S. HRG. 110–871

HELPING FAMILIES SAVE THEIR HOMES: THE ROLE OF BANKRUPTCY LAW

HEARING

BEFORE THE

COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

NOVEMBER 19, 2008

Serial No. J–110–124

Printed for the use of the Committee on the Judiciary

U.S. GOVERNMENT PRINTING OFFICE

51–814 PDF WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
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HELPING FAMILIES SAVE THEIR HOMES: THE ROLE OF BANKRUPTCY LAW

WEDNESDAY, NOVEMBER 19, 2008

U.S. SENATE,
COMMITTEE ON THE JUDICIARY,
Washington, DC

The Committee met, Pursuant to notice, at 10:05 a.m., Room 216, Hart Senate Office Building, Hon. Richard J. Durbin, presiding.

Present: Senators Leahy, Feingold, Schumer, Whitehouse, and Specter.

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

Senator DURBIN. This hearing will come to order. I ask my witnesses and guests, please take seats.

Good morning, and welcome to the hearing of the Senate Judiciary Committee on Helping Families Save Their Homes: The Role of Bankruptcy Law.

I thank Chairman Leahy for permitting me to hold this hearing, and I thank my colleague in particular, Senator Specter, the Ranking Member from Pennsylvania, for attending; others have sent statements and some will join us.

In a few moments after I make my remarks, Senator Specter will have his opportunity and we will then allow the panel of witnesses to testify.

A year ago, I chaired a hearing before this committee on the looming foreclosure crisis facing our Nation. At that hearing, we heard about the combination of subprime loans, falling housing prices, and resetting adjustable rate mortgages that had put thousands of families out of their homes and threatened millions more with foreclosure.

We heard predictions: how these foreclosures would result in record decreases in home values across America; instability in the financial service industry; and finally, a meltdown in the economy. That was the crisis this committee was told we were facing 1 year ago. Last year, I offered legislation to avert this crisis, or at least to moderate it, by making a simple change in the bankruptcy law.

My proposal was straightforward. Currently, a bankruptcy judge in Chapter 13 proceedings can modify the structure of any secured debt, except for a mortgage on a home, a primary residence. I proposed removing that exception and permitting mortgages on primary residences to be modified in bankruptcy court just like mortgages on farms, ranches, vacation homes, and other real estate.

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As we heard at last year's hearing, the benefits were clear. This proposal would significantly reduce the number of foreclosures and help hundreds of thousands of families stay in their homes. Mortgage modification and bankruptcy benefits everybody—the homeowner, the lender, the neighboring homeowners, and the economy—far more than a foreclosure proceeding. My proposal would give lenders, servicers, and investors a real incentive to voluntarily re-work mortgages, an incentive that doesn't currently exist.

My proposal would not significantly raise the cost of mortgage credit, since the costs associated with Chapter 13 bankruptcy are actually far less for lenders than the costs associated with foreclosures. How many bankers have told me, we do not like to cut the grass, provide security, clean the windows, prepare a house for sale in foreclosure. That is not what banks are supposed to do.

We've also discussed how many taxpayers' dollars my proposal would cost: zero. There was a long list of organizations supporting me—AARP, Leadership Council on Civil Rights, Consumer Federation of America. They agreed this proposal represented the best way to reduce the devastating effect of foreclosures on America's families and communities.

Over the past year, I tried three times to pass this proposal: as part of Majority Leader Reid's housing bill in the spring, as part of the Senate Banking Committee's housing bill in the summer, and as part of the financial rescue bill this fall. Each time, the Mortgage Bankers Association and most of the financial services industry opposed my proposal and nothing got done. The very groups that helped to create this crisis showed that they still have power on Capitol Hill by defeating my amendment.

Here we are a year later. Now we are able to see that many of the dire predictions we heard last year that may have sounded like exaggerations actually came true. In fact, the situation has become far, far worse than anybody could have imagined a year ago when we considered this proposal.

The economic crisis we face today is as severe as any America has faced since the Great Depression, and the heart of the crisis, the canary in the coal mine? The foreclosure of American homeowners. Proposal after proposal has been offered to try to fix the economy and help keep families in their homes. In the meantime, we have seen billions of dollars go to prop up Bear Stearns and AIG. We have seen the government take over Fannie Mae and Freddie Mac. We have seen a $700 billion rescue plan, much of it going to the same banks that opposed this proposal. We have seen a succession of voluntary housing programs like Hope Now, Hope for Homeowners, and all sorts of hope, and yet nothing has been successful in fighting the foreclosure on the scale that is required across America.

The question that faces us now is this: after committing over $1 trillion in taxpayer money to what has largely been an unsuccessful effort to date to address the foreclosure crisis and save our economy from a devastating recession, why don't we take a step that would indisputably reduce foreclosures and cost the taxpayers nothing?

Today we will hear from a distinguished panel of witnesses about how bad the foreclosure crisis is and how much worse it can get.

I want to note in particular that my friend, Tom Dart, the sheriff of Cook County, is here to talk about the impact of the foreclosure crisis in the neighborhoods of Cook County, around Chicago, Illinois. I thank him, and all the witnesses, for being here today.

Make no mistake. The outlook for our economy is at best guarded, and probably grim by most appraisal. But change is coming to Washington, and I am confident that early next year we will be able to take effective steps to finally address our economic crisis where it started, by helping families save their homes.

Now I would like to recognize my colleague, Senator Specter, for his opening statement.

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

Senator SPECTER. Thank you, Mr. Chairman.

I begin by agreeing with you, Senator Durbin, Mr. Chairman, about the economic crisis which we face today. It is self-evident. The increasing rate of mortgage foreclosures is an enormous part of that problem. We also know that the mortgage foreclosures triggered the current problem which we have now with the very complex securities which were backing up the mortgages. It is my view that action is required now. It is my hope that the Congress would move on this subject before we conclude for the year.

In saying that, I realize that it is unlikely, since we are in a lame duck session and since our attention right now is being directed at the automobile manufacturers, that the problem of mortgage foreclosures and the tremendous increase in the threat it poses to so many families to be homeless, ought to deserve our attention on par, if not ahead, of our concern for the automobile manufacturers.

The fact is, we can do both. To do that would require a little more effort on our part. We passed a $700 billion bail-out without following regular order and, I submit, very much to the disadvantage of the country. The legislative process requires, customarily, a bill, where we could read and analyze it, then hearings where the proponents of the bill come forward, and opponents, then a markup by the Committee, going over the proposed legislation line-by-line, then floor action where amendments can be offered and the Senate can work its will on a bill. Similar action is then taken on the house side, a conference ultimately occurs, and we meld the two bills together and make a presentment to the President. That was not done on the $700 billion bail-out, much to the disadvantage of the country.

The paperwork grew from 4 pages originally proposed by the Treasury Secretary to 110, and then before we voted, candidly, with our backs against the wall after the House had defeated the bill on September 29th, back on October 1st, 2 days later, for a 7:30 vote, and it had a great deal of pork, which has proved to be enormously embarrassing.

I spent the month of October traveling in Pennsylvania, in accordance with custom, touching all of Pennsylvania's 67 counties, and heard enormous complaints from my constituents about what had happened. It was my expectation that some of that $700 billion would have been used on the mortgage foreclosure point, and I believe that Treasury Secretary Paulson is wrong when he says that that wasn't the intent of our legislation.

I think a better approach has been the one advocated by FDIC Chairwoman Bair, who has come forward with proposals. I agree with Senator Durbin that it would have been very salutary for the full Senate to consider the legislation which he proposed, and at the same time, perhaps a day or two earlier, I had proposed similar legislation with the point being to give the bankruptcy courts jurisdiction to modify the interest rates and to modify the time of payment.

I have concern with Senator Durbin's proposal because of the impact it may have on the future of lenders if the principal sum can be altered in bankruptcy. That was excluded on first homes in order to maintain the availability of capital from lenders without discouraging them.

There are innovative plans at work now across the country: one in Cook County, Chicago; one in Philadelphia, Pennsylvania; another in Pittsburgh. Senator Casey and I held hearings in Pennsylvania on the two plans, and the essence of them is to suspend foreclosures until the court has had an opportunity to call in both the lender and the borrower to try to see if the matter can be worked out.

Two days ago, I introduced legislation captioned "The Foreclosure Diversion and Mortgage Loan Modification Act of 2008" to try to give Federal backing to these approaches, where we try on a voluntary basis to suspend the foreclosure matter and try to work out a schedule of payments so that the homeowners may stay in their home and the lenders have a better chance of recouping the money which they have advanced.

I conclude on the note that I do believe this requires immediate attention and it would be my hope that we would find some way yet to address this issue before we conclude our work for the year, but to do so in regular order. It may take a few more days, but I think the problem requires our effort in that regard.

I thank you, Senator Durbin, for the work you have done in this important field.

Regrettably, I am not going to be able to stay too long because we are hard at work on the auto manufacturers' issue. We are moving in many, many directions, so I might say to this distinguished panel, if you do not see many Senators here it is not that everybody is not hard at work, but there are so many problems, we are like jugglers in the circus, trying to keep up with the many problems we have to deal with.

Thank you, Mr. Chairman.

Senator DURBIN. Thank you, Senator Specter. I just left a meeting with Senator Reid on the automobile industry, so I certainly know what you are talking about. We have very little time and a lot of things coming at us, but I still think this hearing is critically important and timely. I want to thank the distinguished panel of witnesses who have come together. We are going to give each of you 5 minutes for an opening statement.

You will see a timer in front of you. When the light turns red, the Capitol Police come. No. When the light turns red, your time is up and we hope you will conclude your remarks. Since we have a large panel, we are going to hold as closely as we can to the 5-minute time frame. Your complete written statements will be included in the record. As is the custom of this Committee, I ask that each of the witnesses stand to be sworn.

[Whereupon, the witnesses were duly sworn.]

Senator DURBIN. Let the record reflect the witnesses have answered in the affirmative.

Our first witness is Sheriff Tom Dart of Cook County. Sheriff Dart was sworn in as sheriff of Cook County in December of 2006. Prior to that, he served for 12 years in the Illinois General Assembly, and for 3 years as Chief of Staff in the Cook County Sheriff's Office.

Sheriff Dart earned his bachelor's degree from Providence College and his law degree from Loyola University in Chicago. Last month, Sheriff Dart made national news when he became the first sheriff in America to suspend mortgage foreclosure evictions. At the time, Cook County was facing a record rate of foreclosures and evictions and Sheriff Dart recognized that mortgage companies often were not performing even basic due diligence before foreclosing.

After a year in which he tried to negotiate with the mortgage industry to address these concerns, Sheriff Dart decided to take a stand on behalf of the people who were being evicted. As a result of his efforts, Sheriff Dart was able to ensure safeguards were built into the process to provide some protection to those facing foreclosure.

Sheriff Dart, we appreciate your service in looking out for the citizens you represent. Glad to have you here today. You may proceed with your testimony.

STATEMENT OF SHERIFF THOMAS J. DART, COOK COUNTY, ILLINOIS

Sheriff DART. Thank you, Senator. Good morning, Senator Durbin, Ranking Member Specter.

Let me first say what an honor it is to be here before you today, and what a privilege it is to be able to represent the voices of the thousands of homeowners in Chicago and suburban Cook County who are currently facing foreclosure, as well as the thousands more who, despite their best efforts, know that foreclosure is just a few days away.

I am here today because of the stand we took in Cook County, as you mentioned, Senator, to stop all mortgage foreclosure evictions. It was the first move of its kind in the country and one that drew national attention to the crisis faced by so many Americans.

That growing crisis in our county couldn't be ignored any longer and a drastic step had to be taken. When I took office just 2 years ago, there were 18,916 mortgage foreclosure cases filed in Cook County. This year, we project 43,000 will be filed. As a point of reference, Cook County is the second largest county in the United States.

When I took office, we were evicting 1,771 families from their homes due to foreclosures. This year, we are on track to evict 4,500 families. Due to the injustice that I was witnessing on a daily basis, we stopped all mortgage foreclosure evictions until protections could be built into the system.

