles with layoffs in housing-related industries. Regional economies such as California, Florida, Nevada and much of the industrial Midwest, together accounting for well over one-fourth of the nation's GDP, are in my judgment already in recession.

The turmoil in the housing and mortgage markets also threatens to further upend the fragile global financial system, with very clear negative implications for the U.S. economy. Estimates of the mortgage losses global investors will eventually have to bear range as high as $500 billion.[3] The losses recognized by financial institutions to date amount to no more than $75 billion. If the U.S. economy does slide into recession, then of course house prices will decline and foreclosures will rise to an even more serious degree.

Fourth, without a quick policy response, mortgage loan modification efforts are unlikely to increase enough to forestall a surge in foreclosures. A recent Moody's survey of loan servicers found that very little modification had been done, at least through this past summer.[4] This highlights the substantial impediments to modification efforts. Some tax, accounting and legal hurdles appear to have been overcome, but large differences in the incentives of first and second mortgage lien holders and the various investors in mortgage securities are proving to be daunting. Given the overwhelming number of foreclosures, loan servicers are also having difficulty appropriately staffing their

[3] See "Leveraged Losses: Why Mortgage Defaults Matter," Jan Hatzius, Goldman Sachs US Economic Research, November 15, 2007. "A Macro Look at Subprime Losses, ARMs and Convexity Hedging," Alec Crawford, RBS Greenwich Capital, November 2007.
[4] See "Moody's Subprime Mortgage Servicer Survey on Loan Modifications," Moody's Investor Service, September 21, 2007. http://americansecuritization.com/uploadedFiles/Moodys_subprime_loanmod.pdf.

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modification efforts. While the total economic benefit of forestalling foreclosure is significant, these benefits do not accrue to all of the parties involved in determining whether to proceed with a loan modification.

A recent initiative by the Treasury Department and the nation's largest lenders to freeze interest rates on resetting subprime ARM loans is laudable, but should not forestall passage of Senator Durbin's legislation, the Helping Families Save Their Homes in Bankruptcy Act. If the Treasury plan is successful in helping many borrowers, then these borrowers would not avail themselves of the opportunity to avoid foreclosure in Chapter 13 provided by this legislation. If, however, Treasury's efforts are unsuccessful, which may very well be the case, then this legislation would prove invaluable.

Fifth, Senator Durbin's legislation, which would give bankruptcy judges the authority in a Chapter 13 to modify mortgages by treating them as secured only up to the market value of the property, will significantly reduce the number of foreclosures. An estimated over one-fourth of homeowners likely to lose their homes between now and the end of the decade, equal to an estimated 570,000 homeowners, would benefit from this legislation. This calculation is based on the number of homeowners who face a first payment reset through the end of the decade that would meet the means test required in a Chapter 13 and are still current on their mortgage loans. This would be very helpful in reducing the pressure on housing and mortgage markets and will measurably reduce the odds of recession next year. Note that in order to limit any potential abuses in this Chapter 13 modification process, Congress should provide firm guidelines to the bankruptcy courts, such as providing a formula for determining the term to maturity, the interest rate, and the property's market value.

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Sixth, this legislation will not significantly raise the cost of mortgage credit, disrupt secondary markets, or lead to substantial abuses by borrowers. Given that the total cost of foreclosure to lenders is much greater than that associated with a Chapter 13 bankruptcy, there is no reason to believe that the cost of mortgage credit across all mortgage loan products should rise. Simply consider the substantial costs associated with navigating through fifty different state foreclosure processes in contrast to one well-defined bankruptcy proceeding. Indeed, the cost of mortgage credit to prime borrowers may decline. The cost of second mortgage loans, such as piggy-back seconds, could rise, as they are likely to suffer most in bankruptcy, but such lending has played a clear contributing role in the current credit problems.

There is also no evidence that secondary mortgage markets will be materially impacted after a period of adjustment, as other consumer loans which already have similar protection in Chapter 13 have well-functioning secondary markets. Moreover, the non-conforming residential mortgage securities market has already effectively shut down in the wake of the ongoing financial shock, and will only revive after there are major changes to the securitization process. The changes proposed in this legislation are immaterial by comparison.

It is very unlikely that abuses by mortgage borrowers will increase as a result of this legislation given that a workout in Chapter 13 is a very financially painful process. Indeed, the number of bankruptcy filings has remained surprisingly low since the late 2005 bankruptcy reform, likely reflecting the now much higher costs to borrowers in a Chapter 13 proceeding. Short-term housing investors or flippers, those who borrowed

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heavily looking to make a quick profit in the housing boom, would certainly not consider Chapter 13 as a viable solution to their financial problems.

The housing market downturn is intensifying and mortgage foreclosures are surging. A self-reinforcing negative dynamic of mortgage foreclosures begetting house price declines begetting more foreclosures is underway in many neighborhoods across the country. The odds of a full-blown recession are very high. There is no more efficacious way to short-circuit this developing cycle and forestall a recession than passing this legislation.

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