The result of that stand was the creation of new layers of protections for those living in foreclosed homes, as well as for taxpayers, but it was a solution that was designed only for Cook County. It was a Band-Aid that has helped problems locally, but what became obvious was a need for a more systematic solution.

Senator Durbin's plan to allow for the restructuring of mortgage debt during a bankruptcy proceeding is exactly the type of bold stand American homeowners need. It is clear from the present economic conditions, as well as the continuing rise in foreclosure cases, that the time for talking has long passed. A solution is needed right now.

All you have to do is drive down one of the many blocks our eviction teams drive down each and every day, from the wealthiest suburbs to the inner city neighborhoods, and the effects of this crisis are easy to see. Consider a block in Chicago's poverty-ravaged Englewood neighborhood. Once home to 16, 20 homes, that block now has 4 homes standing. The rest have been demolished, and two of the remaining homes are boarded up. The third is about to have a knock on the door from our deputies, explaining that everyone has got to get out.

There was a time when our Eviction Unit visited the exclusive Barrington Township, Cook County's wealthiest area, maybe six times a year. Today we are in Barrington and surrounding towns once a week, carrying out foreclosure cases.

Boarded up and empty homes, as any law enforcement official will tell you, are a breeding ground for criminal activity, but they also represent a staggering loss in property taxes. Think about that Englewood block for a minute. What once was a thriving block with 16 to 20 homes adding to the city's tax base has wilted to just 4. That means higher property taxes for everyone else, a need for more police on that block, and yet another house on the verge of being boarded up. That is an impact everyone can feel.

Going out with our Eviction Unit, I get to hear first-hand so many of the heartbreaking stories of how a family wound up in foreclosure. They are both gut-wrenching and varied. Take, for instance, Linda Gary, a mother of two, living on the west side of Chicago, who took out a second mortgage to put her son and herself through college. She borrowed at 9.5 percent. But after her husband became terminally ill, she tried to refinance it but she was told she couldn't. She filed for bankruptcy, thinking it would solve her crisis. Instead, she learned there were no bankruptcy protections that could help her and her situation for the long term, something she said she was never told before the filing.

Or the 74-year-old widow who had to turn for help from the Chicago Coalition for the Homeless after losing her Southside home to foreclosure in August. After her husband died in 2003, their son moved in to help pay the bills on a house that had been in their family for 20 years. When her son got sick, she refinanced the house, hoping to make ends meet, and was told an ARM was best for her. But when her son got sick again and her adjustable rate changed, she just couldn't keep up with the payments. She couldn't get any help from the bank, and she lost her family's home in August.

These folks are just a few examples of the hardworking people in this country whose lives have been destroyed and who simply need a little bit of help to survive.

In October, Cook County's foreclosure filings were 31 percent higher than they were in October of last year. Right now, 1 in every 313 houses in Cook County is in foreclosure. If banks would just take a look, they'd see that many of these cases involve someone not thumbing their nose at the mortgage industry. Very often it's a hardworking family that simply needs a helping hand.

That's why I'm so pleased to see the kind of opportunity presented by Senator Durbin's bill. It's the kind of helping hand so many people need at this time. You know, when I stopped all mortgage foreclosure evictions in Cook County, there were some who said I was a vigilante, that I was ignoring what I was sworn to do. Critics said I was going too far, that this wasn't the answer, and that we should just continue to talk through this problem. It's not unlike what they're saying to you, Senator Durbin.

But I can tell you first-hand that if we had just continued to talk, which is what people kept pleading with us, and not acted in Cook County, the list of victims would have continued to grow on a daily basis. That's why it's clear the time for talking is done. It's time for a bold stand. Senator Durbin, your bill is exactly the kind of help that Americans need right now.

Thank you all so very much for your time.

Senator DURBIN. Thank you, Sheriff Dart.

[The prepared statement of Sheriff Dart appears as a submission for the record.]

Senator DURBIN. The next witness is David Kittle, chairman of the Mortgage Bankers Association. Mr. Kittle previously served as vice chairman of the Mortgage Bankers Association, as well as chairman of the Association's Political Action Committee. He is currently the executive vice president of Vision Mortgage Capital in Louisville, Kentucky.

Mr. Kittle, thank you for joining us today. Given the economy crisis we're now in and the impact it's had on Americans, we're anxious to hear your testimony on plans that you believe we should be pushing forward to reduce foreclosures.

I look forward to your testimony, and you may proceed.

STATEMENT OF DAVID G. KITTLE, CMB, CHAIRMAN, MORTGAGE BANKERS ASSOCIATION, WASHINGTON, DC

Mr. KITTLE. Thank you for the opportunity to appear before you.

Mr. Chairman, my name is David Kittle. I'm a Certified Mortgage Banker and have 31 years of experience in the field. I have been working with customers, banks, and every part of the mortgage industry during this time. While I am also chairman of the Mortgage Bankers Association, I would like to speak to you today from the perspective of a lender who is still in contact with consumers.

Mr. Chairman, we all agree on the same goals: we all want to help the consumers by stabilizing the market; we want to help families stay in their homes; and we want to make sure the market excesses we saw earlier in this decade do not return. We all agree on that.

However, we disagree on the notion that bankruptcy would help our Nation's consumers. We should be working on efforts to help keep people out of the bankruptcy courts rather than pushing people toward them.

Let me give you three reasons why bankruptcy is harmful to consumers. First, no one should make filing for bankruptcy appear attractive. There are real and severe consequences for consumers who declare bankruptcy. Bankruptcy stays on a credit report for 7 to 10 years. It makes it very difficult to acquire future credit for a new home or car. It can stand in the way of getting insurance. It can make it harder to get a new job, or even rent a home or an apartment.

Two-thirds of those people who file for bankruptcy are unable to fulfill the terms of their repayment plans. Two-thirds. In other words, two-thirds of those who file will still lose their home and still have the bankruptcy on their record.

Second, changing the law will force lenders to impose tougher standards on people trying to get a mortgage. Cram-down legislation would add new risk to the calculation lenders make in setting prices. For the first time, lenders will have to pay more attention to markets with the most volatility and those with higher risks, such as rural areas, inner cities, and subdivisions, where history shows the greatest fluctuation of home values. This could even lead to a new era of red-lining.

Lenders will be forced to demand larger down payments and raise interest rates to balance the risk from judges who would change the mortgage contract and cause lenders or investors to suffer an economic loss.

Third, as you know, our financial markets are incredibly fragile right now. Cram-down legislation would only add more instability. The only option for many low-income borrowers today is to get an FHA-insured loan, where the government minimizes the risk to the lender of making a low down payment loan. Cram-down legislation would make it harder for borrowers to get an FHA loan because lenders would face the possibility that FHA insurance would not cover the loss from a principal reduction.

The same is true for VA lending. In effect, Congress would end the only meaningful lending option currently available to most low-income borrowers almost overnight.

Mr. Chairman, throughout this debate I have heard again and again about why bankruptcy laws should be changed, the idea that rich people with vacation homes get cram-down protection and that the middle class is somehow being cheated out of this protection.

Let me clarify how current law works. If someone in bankruptcy were to have a $400,000 mortgage on a vacation property and the judge were to reduce that to $350,000, the debtor would be required to pay off the entire $350,000 in equal monthly payments during a 3- to 5-year repayment plan, not over the course of 30 or 40 years.

More likely, the judge would force the debtor to sell the vacation home. Vacation home customers pay for this added risk in four ways: higher down payments, higher interest rates, higher origination fees, and shorter, and more expensive loan terms. Future home buyers can expect to see similar treatment if Congress passes cram-down legislation.

In 1978, this Committee passed a broad rewrite of the Bankruptcy Code. It specifically and purposefully excluded primary residences from cram-down. Congress did so to keep the cost of primary residence mortgages low. This is not a loophole. This was an important effort by Congress to encourage home ownership, which even today is the best way for American families to build, grow, and maintain wealth.

Congress should continue to help consumers by keeping mortgage costs low. Passing cram-down legislation during this credit crunch will further destabilize the mortgage market and it will not help significant numbers of families to stay in their homes.

We at the MBA look forward to continuing to work with Congress, our regulators, and the new administration to find new, creative, and productive ways to address the current crisis.

I look forward to addressing any questions that you may have. Thank you.

Senator DURBIN. Thank you, Mr. Kittle.

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

Senator DURBIN. My colleague, Senator Schumer, has joined us here and I know that he is, like the rest of us, trying to do a number of things in the closing hours of the session.

Senator Schumer, if you'd like to make an opening statement at this point, then we'll return to the witnesses.

OPENING STATEMENT OF HON. CHARLES E. SCHUMER, A U.S. SENATOR FROM THE STATE OF NEW YORK

Senator SCHUMER. Thank you, Mr. Chairman. I appreciate it. I had thought the Banking Committee, where I had to introduce the nominee for IG of the TARP, was at 9:30 and they switched it to 10, so I apologize for being here late before I could make an opening statement.

First, I want to thank you, Senator Durbin, for your leadership on this issue. To me, this provision is the key to unlocking the mortgage crisis—key to unlocking it. And you've championed this for a long time, and I've been pushing this for the last several—I've been a co-sponsor from the beginning, but I've been pushing it for the last several months because I think it's our only solution.

And let's talk business here. Let's look at the problem which everybody ignores or pushes away: no voluntary program is going to work. None. Mr. Kittle, you are standing in the way of progress and it's going to hurt your own banks. I have to tell you that. It's a short-sighted view that you suggest.

The reason is very simple. The reason is very simple. Most mortgages, 90 percent, are held in lots of little pieces. They're not held by one bank anymore. When any one of the tranche holders objects to any change in the terms, there is no change in terms. It's unconstitutional, it's a contract, so you can't change it. That's why Secretary Paulson's plan, Chairman Frank's plan, Senator Dodd's plan, all well intentioned, have not done very much. They work out great if the bank still holds the mortgage, but that was 20 years ago. Now, 40 tranche holders hold the mortgage.

Let me explain it for a minute, if I might. You know it. If the 40th tranche is the most risky tranche when they divided up the mortgage, and they said if the home value goes to 98 percent of its value, you get wiped out, 40th tranche holder, and everyone else gets repaid, then that 40th tranche holder has no interest in seeing a refinancing, whereas, if the bank had held that mortgage and it was 98 percent of its value, they would.

But this tranche holder is only interested—or the representative of the tranche holder—in his interest or her interest, which is that portion that's 98 to 100. They got a little more interest for it, they have to take the risk. But they may as well sit around and wait for 10 years until housing values come back up and the house will be 100 percent of its value, or more. And so they hold up progress. That's their job. But it's not our job. I would suggest to everyone on the panel, it's not your job because you're representing the financial system as well.

The only constitutional way—the only constitutional way—to break into this contract is bankruptcy. Of course, every other player in bankruptcy faces the risk that should their borrower be unable to pay, that there's going to be a write-down, except first mortgages. It makes no sense. It makes no sense.

If we were to go and pass the legislation that Senator Durbin has sponsored and I have co-sponsored, you would immediately, with the cram-down provision, give that 40th tranche holder the incentive to negotiate because that tranche holder would say, hey, bankruptcy may wipe me out. If I can get 20 percent, or 30 percent, or 40 percent, I'm taking it. But until that happens, we're not going to get any change, and we're not going to find a floor to the housing market, and our financial system will be precarious.

And Mr. Kittle, I would suggest to you your own constituency is hurt more by not having this provision than by having this provision. I have talked to some of the big bankers, and they understand it. But the smaller bankers, who probably hold a lot of mortgages, are not. But there's a responsibility to the country here. Passing this provision could be the difference between a medium recession and a deep recession, or even worse. So we have a responsibility here. We have a responsibility. We are not going to be able to pass this in this Congress with 51 votes, Democratic votes, with the President opposed. But I can tell you, Senator Obama, I know, is for this provision. President-Elect Obama. Excuse me.

I think we had, in our negotiations, which I was part of, on the TARP, we had three or four Republican Senators, once they heard the arguments that I've just made here, who said we're willing to go along. I believe it's going to happen. I also believe it must happen.

So I want to thank you for holding this hearing. Again, to repeat to the panel and to America: we will not get to the bottom of this economic crisis until we solve the mortgage crisis, until we find a bottom. We will not find a bottom to the mortgage crisis until this legislation is passed. That is because of the new way mortgages are structured, chopped up in little pieces, with no one banker representing them.

The legislation that Senator Durbin has put in has been carefully crafted not to raise the cost of future mortgages, Mr. Kittle, because it's only aimed at previous mortgages, and I believe he was willing—I don't know if it's in the legislation—to limit it to subprime, and maybe ALT As, so all the regular mortgages that are issued are not going to be affected by this.

So let everyone rise to the occasion. We have a crisis that can be solved by a simple and thoughtful piece of legislation sponsored by Senator Durbin. We have to rise to that occasion.

Thank you.

Senator DURBIN. Thank you, Senator Schumer.

Our next witness is Michael Calhoun, president of the Center for Responsible Lending, a research and policy institute on consumer lending issues. Mr. Calhoun has more than 25 years' experience in consumer law and was a principal drafter of the laws in North Carolina regulating predatory mortgage loans and mortgage brokers and lenders. He has a bachelor's degree from Duke, a law degree from the University of North Carolina.

Thank you for joining us. Please proceed with your testimony.

STATEMENT OF MICHAEL D. CALHOUN, PRESIDENT, CENTER FOR RESPONSIBLE LENDING, DURHAM, NC

Mr. CALHOUN. Thank you, Senator Durbin, and thank you, Senator Schumer.

The economy cannot recover until we stem the tide of foreclosures. American families are losing their homes at a staggering rate, and it is only projected to get worse. Foreclosures are currently happening at more than 2.3 million homes per year. Credit Suisse projects that, over the next 5 years, 6.5 million families will lose their homes. That is 1 out of 8 of all mortgages outstanding in the United States.

This was not a typical or accidental foreclosure crisis. Mortgage brokers, lenders, and securitizers were paid huge fees and bonuses to steer families into risky, unsustainable mortgages, even though the families qualified for much better loans, though those loans paid much lower fees and bonuses.

Today, the most pressing need for families and the overall economy is to help these homeowners stay in their homes. The voluntary loan-by-loan modification efforts have fallen short and will continue to do so. Recent reports have found that only 3.5 percent of delinquent subprime loans received modifications in August of this year, and 8 out of 10 seriously delinquent homes are not on track for any loss mitigation outcome.

The obstacles to this have been well documented: securitization, investor concerns about lawsuits, second liens, and lack of capacity. The most promising voluntary program proposed to date is the FDIC's proposal to use some of the TARP authority to provide guarantees to mortgages that are sustainably modified, and we have urged Treasury to implement that immediately.

But regardless of which voluntary programs are implemented, lifting the ban on judicial modifications is a crucial element to success for two reasons. First, it will provide the incentive to lenders and servicers to engage in modifications, and servicers will have the protection that they are acting in an investor's best interests by entering into those modifications.

Second, this reform will provide a critical backstop for homeowners whose servicers for some reason still cannot, or will not, participate in voluntary modifications. We note this same approach was used successfully in the 1980s to resolve the farm loan crisis, despite objections that sound virtually identical to those raised to the proposal before this Committee today.

Importantly, this bankruptcy reform is carefully tailored to be targeted and fair. This may be the key point in all of my testimony. Modifications to principal would be available only for families whose homes would otherwise end up in foreclosure. This is an additional requirement beyond the ordinary requirements for eligibility to file for Chapter 13.

Thus, this reform encourages, rather than undercuts, participation in voluntary modification programs. Lenders hold the key to the courthouse. If they provide those modifications, the borrower is not eligible for the bankruptcy relief. Furthermore, in bankruptcy the relief is limited to market interest rates, limited as to term, and principal reductions can be no lower than the full value of the property. Homeowners would have to meet the stringent requirements of the Bankruptcy Code before receiving a permanent modification. That means completing a rigorous 5-year plan.

I will close with the following: less than 2 months ago, the Federal Reserve loaned AIG $85 billion as a lifeline. Since then, AIG has incurred larger-than-projected losses on its credit default swaps, contracts betting on the subprime mortgages that are causing the current crisis. Last week, the Fed responded to AIG's worsening condition by writing down this $85 billion debt to $60, lowering the interest rate substantially, and extending the repayment term to more than double it.

Certainly for borrowers for whom the difference in losing their homes and staying in their neighborhoods is only hundreds of dollars a month, they should be afforded an opportunity for reasonable modifications, especially when these modifications are the key to stabilizing the whole economy.

In conclusion, bankruptcy is essential to resolving our financial crisis. It can be implemented quickly and at zero cost to taxpayers, and it should be enacted immediately.

Thank you.

Senator DURBIN. Thank you, Mr. Calhoun.

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

Senator DURBIN. Our next witness is Scott Stengel, partner at the law firm of Orrick, Herrington & Sutcliffe. He practices primarily in areas of insolvency, bank regulation, corporate, and commercial law. He is a graduate of Notre Dame Law School, and served as law clerk for Judge Douglas Tice on the U.S. Bankruptcy Court.

Mr. Stengel, thank you for coming. Please proceed.

STATEMENT OF SCOTT STENGEL, PARTNER, ORRICK, HERRINGTON & SUTCLIFFE, LLP, WASHINGTON, DC

Mr. STENGEL. Thank you, Mr. Chairman. I'm grateful for your invitation to testify today on the role that bankruptcy law should play in the current housing crisis.

I'm a partner in the Washington, DC office of Orrick, and a significant part of my practice is devoted to advising participants in the capital markets on the application of bankruptcy and other insolvency laws.

I appreciate the opportunity to share with you this morning some observations from that perspective and to assist the Committee in understanding the impact that proposed legislation might have on the mortgage-finance market. I'm speaking only for myself today and not on behalf of my law firm or my clients.

At the outset, I want to express my gratitude to the members of this Committee and to the other officials at Federal, State, and local levels who have worked so tirelessly to address the economic challenges facing our Nation.

Speaking just as a citizen, I am heartened by the leadership that has been exhibited and am confident that, when honest policy debates are combined with a collaborative spirit, constructive solutions can emerge.

In the last 7 months, however, a dizzying array of legislative and regulatory initiatives has been adopted that represents a staggering level of Federal intervention in our economy and a dramatic shift in many longstanding government policies.

From my perspective as a lawyer advising market participants, I can say that much in these programs is still being digested and, in some cases, deciphered. Yet, what has become clear is that each one is rippling through the financial markets and the broader economy and is influencing the behavior of both businesses and consumers in ways that no doubt were intended and in other ways that may have been unforeseen.

This butterfly effect, in my view, should not be overlooked or underestimated as changes in the bankruptcy laws are considered and, in the current environment, counsels in favor of especially careful deliberation.

Among the most pressing issues that I continue to perceive in the capital markets, as a lawyer, is uncertainty in pricing risk. Before the present credit and liquidity crises, this process was facilitated by credit rating agencies independently assessing the probability of default on a security and assigning a corresponding rating.

In the last year, however, questions have been raised about the degree of comfort that can be taken from such a rating, and the resulting uncertainty has sparked a flight of capital, especially among investors who relied heavily on credit ratings in making judgments on pricing risk. This has resulted in liquidity becoming increasingly scarce and market volatility skyrocketing, which in turn have fueled a vicious cycle in which the overall tolerance for uncertainty has declined sharply.

From the standpoint of the capital markets, therefore, the time would seem ripe for policies that are designed to provide greater clarity and stability on issues that factor into investment decisions and associated risk assessments.

A prominent example is the impact of bankruptcy and other insolvency laws on the rights of creditors. An inordinate degree of uncertainty attends the application of these laws generally, not only because they have a more debtor-friendly orientation than their counterparts in other countries, but also because they are administered by courts that continue to claim broad powers in equity.

This lack of predictability can generate material risk premiums for liquidity from the capital markets, which ultimately must be passed through to borrowers in the form of higher interest rates or other charges if credit can be extended at all.

In the same vein, this would seem an inopportune time to propose initiatives that could increase uncertainty among investors in pricing the risks associated with capital-markets transactions. This includes, I fear, any legislation authorizing bankruptcy courts to strip down or otherwise modify the principal and interest that are due on a loan secured by a debtor's principal residence.

The prohibition against such forced modifications in bankruptcy is three decades old and, contrary to arguments that have been advanced by some scholars, has little to do with the kinds of mortgage loan products that were offered when the Bankruptcy Code of 1978 was enacted. Rather, its purpose always has been to foster a liquid and efficient mortgage finance market, which I think we all agree is needed now more than ever before.

I wholeheartedly agree that the rising tide of foreclosures must be stemmed in order to stabilize the housing market, and even more to alleviate the increasingly unsustainable burdens on families across the country.

But with all due respect, I am equally convinced that a change to the bankruptcy laws is not the answer. Instead, with Fannie Mae and Freddie Mac in conservatorship and with promising new financial products like covered bonds on the horizon, I respectfully recommend that the Congress consider a more holistic approach to reinvigorating our system of mortgage finance and that, as a part of that framework, a comprehensive protocol for voluntary loan modifications be established that especially includes meaningful incentives to participate.

I would be pleased to answer any questions that the Committee may have. Thank you.

Senator DURBIN. Well, thank you very much, Mr. Stengel.

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

Senator DURBIN. Our next witness is Professor Christopher Mayer. He's the Senior Vice Dean and Professor at Columbia Business School. Previously, he held positions at the Wharton School, the University of Michigan, and the Federal Reserve Bank of Boston. He has a B.A. from the University of Rochester and a Ph.D. in Economics from MIT.

Thanks for joining us. Please proceed.

STATEMENT OF DR. CHRISTOPHER J. MAYER, SENIOR VICE DEAN AND PAUL MILSTEIN PROFESSOR OF REAL ESTATE, GRADUATE SCHOOL OF BUSINESS, COLUMBIA UNIVERSITY, NEW YORK, NY

Professor MAYER. Thank you very much, Senator Durbin. Good morning to the Committee. Thank you for inviting me to speak today.

I have spent the last 16 years studying housing and credit markets, including working at the Federal Reserve Bank of Boston, and so I appreciate the opportunity to speak to the Committee.

Preventing foreclosures is a crucial goal because of the pain associated with residents losing a home and the negative impacts on local communities and governments. However, it is essential to consider the broader context of the housing and foreclosure crisis. Reducing foreclosures through allowing judicial strip-downs comes with many risks, including reductions in future credit availability, as well as the possibility of many millions of additional bankruptcy filings and of substantially slowing down the recovery of housing and mortgage markets.

These negative consequences would impact nearly all Americans, not just those facing foreclosures. Instead, policymakers should focus on restoring reasonable credit through the mortgage market, a policy that could substantially reduce foreclosures by reducing the rate of house price declines, as well as benefiting tens of millions of homeowners and potential homeowners.

I begin by providing a different interpretation of existing research than that that will be presented by Professor Levitin. Evidence from existing studies strongly suggest strip-downs or delays in foreclosures reduce the amount of available mortgage borrowing and may also increase mortgage rates. This is just common sense. Lenders facing the possibility that borrowers can walk away from their payments without the threat of losing their home will charge more money for a mortgage or require higher down payments.

A second issue with the current legislation is that it provides disincentive to borrowers to negotiate under most existing private and FDIC-sponsored loan modification programs, likely delaying the resolution of the housing crisis. Chairwoman Bair has stated that the recently announced FDIC program to modify IndyMac mortgages provides a benchmark for other private lenders to roll out large-scale programs to quickly modify millions of loans, and other banks have followed.

Yet, by allowing borrowers to file for bankruptcy and get a permanent strip-down as an alternative to accepting loan modification with forbearance, this bill would make loan modifications under these current plans dead on arrival for most of the borrowers. Evidence from Japan shows that long delays in resolution can harm economic growth for years, keeping credit markets frozen and leading to further losses for banks, which unfortunately fall back in the hands of taxpayers.

One of the largest tragedies of the current subprime crisis is the fact that some borrowers were misled into getting mortgages they did not understand and would eventually not be able to afford, yet the existing legislation includes all subprime loans, or maybe a larger group of loans, both easily understood fixed-rate mortgages, as well as much more toxic 228s and option ARMs.

Allowing fixed-rate borrowers with simple mortgages to strip down their balance is unfair to the many other borrowers who took on mortgages and bought houses they could better afford. Applying strip-downs only to higher rate mortgages also sends a strong message to lenders that they should be wary of lending to risky borrowers in the future, setting back much of the progress in the last decade of providing credit to risky borrowers.

Along with Professor Glen Hubbard, I have put forth an alternative proposal to fix the mortgage market. The Hubbard-Mayer proposal would put a floor on house price declines, clean up household balance sheets, and prevent foreclosures by refinancing millions of homeowners into stable 30-year fixed-rate mortgages.

We believe the appropriate course for policy is to reestablish normal lending terms for housing finance and, given that the government is originating more than 9 in 10 mortgages through Fannie Mae, Freddie Mac, and the FHA, the government is in a prime position to do this. The appropriate mortgage rate today would be about 5.25 percent.

A second part of our plan is to create a modern equivalent of the Homeowner Loan Corporation to help homeowners with negative equity refinance into a stable 30-year fixed-rate mortgage with a 95 percent loan-to-value ratio. Lenders and taxpayers would split the losses on refinancing the mortgages with the new agency, and in return the Homeowner Loan Corporation would take an equity in the property so that taxpayers would be protected.

The fiscal effect of this program is substantial. Lower mortgage rates provide a stimulus of $118 billion per year in lower mortgage payments and is a middle class program that would benefit almost 20 million homeowners, allowing them to reduce their mortgage payments by $350 a month.

The current mortgage melt-down and housing crisis has had significant repercussions for the economy and our financial system. Rather than using the bankruptcy courts, which might take years and lead to higher lending costs in the future, policymakers should focus on cleaning up the mortgage market. In the process, taxpayers would protect the nearly $6 trillion in mortgages and mortgage guarantees that now sit on the Federal balance sheet. Without appropriate and prompt action, the problems in the housing market will just get worse, with serious consequences for all Americans.

Thank you very much.

Senator DURBIN. Thanks for your testimony.

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

Senator DURBIN. Our final witness is Adam Levitin, Associate Professor of Law at the highly regarded Georgetown University Law Center. Professor Levitin specializes in bankruptcy and commercial law. He directs the Georgetown Hebrew University in Jerusalem, and the Business and Commercial Law program. Previously, Professor Levitin practiced in the Business, Finance, and Restructuring Department of the law firm of Weil, Gotshal & Manges.

Professor Levitin holds an undergraduate degree from Harvard, two master's degrees from Columbia, and a law degree from Harvard Law School. He served as a law clerk to Judge Jane Roth on the Third Circuit.

Thanks for being here. We welcome your testimony.

STATEMENT OF PROFESSOR ADAM J. LEVITIN, GEORGETOWN UNIVERSITY LAW CENTER, WASHINGTON, DC

Professor LEVITIN. Senator Durbin, Mr. Chairman, members of the Committee, good morning. My name is Adam Levitin and, as you noted, I'm an Associate Professor of Law at Georgetown University Law Center.

I wish to make two points this morning. First, permitting bankruptcy modification in mortgages will have only a minimal impact on mortgage credit. Second, bankruptcy modification is the only method for dealing with the obstacles to loan modification created by securitization.

Bankruptcy modification will only have a de minimis impact on mortgage credit. Mortgage costs will not go up and mortgage credit availability will not be reduced, except at the very margins. For the average borrower, there will likely be no, or almost no, impact.

This is because lenders typically lose less in bankruptcy modification than in foreclosure. Indeed, by definition, the Bankruptcy Code guarantees a mortgage creditor at least as much of a recovery as in foreclosure, namely, the value of the property.

I've conducted the only research that examines the foreclosure modification tradeoff for lenders. Currently, foreclosure losses for lenders are running at around 55 percent of loan principal. Cramdown, even in lenders' worst-case scenarios, like Riverside and San Bernadino, California, would only result in an average 23 percent loss of loan principal.

As foreclosure losses are greater than bankruptcy modification losses, lenders will not price against bankruptcy modification. The Mortgage Bankers Association, however, has been touting a bogus claim that bankruptcy modification will result in a 150 basis point across-the-board increase in mortgage interest rates.

Let me be very clear. The Mortgage Bankers Association's 150 basis point number is false. It is grossly irresponsible and it is disprovable. It is the result of a cherry-picked comparison between interest rates on investor property mortgages, which can be currently modified in bankruptcy, and single-family mortgages, which cannot be.

The Mortgage Bankers Association claims that the entire rate spread between these mortgage types is due to the different in bankruptcy modification risk. Not only does this ignore the milieuxed other risks that attend investor property mortgages, like whether the investor can find a tenant or whether that tenant will pay the rent, but is also cherry-picked.

An honest approach would note that there is no difference on interest rates on private mortgage insurance rates or on GSE delivery fees between single-family mortgages, which cannot be modified currently in bankruptcy, and two-family mortgages, which can already be modified. These mortgages have different risk exposures to bankruptcy, but no price difference. This strongly suggests that the market does not price against bankruptcy modification.

So if modification is such a better outcome than foreclosure for lenders, why aren't we seeing more voluntary modifications? The answer lies with securitizing and the contractual and incentive problems it creates. Securitization separates beneficial ownership of mortgage loans from the servicing of loans. This creates several problems for loan modifications, two of which I will touch on now.

First, the servicers contracts, in almost 40 percent of securitization deals, limit their ability to perform modifications. Servicers are often banned from writing down principal, from reducing interest rates, from changing amortization, or they are limited in the number of loans they can modify.

As Senator Schumer noted, these contractual obligations can only be removed with the 100 percent unanimous consent of the mortgage-backed security holders. That will be difficult, if not impossible, to get in many cases. The contractual obstacles to efficient loan modifications created by securitization cannot be circumvented in any way except bankruptcy.

Securitization also creates economic incentives for foreclosure. If we want to understand why we are seeing such dismal voluntary efforts at loan modification, we have to take the advice of Deep Throat and "follow the money". That trail leads to mortgage servicers, like many of the members of the Mortgage Bankers Association. Servicers are supposed to manage securitized loans in the interest of mortgage-backed security holders, yet servicers' compensation creates an incentive for servicers to foreclose, even if modification is in the interest of investors.

When servicers modify a loan, they received fixed-rate compensation. But in foreclosure, the servicer is compensated off the top of foreclosure sale proceeds on a cost-plus basis. There is no one monitoring the cost and there is no one monitoring the plus.

This compensation structure creates a powerful economic incentive for servicers to foreclosure, regardless of the impact on investors, on homeowners, and on communities. Bankruptcy modification would shut down this gravy train and will move the economic incentive for servicers to foreclose.

Bankruptcy modification would hurt servicers' bottom line, and that is why servicer trade organizations like the Mortgage Bankers Association have been fighting so hard against it, even as mortgage-backed security holders have been largely silent.

I will note that there is no one on this panel who speaks for mortgage-backed security holders. Bankruptcy modification is the only method for dealing with the contractual and incentive problems to loan modification created by securitization. Unless those problems are addressed, we will not be able to abate the flood of foreclosures. I strongly urge Congress to pass the Helping Families Save their Homes in Bankruptcy Act.

Thank you. I look forward to your questions.

Senator DURBIN. Well, thank you for your testimony.

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

Senator DURBIN. I welcome to the Committee hearing today not only Senator Whitehouse, but also the Chairman of the Committee, Senator Leahy.

Before we ask questions, Senator Leahy, would you like to make an opening statement?

STATEMENT OF HON. PATRICK J. LEAHY, CHAIRMAN, COMMITTEE ON THE JUDICIARY, A U.S. SENATOR FROM THE STATE OF VERMONT

Chairman LEAHY. I would. Thank you very much. I apologize for coming in and leaving. I think this is an extraordinarily important issue. Senator Durbin and I had talked about this a number of times when we were out of session. He has been a leader in this area, and urged that we have the hearing. Senator Durbin, I thank you for holding this. I couldn't help but notice, on one side of the table you have a professor from our alma mater, the Georgetown University Law Center.

And then Sheriff Dart, Cook County sheriff. I must say, I've watched you on television and heard some of your statements on eviction. I applaud you, as the people in Vermont did, too. I thought you showed not only a sensitivity, but a sensible attitude. I applaud you and your department.

Everyone knows that home ownership is a fundamental part of the American dream. The housing crisis has contributed enormously to the economic downturn. Home ownership is a primary source of financial well-being, and the most valuable investment most Americans are going to make. Home ownership helps Americans find security, community, stability, and pride. Those are values that Federal policy should preserve.

In 2003, President Bush made increased home ownership a central part of his domestic policy. He said, "This administration will constantly strive to promote an ownership society in America. We want more people in their own homes. It is our national interest..." and so on.

Five years later, as thousands of American families have been evicted from their homes, the administration has sided with banks, not ordinary Americans, through their opposition to our efforts to provide authority to bankruptcy judges to adjust the terms of mortgages on primary residences.

Sheila Bair, the chair of the Federal Deposit Insurance Corporation, has proposed a relief program that provides significant incentives for lenders to modify the interest rates for borrowers. She has proposed to use a portion of the funds that we have already authorized in the bail-out package to assist homeowners and protect lenders, which would complement additional authority in the bankruptcy courts. Unfortunately, Secretary Paulson and the administration have not embraced this proposal. They have continued to insist our funds be used only to help banks.

In December 2007, the Committee held a hearing on the Helping Families Save their Homes in Bankruptcy Act of 2008, S. 2136. A number of witnesses endorsed the measure. Economist Mark Zandy estimated that such authority could keep 600,000 people in their homes. It was far from a bail-out. It was a mechanism to help the economy.

Homeowners who gained relief from bankruptcy court would continue to pay each month toward the satisfaction of the debt. You halt mortgage defaults; it is a critical component of our economy recovery.

In March and April, this Committee considered, and voted to report, Senator Durbin's legislation to authorize bankruptcy courts to modify primary home mortgages. The bill was reported in July and the Committee report was filed in September. The proposal has been blocked. In a few weeks, the Obama administration is going to have to look at something similar. Banks, critical of providing this authority to bankruptcy courts, claim that doing so will cause interest rates to rise, and will make mortgages harder to obtain.

What has caused the difficulty in obtaining mortgages is the unprecedented credit crisis, as seen in the enactment of a $700 billion rescue plan. The credit crisis did not stem from bankruptcies, but from far more fundamental and serious concerns about practices of the financial institutions themselves.

Now, Senator Durbin, I recently received a letter from the National Conference of Bankruptcy Judges. They expressed confidence that the bankruptcy courts are well-equipped to handle this authority that you have been proposing, and that the existence of such authority may spur parties to come to agreement without judicial intervention. There has been too little meaningful progress in the private sector to modify home mortgages, and we already give bankruptcy courts the authority to modify mortgages on family farms and second homes.

Now, there is no reason not to do so, especially when so many Americans are struggling. I am confident that the men and women who serve as bankruptcy judges will exercise that authority very carefully. The bottom line is, American families need relief. With all that we have done to provide relief to the country's biggest banks and financial institutions, I think Americans are right to ask Congress: what are you going to do for ordinary, hardworking people, whether they're in Illinois, Rhode Island, Vermont, or Pennsylvania, where Senator Specter is from.

We all agree, you cannot simply solve an economic crisis by having an unprecedented number of foreclosures and people out in the streets. That is not helping anybody, and it's certainly not doing anything to stabilize the price of homes. It is something that creates a severe crisis in communities. There are some parts of this country where whole communities have been literally devastated and they have lost their community identity because of this.

There have been instances of speculation that should not have occurred, but there are a lot of hardworking men and women who had a home, a roof over their head for themselves and their children, and something should be done to help them.

So, Senator Durbin, I thank you for doing this. I thank Senator Whitehouse, who has worked so hard on this, and others. Senator Specter is here. I just hope we can come to a conclusion before we see a lot more bankruptcies.

Sheriff, thank you.

Senator DURBIN. Thank you, Chairman Leahy.

We will now go to questions. I'd like to start, first. Sheriff Dart, it's only been a few weeks since you announced that you weren't going to enforce eviction orders. What has been the impact? Have you seen any measurable change?

Sheriff DART. No, we have not seen any change. We sat down with the judiciary in our area to try to work out some new parameters to try to assure that things were going to be handled appropriately. There is hope that there will be some change in the future, but since this agreement about a month ago we have had 110 evictions to do and I've called off 107 of them. We've gone out there and it's not what it's supposed to be.

Senator DURBIN. Weren't you running into situations where renters were dutifully making their monthly payments?

Sheriff DART. Senator, the stories we have are just mind-boggling. That's the point about your legislation. It's so important. I've read through it. It makes such sense, and the urgency of this is there. I've walked into these homes time after time, looking at stunned people who have no idea why I am there.

I walked into a family in Englewood: a mother, father, a 16-year-old, a 5-year-old, and two 9-month-old twins. He's standing there showing me his lease agreement he had signed with the mortgage holder. The lease agreement was signed after the foreclosure had already been done, and they were still doing these things. He is wondering what he's going to do. In the old procedures, frankly, before I stopped them, he and his family would have been out on the street.

We have had constant—to have a person come and say, Sheriff, is there some way we can work this out, we want to pay, we want to work something out—they have nowhere to go. I just can't emphasize enough to you, it sounds so antiseptic until you go out there and you see these people. There's nothing nice about evictions, I think we all agree with that. But until you actually are out there and you see every piece of furniture, every item that someone owns, it's heartbreaking. And children, more often than not, are involved.

What little they own is taken out to the street, and in most of the areas where we work, most of those things are stolen between the time we put them out and the time they're able to get transportation to move these things. So this is something you can't have here. You have to have precision, A. But B, you also have to have options, which are clearly not out there right now. This is just absolute chaos. It's clear, the banks and the industry, they don't even know where they're sending us out to.

We went out to do an eviction a couple of months ago. It had been an eviction—a foreclosure eviction, had been in the system for a while. We go out there, there's no house there! The house is gone. It's a vacant lot. The house had burned down 2 years prior, but no one from the bank, the mortgage holder, had even cared to go out there.

It's similar to what Senator Schumer was talking about, how there's so many people with pieces of this. Nobody knows who has what anymore. It's a piece of paper, but there's real families involved. I just can't emphasize enough to you, Senator, it is absolute chaos out there.

Senator DURBIN. Mr. Kittle, you've got a tough assignment here because, with the upcoming Christmas season, you're taking on the role of Scrooge in this, basically saying, tough luck, foreclosure happens and that's the way it's got to be. If mortgage bankers don't want to renegotiate, so be it; you signed the mortgage.

I listened to Professor Levitin, and I think he opened my eyes to something I'd never heard, and I'd like to hear you respond to. We used to have a Senate president in Illinois that Tom remembers named Cecil Partee, and he used to say, "In politics, for every issue there's a good reason and a real reason." We've heard a lot of good reasons why the mortgage bankers don't want to see the bankruptcy court rewrite the terms of the mortgage to keep people in their homes: oh, there's this moral hazard thing, which has diminished in credence since we decided to give $700 billion to banks with rotten portfolios.

But now comes Professor Levitin who says, guess what? Follow the money. The mortgage bankers don't make as much money when you have a modification. They make their money in foreclosure on a cost-plus basis. So if you want the real reason why they're resisting this, it's because they're about to lose money if there's a modification. How would you respond?

Mr. KITTLE. Well, thank you again for having me here today, Senator. I am not Scrooge, and neither is my association or my members. I would say, first of all, in response to that, that this legislation, in my oral testimony, seven—almost seven—67 percent, two-thirds of everybody that goes to the bankruptcy court will fail. So the real Scrooge in this is the legislation, in that they will lose their house anyway, their credit will be destroyed for 5 to 7 to 10 years. They can't get an apartment, they can't get a house, a car.

Senator DURBIN. Could you address his point?

Mr. KITTLE. I'm about to. I'm about to. Mr. Levitin's information is inaccurate, flawed, and misleading. He went online with his information and used online quote generators to derive his paper, a paper that, even on his web site, he says is a work in progress. It hasn't even been vetted by his peers. He doesn't factor in people's salary or their debt-to-income in his statistics. We lose—

Senator DURBIN. Is it true that it's a cost-plus situation in foreclosure?

Mr. KITTLE. We lose—the point that he made and that you just asked me, that we make more money on a foreclosure than helping somebody, what he failed to mention is that we lose the VA guarantee, the FHA insurance, and the private mortgage insurance either gets reduced or eliminated when this happens. That wasn't factored into this. He admits that lenders would require, in his paper—buried, but he admits it—that we will require, going forward, higher loan-to-value loans. That is an interest rate increase calculated into our 150 basis points.

Senator DURBIN. I want to give him a chance to respond. Professor Levitin?

Professor LEVITIN. First of all, it seems Mr. Kittle has not read the most recent version of my paper. It sounds like he's working off of a working version that goes back to February. So if he were to look at the most recent version that is publicly available on the Internet, all the citations can be checked, and has gone through several rounds of peer conferences, first, what he would see is that the paper he's responded—that he's talking about does not actually address the servicer incentive issue. He's talking about a different paper.

Second, what I would like to point out is, in his comments, in his response to you, he didn't actually address the question of how servicers are compensated. When servicers get cost-plus compensation in foreclosure, they are entitled under the mortgage contract to get the cost of the foreclosure. There's no one monitoring the costs. The only time these costs get any scrutiny is when there is a bankruptcy filing.

The results then have been shocking. Professor Katherine Porter at the University of Iowa has a paper that goes through and details this in amazing detail. You see stories like Wells Fargo levying a $250 collateral inspection fee on an underwater property in Louisiana. This property was not financially under water, it was physically under water. Wells Fargo did not send out a scuba team to inspect the house. It was in flooded Jefferson Parish, Louisiana. This is not a one-off incident.

There is a distinct pattern of illegal fees in foreclosures being driven by this cost-plus economic model, and bankruptcy is the only way to cut that off. Bankruptcy is the only way to scrutinize the cost of foreclosure, it's the only way to change the incentive structure.

I would also add, regarding the two-thirds of Chapter 13 plans failing, that number does not account for the fact that homeowners are unable to deal with their largest single debt in Chapter 13 right now, with mortgages. If you make mortgages modifiable in Chapter 13, that two-thirds number is going to look very different.

So arguing that we're going to see two-thirds of bankruptcy plans fail, just—it's a meaningless number because it's not accounting for the impact of this legislation.

Senator DURBIN. Thank you.

The order of questions. If Senator Specter returns, he would be first. But since he's not here: Senator Feingold, Senators Leahy, Schumer, and Whitehouse.

Senator Feingold?

Senator FEINGOLD. Thank you, Mr. Chairman, for holding the hearing, but more importantly, for your tremendous leadership on this issue. I want to start by noting that you are the one who sounded the alarm on this problem almost a year ago. Your hearing in December 2007 was entitled "The Looming Foreclosure Crisis." As we have seen this severe economic downturn take shape over the past few months, a significant cause of which has been the huge numbers of foreclosures on subprime mortgages, you would have every right to say, "I told you so."

You tried to reduce the number of foreclosures, which might have had an effect on falling real estate prices. You tried to protect more Americans from losing their homes. But the lending industry said absolutely not to letting these bad mortgages be modified in a bankruptcy proceeding, and the Nation is now reaping what that self-centered and short-sided position has sown.

Even as late as October when the bail-out package was being considered, this one simple and eminently reasonable change in the law, which is perhaps the only proposal out there that is guaranteed to have a significant impact on the number of foreclosures, was somehow taken off the table. No, we were told, that would be going too far. No, it was said the banking industry simply would not stand for that change. From what we have heard today, it still won't.

What was the result? The voluntary loan modifications effort to date have completely failed to slow the rising number of homes going into foreclosure. Just last month, foreclosures increased in our State in Milwaukee County by 41 percent compared to the previous month, and foreclosure rates across Wisconsin have increased by over 20 percent compared to last year. About a million home loans nationwide had gone into foreclosure at the end of 2007. By the end of this year, 2 million more may meet the same fate.

One estimate is that over 10 percent of all residential borrowers could be in foreclosure by 2012. These are obviously frightening numbers. There simply is no more time to waste. The next Congress must act very quickly to take your advice, Mr. Chairman. The ripple effects of rising foreclosures are enormous. Foreclosures lead to falling real estate prices, which lead to more foreclosures. Local businesses are deeply affected as well, and empty houses lead to crime and greater costs for social services offered by local governments.

I want to make one other point and then ask a couple of questions. One thing that I think is not well understood is that because of the complex structure of these securitized mortgages that are at the root of the financial calamity the Nation finds itself in, voluntary programs to readjust mortgages may simply be doomed to failure. The securities themselves in many cases prohibit reducing the principal owed or otherwise changing the terms of the mortgage, so it's not just a matter of a single lender deciding to take a little bit of loss to save a homeowner from foreclosure. Many of these mortgages have long since been sliced and diced, and sold and re-sold. Senator Schumer, I understand, alluded to this problem earlier.

So a voluntary program won't help. It just won't do it. Only a bankruptcy court has the power, if Congress would only grant it, to rewrite these mortgages to prevent them from losing even more value.

So again, of course, I thank you, Mr. Chairman, for sticking with this issue. I offer you my full support, with the hope that we can finally prevail early next year.

Now, Sheriff Dart, let me ask you, first, about the need to extend some assistance in this crisis to renters, since your temporary suspension of evictions in Cook County has generated a lot of interest nationwide.

Providing safe and affordable rental housing is a key component of our Federal housing policy. I have introduced legislation that would significantly boost affordable rental housing problems. The renters who pay their rent on time every month may not know that the owner of their property is actually delinquent in payments and may be facing foreclosure.

Certain States, including my State of Wisconsin, do not have protections in place for these folks who face eviction through no fault of their own. To help this issue, Senator Kerry from Massachusetts has introduced legislation requiring that renters who live in a foreclosed property be given at least 90 days' notice before being evicted, and granting the right to stay in rental units, within certain limitations.

Could you comment on how this proposed legislation would assist your efforts in Cook County, and are there other solutions that Congress should undertake to better protect renters?

Sheriff DART. Yes, Senator. It's a fantastic question. The stories I have are amazing. I go out on a lot of our evictions myself. To see the people—I mean, I can't put a fine enough point on this—completely stunned. They have no idea why we're at the door. Traditionally, until I made some of the changes—the tradition was, if nobody was at the residence we would use whatever means necessary to enter the house, remove the property, put it out, and off we'd go to our next one. These are people who had paid all their rent, had paid everything. They are off at work, their children are at school, and they're coming home to find everything they own out on the street. There's humiliation, obviously, but in addition to that, most of their stuff is stolen while it's out there.

I have more cases I can name. That's why we started adjusting it. But what we started doing, frankly, was an ad hoc process, Senator, that we were doing, some legal authority we were looking for. But there was not any type of systematic way of trying to address this. And we had a statute that went into effect in Illinois just this past year that was to allow renters a 120-day window when a foreclosure would go through so that they could get their things together.

The problem was, once again—and I had mentioned this earlier, and you just alluded to it, too, Senator—because there is such complete and absolute chaos out on the streets right now in this area, with nobody knowing who holds what, who owns what, the banks and mortgage industries have no idea what they're holding anymore. There's no way to know who gets the 120 days. There's no way to be assured that the people have been given notice that they have that available to them. It's just, if we get lucky when we go out to the eviction and we happen to get the homeowner there and are able to tell them this, then maybe they can get that 120 days.

Our budgets are so limited at this date. I've hired a social worker now who goes out with our eviction teams, to go out and try to talk with these people. I have an attorney now I brought on who specifically is on the phone to talk to these people, because we're trying to guide them on what to do because they are completely stunned.

Senator, I mentioned a couple different stories. I had one renter—and this is not unusual. I had one renter. We went out there to do the eviction. Once again, completely stunned. He's there with his wife, four children. Two of them are 9-month-old twins. Normally, before I stopped things, he would have been out on the street. He shows me a document, which is a lease, a lease that was signed with him and the owner of the property, after the foreclosure had already occurred. This guy is out leasing the property. We just stopped it.

You know, people questioned our legal authority to do some of this stuff. But the renters right now, Senator, you're definitely on to something. As far as a group of people who are being victimized left and right every single day, it is truly the case. We have modest things we're doing now, but it's really bad.

Senator FEINGOLD. Thank you, Sheriff. Are you comfortable then with the Kerry legislation? Is that something you're familiar with?

Sheriff DART. I'm somewhat familiar with it. I know it would go a long way to helping.

Senator FEINGOLD. Could we send you a question and have you answer it in writing afterward?

Sheriff DART. Yeah, I'd be happy to.

[The question and answer appear as a submission for the record.]

Senator FEINGOLD. The Chairman has allowed me one more question, and I really do appreciate it. I thank Senator Whitehouse.

Each of you, Mr. Calhoun, Mr. Levitin, mentioned in your written testimony the issue I mentioned in my statement concerning contractual road blocks and the voluntary restructuring of many of these loans. Yet, you believe that a major positive effect of giving bankruptcy courts the power to modify the loans would be to encourage more voluntary modifications.

How big of a problem do you think these contractual issues will pose for that prediction, and do we have any idea of how many of these mortgages simply cannot be modified except by a court? Mr. Calhoun?

Mr. CALHOUN. We believe that the biggest impact of this legislation will be an increase in voluntary modifications. First off, if I can go back to just this point about the misincentives that are in the market today, about the servicer misaligned incentives, you don't have to just argue about it. Market participants have recognized this. For example, Fannie Mae and Freddie Mac found that, because of these misaligned incentives for servicers, that servicers were pushing people into foreclosure when it led to a greater loss for Fannie and Freddie.

So they adopted a policy of providing additional cash payments to servicers if they would explore other options other than foreclosures. Unfortunately, the private trusts that control 75 percent or more of the mortgages don't have that option. They don't have the authority to make those cash payments.

Sheila Bair made the same—reached the same conclusion. Her plan includes payments—I think it's up to $1,000—to servicers to engage in modifications, recognizing, unless you change that current incentive structure, that the modifications won't happen.

Senator FEINGOLD. Thank you. I'm going to just ask for a quick response from the Professor, because I'm already well over my time.

Professor LEVITIN. To answer the statistical question you had, how many of these securitization deals or modifications contractually—we don't have a great sense of that. There is a study by Credit Suisse that looks at a very small sample of deals, about 31 deals, and it finds that in almost 40 percent of those modifications, they are in some way restricted. That number is actually under—that 40 percent, though, is actually probably too low because Credit Suisse was not looking at all possible modification limitations.

So we don't know exactly, but there's a lot of deals out there where there are contractual obstacles to modification. That's going to be a real problem, even with incentive payments to servicers, or some sort of bounty.

Senator FEINGOLD. Thank you, Professor. Thank you, Mr. Chairman. Thank you, Senator Whitehouse.

Mr. CALHOUN. Mr. Chair, if I may add, this is just an example of where the system was created with these built-in obstacles. This ban against modifications was put in, in large part, because servicers typically have to advance delinquent principal and interest when a loan falls behind. So servicers were kind of gaming that system and avoiding having to advance those payments by engaging in modifications: just modify the loan, then it's current, you don't have to advance it.

So in response, the drafters of these pooling and service agreements put in these anti-modification programs to address that. But it shows once again just how many technical obstacles and structural obstacles there are in a just voluntary program.

Mr. KITTLE. Mr. Chairman, may I respond to that, please?

Senator DURBIN. Senator Whitehouse, do you want to ask or should I allow Mr. Kittle?

Senator WHITEHOUSE. If he'll be brief. We are in my time at this point.

Mr. KITTLE. Just to say that we look forward to working with Sheila Bair at the FDIC on her proposal. We think it has merit. It's another tool in the toolbox to say that we don't need the foreclosure. But to get to the strips, Senator Schumer said that none of these were being modified, and that's inaccurate. There are some in the strips and tranches being modified. We would like to see more, but to blanketly state that all the strips and tranches are having no modifications is inaccurate. It is happening on a limited basis. Thank you.

Senator DURBIN. Senator Whitehouse, thank you for your patience.

Senator WHITEHOUSE. On how limited a basis?

Mr. KITTLE. I'm sorry?

Senator WHITEHOUSE. On how limited a basis, Mr. Kittle?

Mr. KITTLE. I can get you that information. I'm happy to. I can't give you a percentage today, but I'll be happy to get it for you.

Senator WHITEHOUSE. I would appreciate it, yes.

Mr. KITTLE. All right. You'll have it.

[The information appears as a submission for the record.]

Senator WHITEHOUSE. Is it Professor Mayer, Dean Mayer, Mr. Mayer?

Professor MAYER. Professor.

Senator WHITEHOUSE. Professor Mayer, when the prohibition on primary residence mortgage modification was put into the Bankruptcy Code, I think in 1978, what then was the status of the mortgage securitization industry?

Professor MAYER. There was very little securitization at that point.

Senator WHITEHOUSE. Almost none, in fact. Correct?

Professor MAYER. Yes.

Senator WHITEHOUSE. So this has been a significant new development since that original piece of legislation, the mortgage securitization process. Correct?

Professor MAYER. Yes.

Senator WHITEHOUSE. And that mortgage securitization process has significantly influenced the ability of a homeowner to renegotiate their mortgage, has it not?

Professor MAYER. It really depends on the securitization. Fannie Mae and Freddie Mac securitize their portfolios. They represent, by far—people have been talking about 80, 90 percent of mortgages outstanding being securitized. There's nothing inherent in the securitization process that would limit that. In fact, the initial growth, and by far the biggest part of that, really is Fannie and Freddie securities.

Senator WHITEHOUSE. Then why are we seeing so many—here's what I see in Rhode Island. The community banks that hold the mortgages say they have no foreclosure problem and that the foreclosure problem is almost entirely with the securitized mortgages. So, there's one piece that I see from my home State.

Secondarily, I don't know who you go to renegotiate. You heard the Sheriff, who does this, say his people, they don't know who to talk to.

Professor MAYER. Right.

Senator WHITEHOUSE. Then you've got a mortgage servicer who's got behind him a whole string. This thing could have been sliced and diced into 20 strips. They've gone to the four winds. You don't know who's out there. All of those investors have a potential claim against the bank. Why is that not a disincentive for the bank to renegotiate? That puts them in a more difficult position with respect to renegotiation than the community bank that holds the mortgage. Are you telling me they're in the same position?

Professor MAYER. No.

Senator WHITEHOUSE. They're in a more difficult position—

Professor MAYER. Yes.

Senator WHITEHOUSE [continuing.]—With respect to renegotiating.

Professor MAYER. Absolutely.

Senator WHITEHOUSE. Absolutely.

Professor MAYER. I would—I would make one other comment on this, which is, it's useful to look at what banks are doing with their own portfolio mortgages where they don't have those restrictions. So a number of the banks have put out programs and basically the bulk of those programs rely on forbearance as opposed to stripping down the mortgage. The difference between forbearance and stripping down the mortgage is, under forbearance, some portion of the principal remains tied to the property but you're not paying interest on that portion.

So, in other words, you're writing down the payments but you're not so-called stripping down, or cramming down, the mortgage balance. That is a big distinction in the way the Bankruptcy Code—the way the bill is currently being crafted versus how banks are dealing with their own loans on their own portfolios where there are no restrictions on what they're doing. The place where the banks have been doing—

Senator WHITEHOUSE. The difference is that those homeowners stay in their homes. Correct?

Professor MAYER. Yes.

Senator WHITEHOUSE. Yeah. That's a pretty significant difference, isn't it?

Professor MAYER. But it does suggest that a program that completely strips off the balance goes much further than protecting the lender and actually goes to the point of imposing losses on the lenders, where the lenders now are choosing a different approach. And, in fact, Sheila Bair has specifically, in the FDIC IndyMac program, also relies on forbearance, not strip-downs. So that's a very appreciable distinction.

Senator WHITEHOUSE. But is there not also an appreciable distinction between being Sheila Bair and being the FDIC and having the power of the Federal Government behind you, and being in possession of a bank or in control of a bank that has entered your jurisdiction, I believe, for insolvency reasons than it is to be a private banker, looking over your shoulder at potential liability to all those owners of all those strips?

Professor MAYER. Oh, I completely—my point in bringing up what banks are doing on their own portfolio is kind of understanding that this bill goes much further than even what Sheila Bair is proposing with the view of trying to protect the FDIC shareholders. She very much believes in doing—in obviously doing things to reduce foreclosures and helping out investors.

Senator WHITEHOUSE. Correct. But it doesn't go further than the Bankruptcy Code goes, say, for second home mortgages, does it?

Professor MAYER. That's—but again, the distinction is—

Senator WHITEHOUSE. I asked a question. Is there an answer to it?

Professor MAYER. Huh?

Senator WHITEHOUSE. I think I'm entitled to an answer to my question. It doesn't go further than the Bankruptcy Code goes with respect to second home mortgages.

Professor MAYER. That's correct.

Senator WHITEHOUSE. Correct. And it doesn't go further than the Bankruptcy Code with respect to commercial debt, correct?

Professor MAYER. Both of which are more expensive.

Senator WHITEHOUSE. So if the Mortgage Bankers Association were to go into bankruptcy tomorrow, they would enjoy precisely the benefit that they are trying to deny American homeowners as they argue here today. Is that not correct?

Professor MAYER. I'm not defending the Mortgage Bankers Association. I don't agree with them on many of the things they're talking about, so I have no stake in that—in that—in that view.

Senator WHITEHOUSE. All right. Well, I thank you.

I thank the Chairman.

Senator DURBIN. I want to get back to this question about just what kind of question is being made to renegotiate.

Mr. Calhoun, you quoted an October 2008 Credit Suisse report which said that 3.5 percent of subprime mortgage delinquent loans were being renegotiated.

Mr. CALHOUN. In the month of August. And that's consistent with all the other objective reports we see. The Attorney General's Working Group issued a report recently that found that voluntary modification efforts were profoundly disappointing.

But if I can go back just 1 second, I think these criticisms about both the cram-down and about, the MBA doesn't want to push consumers into bankruptcy, miss the very fundamental point of this legislation. If you want to avoid cram-down, if you want to avoid consumers having to go into bankruptcy, it's real simple: modify the mortgages like you've been saying for the last 2 years you would do.

But if you're not going to do that, you can't leave the consumers empty handed. They have to have another option. So they're asking to have it both ways. They say, don't push us into these things we don't like, and don't make us do the modifications. This bill just says, pick which one you want to do. You say you want the modifications and you're going to do them? Well, them do then and you don't have to worry about bankruptcy.

Senator DURBIN. Mr. Kittle, you talked a lot in your statement about moral hazard. To try to bring that down to understandable terms, I think that means that people just aren't embarrassed anymore, in your point of view, of going into bankruptcy court. To them, it's just a trip to Disneyland and they'll be back home again soon. They should take this seriously. If they're going to go into bankruptcy court, they ought to understand that this is not something that America is joyful over, and they're going to pay a price for it. I think that's what your testimony said.

I don't buy that, because I've been to bankruptcy court as a trustee and representing people. I don't know many of them who go there joyfully. I think most people go there with a sense of embarrassment. They wish they hadn't reached this point. But medical bills, mortgage foreclosure pushed them to a point where they have no place to turn. For many of them, they literally have no place to turn. So I don't think that this is something that people will skip off to and say, oh, don't worry about paying the mortgage, we can always go through bankruptcy. I just don't think people are going to do that. I think they understand how serious it is.

That was the argument that was made a year ago by your organization. Don't you think that argument has really lost some credibility now that we have decided to give $700 billion to banks who have made rotten, miserable decisions when it comes to their own portfolios and continue to take outrageous bonuses, and parachutes, and commissions despite their proven incompetence? What about the moral hazard argument there? Do you think there's a problem with your argument now?

Mr. KITTLE. Senator Durbin, I just quickly looked over my testimony and I didn't see the word "Disneyland", anybody being happy going to bankruptcy. I never saw that in my testimony.

Senator DURBIN. Well, I can tell you what you said then. Let me quote what you said.

Mr. KITTLE. Well, I've got it here and I don't see "Disneyland".

Senator DURBIN. "Keep people out of bankruptcy court. Don't make it appear attractive." Do you think it's attractive to people to go to bankruptcy court? That was a quote.

Mr. KITTLE. I think we are encouraging people to go to bankruptcy court, Senator.

Senator DURBIN. You really do?

Mr. KITTLE. I think it's wrong when you have two-thirds of them—and I'll restate it. Two-thirds of them fail, regardless of what Levitin says.

Senator DURBIN. We've been through that already.

Mr. KITTLE. It's the same—

Senator DURBIN. But let me just ask you—

Mr. KITTLE. It's the fact.

Senator DURBIN. Step back and get to 30,000 feet and look down on this world that we live in, and explain to me how you can say to these people that Tom Dart has to evict that it's just a damn shame, those things are going to happen. That's foreclosure and you've got to pay a price, you and your family, buddy. But for the bank downtown, your tax dollars were just sent over to them in the form of billions of dollars to get them through some miserable decisionmaking that they made. Do you see a problem there with that logic?

Mr. KITTLE. Well, first of all, you mentioned the bail-out. I didn't vote for it.

Senator DURBIN. Would you have voted for it?

Mr. KITTLE. Personally, sir?

Senator DURBIN. Yes.

Mr. KITTLE. No.

Senator DURBIN. OK. So what would you have done as an alternative?

Mr. KITTLE. I believe that there are certain things that happen to certain people, and we have places and processes.

Senator DURBIN. That's a political answer, but that's not an answer.

Mr. KITTLE. Well, this is a political setting. And what I'm telling you is, some people have to fail, some businesses have to fail.

Senator DURBIN. So you would just say, step back, Federal Government—

Mr. KITTLE. Can I talk to you about personal responsibility for a second?

Senator DURBIN. Well, talk to me about this for a second.

Mr. KITTLE. I will. I'm going to—

Senator DURBIN. We have a Federal Government.

Mr. KITTLE. I'm going to put myself in the middle of it.

Senator DURBIN. We have a bipartisan proposal from an administration to provide $700 billion—some say a trillion dollars—to help these banks that have made these bad decisions. Do you struggle at all with the concept of what you're saying to the evicted family as opposed to these banks? Does that create a problem for you?

Mr. KITTLE. A year and 2 months ago, Senator, I had to close my own company because of what's happening in this mortgage business. My wife and I have lived out of our savings for the last 14 months and an income that I do out of consulting, while maintaining a straw, very small company that's still there. I had to lay off most of my employees. During that time I was prudent enough, and fortunate enough, and blessed enough to put enough money away to get through these 14 months. And I am sorry for those people that can't, so I feel the pain out there. I've been able to avoid filing bankruptcy myself. I've been able to make all of my payments on time. So this has affected me personally. I'm here telling you, yes, sir, I feel the pain, and I can look you in the eye and tell you that.

Senator DURBIN. I am not going to get an answer, obviously, to that. I'm sorry for your misfortune, but obviously you weren't at the highest levels of banking and financial institutions where some people are being protected.

But let me go back to this point that's been made over and over again. Senator Schumer, being from New York, can use the word "tranche", Senator Whitehouse can use "strips". To me, it reminds me of a trip to Chuck E. Cheese with the Whack-A-Mole: every time you hit one, another one pops up. That seems to be the situation with securitization of mortgages. Once you've got several people satisfied, another one pops up and says we're not satisfied, so we won't agree to modification. Do you concede that that is a fundamental problem in this conversation?

Mr. KITTLE. I see that it is a problem with the strips and tranches to try and find out. I don't think we've ever said that it's not, but I still—

Senator DURBIN. How would you solve it?

Mr. KITTLE. How would I solve it?

Senator DURBIN. Uh-huh. How would you solve it? How would you get these—if they're 10, 20, 30, or 40 different elements in securitization, how do you get them all to the table and all—

Mr. KITTLE. I will tell you that right now, our members are doing, and they are solving it, and they are doing loan modifications.

Senator DURBIN. Three and a half percent.

Mr. KITTLE. That's his number.

Senator DURBIN. No, that's Credit Suisse.

Mr. KITTLE. Citi Mortgage just announced three or 4 weeks ago they were going to take an aggressive plan to help people, their customers, modify loans who weren't even in trouble yet, to talk to them. Please call us. Their chairman was on CNBC saying this program is being implemented. B of A, one of the largest servicers in the United States, Citi and B of A, two of the top five, are modifying loans as quickly as they can. They are making progress and they're doing the job.

Senator DURBIN. So, Mr. Calhoun, have you seen that progress?

Mr. CALHOUN. There have been some efforts, but way too little. You evoked some holiday movies, I think. Maybe the more apt one is, it's about that time of year where they show "A Charlie Brown Christmas", and we have Lucy holding the football, promising that Charlie Brown is going to get to kick it. Those who think voluntary modifications alone are going to fix this must think Charlie Brown is going to get to kick the football this year. They're not going to do it, for these very reasons. We've been at this for the last 2 years. It isn't like the crisis has only been with us for a couple of months. And we've heard promises for the last 2 years, that just voluntary modifications would take care of the problem. They're not.

If I can respond to one other point that keeps getting raised about, two-thirds of bankruptcies currently fail. Well, one of the main reasons for that is, currently the court can do little to help borrowers with their largest, most troublesome debt: their mortgage. For example, in Georgia and other States that have non-judicial foreclosures, the only way you can avoid immediate foreclosure, because we don't have our sheriff from Cook County there, is to file bankruptcy. But all it can do is buy you a little more time to get out of the house, because the court lacks the authority to deal with that debt.

Then finally, again, all the lenders and servicers have to do is engage in reasonable modification efforts, and then they have the power to take bankruptcy off the table. That's all that you're asking them to do, is to do what they say they're going to do anyway. Then all this parade of horribles about bankruptcy becomes moot.

Senator DURBIN. Mr. Stengel, you talked about the fact that if you start changing the law—I don't want to put words in your mouth, you can correct me—that there's a certain instability here, or unpredictability, and that's not good for the credit markets. Is that a fair summary of what your message is?

Mr. STENGEL. I think so. Having listened to a number of follow-up comments, maybe just stepping back 1 second. I think, just as a preliminary matter, one issue that's been ignored is the takings issue for appreciating assets. So I think that in contrast, perhaps, to Senator Schumer's position, there may be constitutional infirmities with this approach. But assuming that those can be resolved in an acceptable way, I think that our mortgage finance system is in peril and has broken down.

Senator DURBIN. Do you think that voluntary renegotiation has been successful?

Mr. STENGEL. Not in their current form, no. I think there are no meaningful incentives that have been provided and there are many disincentives, for servicers, in particular. No one has mentioned the litigation threat.

Senator DURBIN. May I also suggest to you, when we did the reform of the Bankruptcy Code a few years back, I don't remember a constitutional argument saying that it was a "takings" as we changed the terms of what you could recover in bankruptcy in those days, because it was to the benefit of creditors. They were all as happy as could be with the notion that they were going to come out in a better position in bankruptcy than before the reform. So I don't necessarily buy the takings.

But let me get back to the unpredictability part of it. Isn't there some unpredictability in the world—in this credit world today in terms of foreclosures, and isn't it a fact that a foreclosure is a pretty disastrous economic event for many creditors?

Mr. STENGEL. I agree completely. I agree completely with you. But I think that we can't lose sight of what the world is going to look like tomorrow. That 40th tranche holder isn't going to put money into the system, or they're going to put money into the system at prices that are going to price borrowers out of the market. So unless whatever is done for foreclosures is done in a holistic way, thinking about what our mortgage finance system is going to look like tomorrow for people are going to provide the money, I think that we're walking down a fairly dangerous path.

Senator DURBIN. So we may see the abandonment of the notion of no-doc loans.

Mr. STENGEL. It's hard to make an argument on the other side of that. When I took out my own loan and someone said, now you're going to have to provide documented income, I said, how can that possibly not be the case? So—

Senator DURBIN. But it was.

Mr. KITTLE. Could I respond to that, Senator?

Senator DURBIN. Certainly.

Mr. KITTLE. The Mortgage Bankers Association and its members are making the best loans today than we've made in 15 years. We're back to very stringent underwriting guidelines. Very, very few, if any, of the no-doc loans are being made. So to me, that would—

Senator DURBIN. You're still making no-doc loans? Excuse me. Are they still making no-doc loans?

Mr. KITTLE. I would say, in some cases small banks that know their customer, that come in, that have assets, that are putting 30 to 40 percent down, in that particular business decision they are probably making them. Yes, sir.

Senator DURBIN. Do you think, Mr. Kittle, that—

Mr. KITTLE. Can I respond to something, just, if you don't mind?

Senator DURBIN. Well—

Mr. KITTLE. Senator Schumer singled me out on four occasions and he said something, and I just—he's not here. I would like a chance to respond just to one of those. He said that me, and MBA, that we were very short-sighted. Part of this is exactly what Mr. Stengel addresses here. If this legislation goes through, we will be putting a permanent tax on everybody that buys a house going forward of $295 a month, over $3,000 a year. We have a 31-year precedent already set. The last time this bankruptcy went through—

Senator DURBIN. Are you going to present some evidence of what you just said?

Mr. KITTLE. Yes, sir. And—

Senator DURBIN. When?

Mr. KITTLE. Regardless—

Senator DURBIN. When will you present this evidence?

Mr. KITTLE. Regardless of their race, gender, or income level—

Senator DURBIN. Sir—

Mr. KITTLE.—this tax will go on them.

Senator DURBIN. Would you respond? When will you present the evidence to back up this?

Mr. KITTLE. We can get it to you quickly.

Senator DURBIN. Quickly. Didn't bring it with you today?

Mr. KITTLE. Well, we—I could—the numbers are already there. The precedent is already there. When it was changed in 1978, it went up 2 percent.

Senator DURBIN. Well, Professor Levitin, how did you miss that? Two hundred and ninety-five dollars a month, it's going to cost.

Mr. KITTLE. Because he didn't use the correct calculations.

Senator DURBIN. Well, what—

Professor LEVITIN. The correct calculations? I mean, I would hope that the Mortgage Bankers Association, of all entities, would know that there are—even if we didn't have bankruptcy at all in the world, there would still be a price spread between investor properties and owner-occupied properties. They're just different risks. If you're going to have an investor property, you need to find a tenant. Sometimes you can't do that. Sometimes you find a tenant and the tenant doesn't pay, or you find a tenant and the tenant trashes the place. To come up with this really nonsense 150 basis point number, which I'm guessing, but I can't be sure, is the basis for Mr. Kittle's calculations, it just—I mean, it boggles the mind how one can make this argument with a straight face.

Senator DURBIN. I thank the panel for their testimony today. Obviously there may be some questions submitted to you. Mr. Kittle is going to provide us with his analysis that led to his last conclusion.

Sheriff Dart, thank you. Thanks to each and every one of you for your testimony. We will leave the record open for others who may submit some written questions in the near term, but as of now this Committee stands adjourned. Thank you.

[Whereupon, at 11:47 a.m. the Committee was adjourned.]

[Questions and answers and submission follow.]

QUESTIONS AND ANSWERS

Q: Do financial institutions make more money when families stay in their homes and pay a reduced mortgage based on the current value of the home, compared with the money they would make through foreclosure?

A: In many, if not most, instances, owners of a mortgage or stream of income from a mortgage -- either lenders holding the loan in portfolio or investors in MBS -- will make more money if a family stays in its home and pays a reduced mortgage based on the current value of the home than they will if the home is sold in foreclosure. In fact, owners are likely to be better off receiving continued mortgage payments even if the principal writedown needs to be accompanied by a reduction in interest rates and/or an extension of the loan term to make the home affordable for the homeowner.

There are several reasons why it is best to keep the homeowner in the home in a mortgage based on the current value of the house. Due to the oversupply of homes for sale in most mortgage markets right now, homes cannot be sold in foreclosure at anything close to the original price, or even for a fair price in today's market. What's more, as the number of foreclosures in a neighborhood increases, housing prices in that neighborhood decrease additionally. In addition, keeping a family in the home reduces the chance of property damage to a vacant home; in many neighborhoods, foreclosed homes last only a few days before being destroyed by theft, vandalism, or arson, any of which may render the home unsalable.

In the various streamlined mortgage modification models being used by the FDIC and several other financial institutions right now, the first step in the model is to run a net present value calculation to ensure that the mortgage owner is better off financially by making a modification rather than by proceeding with a foreclosure. Similarly, if legislation is passed to permit judicial modification of mortgages, the analysis in bankruptcy court will permit modification and reduction of principal only in cases where the homeowner can afford to make continued payments on the home at a commercially reasonable rate of interest.

Certainly, there will be situations in which a principal writedown, even if accompanied by a reduced interest rate and/or extended loan term, will not make the home affordable to the current homeowner. Even in those cases, however, mortgage owners will generally be better off financially if the servicer helps the homeowner to arrange for a short sale or deed-in-lieu rather than proceeding with an expensive foreclosure.

Finally, it is worth noting that servicers of a mortgage, who are not the beneficial owners but who are the ones on the front lines of the decision whether to modify a mortgage or proceed to foreclosure, often have different financial incentives than the mortgage owners themselves. It is common in the servicing industry for servicers to be paid more to foreclose on a loan than to modify it, and servicers also have a financial interest in the late fees and penalties assessed on homeowners who fall behind in their payments. Any solution to the foreclosure crisis must deal with the question of servicer incentives as well as the need to maximize returns to mortgage owners.

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Office of the Sheriff
Richard J. Daley Center
Cook County
Chicago, Illinois 60602

Thomas J. Dart
Sheriff

December 12, 2008

The Honorable Patrick Leahy
Chairman, Committee on the Judiciary
United States Senate
Attention: Justin Pentenreider
224 Dirksen Senate Office Building
Washington, DC 20510

Dear Mr. Chairman:

Per your request of December 2, 2008, please find enclosed my written responses to the questions from Committee members concerning my testimony at the Unites States Senate Committee on the Judiciary hearing regarding "Helping Families Save Their Homes: The Role of Bankruptcy Law" on November 19, 2008. I have also sent an electronic version of my responses to Justin_Pentenreider @judiciary-dem.senate.gov.

It was an honor to appear before your Committee, Mr. Chairman. I deeply appreciate your kindness to me. If I can be further assistance to you or the Committee, please do not hesitate to call on me.

Sincerely,

Thomas J. Dart
Sheriff

OFFICE OF THE SHERIFF
RICHARD J. DALEY CENTER
COOK COUNTY
CHICAGO, ILLINOIS 60602

THOMAS J. DART
SHERIFF

Written Questions from Senator Richard J. Durbin
Senate Judiciary Committee hearing on
"Helping Families Save Their Homes: The Role of Bankruptcy Law"
November 19, 2008

Questions for Sheriff Tom Dart

1. As you discussed in your testimony, one of the troubling consequences of foreclosures is that foreclosed properties often become a magnet for criminal activity.

    (a) Do you think that reducing the rate of foreclosures would be helpful to your Department's efforts to fight crime?

Answer: In many hard-pressed neighborhoods in suburban Cook County and in the City of Chicago homes in foreclosure proceedings quickly become abandoned buildings—abandoned by owners, landlords, tenants, lenders, realtors, neighbors—abandoned by everyone except criminals. Abandoned buildings breed crime because they are easy targets of opportunity for gangs, drug abusers, thieves, and other criminal predators. An abandoned building becomes a site for drug transactions or drug use, a cache for contraband or firearms, a haven for predators of all types, a daily challenge for law enforcement agencies, a dangerous nuisance to every law-abiding, responsible neighbor and a terrible hazard to children. Law enforcement agencies struggle every day to contain the damage these sites do to neighborhoods, families and businesses. Often, a municipality is left with only one effective regulatory tool: condemnation and demolition, a tool which accelerates the decline of a neighborhood, wipes out the value of the asset to the lender and diminishes the supply of potentially affordable housing. Any measure at the Federal or State level which reduces the rate of home foreclosure will help law enforcement efforts to fight crime by eliminating easy sites for criminal activity.

    (b) In your experience, how much time does it take between when a home is foreclosed upon and when that property becomes a magnet for crime?

Answer: In my experience, in many neighborhoods, criminal activity can happen upon the filing of a foreclosure action, well before the Sheriff's deputies appear at the premises to evict and deliver the property to a receiver. For example, 214-216 S. Whipple St., Chicago, is property which has been foreclosed and **pending** the actual eviction. According to Chicago Police Department records, the following offenses or arrests occurred between November 13, 2008 and November 26, 2008 (about the same time as the Committee hearing): vandalism, numerous drug abuse violations, and assault. The property is located within two blocks of a charter elementary school. This is just a snapshot of what occurred at about the same time the Committee was deliberating on the subject of home mortgage foreclosure. Since July of this year, when the foreclosure action was filed, there have been numerous offenses and arrests in the immediate area for vandalism, drug abuse violations, assault, aggravated assault, and larceny.

MORTGAGE BANKERS ASSOCIATION®
Investing in communities

Senate Judiciary Committee
Hearing on
"Helping Families Save Their Homes, the Role of Bankruptcy Law"
November 19, 2008

Questions submitted by the Committee to David Kittle

1. Regarding my proposal to permit modification of mortgages on primary residences in bankruptcy court you testified: "If this legislation goes through, we will be putting a permanent tax on everybody that buys a house going forward of $295 a month, over $3,000 a year."

Please provide the data you have used to derive the figures you used in your claim.

Primary residence mortgage bankruptcy cramdown legislation as drafted today will change how lenders price for risk. Lenders price for risk based on the credit worthiness of the borrowers which is based on the idea that a borrower's past credit performance is the best indicator of future performance. Servicers also require appraisals to estimate the current value of the property relative to the loan size as a means to ensure that the collateral is a sufficient pledge for the loans. The future value of the property is not easily factored into the origination equation because lenders are ill equipped to estimate future real estate values, although GSEs have from time to time imposed declining market fees.

Under this proposed legislation, lenders will have to take potential changes in property values into account as a primary consideration in the lending process. Moreover, given that S.2136 renders mortgage insurance ineffective to offset principal losses due to cramdown, various parties financing or investing in the loan will have to price in default risk, recognizing the loss of credit enhancements. We believe the most immediately impacted markets will be those dependent on government loan programs and GSE loan programs. Government programs continue to operate reasonably well despite a relative freeze of credit in the private markets. This is due mostly to the presence of mortgage insurance and guarantees on these programs. Because mortgage insurance or guarantees effectively will be void in a lien strip, these programs lose their liquidity as few servicers will accept the risk of tens- or even hundreds-of-thousands of dollars of principal loss in exchange for a nominal 19 – 44 basis point servicing fee (i.e., $190 - $440 annual fee to service $100,000 loan). We fear that without a significant change to the bankruptcy legislation, the remaining liquid markets will dry up.

Also impacted by S.2136 are markets that have been served only by private banking and investing. These are loans to borrowers who have traditionally failed to meet the loan, credit or collateral standards of government or GSE programs. These programs are currently severely impacted by the lack of investor take outs. Few investors are willing to purchase non-government mortgage-backed securities of any quality due to a lack of confidence, performance and first dollar loss protection (such as mortgage insurance). Lending to poor credit borrowers is non-existent, while credit to high quality jumbo borrowers is effectively reduced to each lender's portfolio capacity. With capital and accounting restraints and severity of losses on loans in general, this capacity is severely reduced. Portfolio lenders are, therefore, inclined to lend only to the most creditworthy borrowers. With the addition of cramdown risk, lenders will further restrict their lending according to loan type, geography and property type. Most impacted in the private banking/label environment are properties subject to the greatest decline in property values, such as new subdivisions, inner city areas, rural areas, and regions with steady declines in population and employment. These borrowers will have limited access to credit and will be subject to higher rates, more fees at closing, restrictions in underwriting and, perhaps most importantly, subject to increased downpayment requirements to offset the risk of loss. To the extent the mortgage market can be competitive, different lenders will respond differently, and the degree to which rates and costs change will vary from market to market and by property type.

We expect that, taking into account all of the increased costs borrowers will face and capitalizing those costs into the rate alone (i.e., assuming continuation of zero or low downpayments), borrowers will be forced to pay approximately 1.5 percent more for their loan than if cramdown legislation were not passed. For some borrowers, this may be a low estimate; for others this may be high. But an additional 1.5 percent is on the low range of our estimates. The actual average will depend, for example, on how many new mortgages are financed without very large downpayments.

If one were to assume a 30-year fixed-rate mortgage for $300,000 at a 6 percent interest rate, and rates were to increase by 1.5 percent to 7.5 percent, the principal and interest payment for that loan would increase by $298.99. The increase attributable to cramdown would fluctuate with the loan amount.[1]

Our analysis is based on the fact that the mortgage market prices for risk. Cramdown legislation would introduce significant new risks for lenders, servicers and securitizers of

[1] Rates have declined in recent weeks. If one were to take the average loan size in November 2008 (according to the MBA Survey of Mortgage Applications) of $229,400 and apply a common interest rate in today's market, 5.54 percent, the principal and interest payment would be $1,308.27. If the interest rate were to increase to 7.04 percent, the new principal and interest payment would be $1532.37, a difference of $224.10 per month. A $300,000 mortgage at 6 percent is an example we have been using since debate on this issue began, as the numbers are easier to quickly understand and remember. The principal and interest payment on that loan would be $1,798.85. If that same borrower were then forced to pay an additional 1.5 percent on his rate, the payment would be 2,097.64.

primary residence mortgages. Higher default incidence rates, higher loss severity rates, higher administrative costs, increased political risk and increased market uncertainty combine to increase costs for consumers. To avoid or offset these risks, entities would alternatively, and most likely, increase the cost of a new mortgage through larger downpayments, tighten credit standards, if such loans are made at all in declining or volatile markets such as rural, urban and new property development areas.

The following are our underlying assumptions and a further explanation of the increased market costs of passing this bankruptcy legislation.

Higher default incidence rates would increase mortgage rates by 70-85 basis points.

If cramdown legislation is approved, default rates would increase for two reasons. First, more mortgages would be drawn into consumer bankruptcy filings. The result would be that defaults would increase by the number of people who previously would default on everything except their mortgage. In addition, bankruptcy filings would increase due to the asymmetrical nature of the filing. Giving people the option to write-down their mortgage when values are at their lowest point, without the option of lenders recovering the lost principal when values go up, will increase bankruptcy filings, particularly if the debtor expects to sell the house in a few years. This option of wiping out part of the loan while keeping the house and its future appreciation would make bankruptcy more attractive and could subsequently drive up the number of defaults. These higher default rates would result in a 70-85 basis points increase in mortgage rates.

Higher severity rates would increase the cost of a mortgage by 20-25 basis points.

Enactment of the current cramdown proposal would increase loss severity. Because mortgage insurance claims are in effect void in the event of bankruptcy cramdown, the loss associated with a cramdown is far greater than the loss associated with a foreclosure. For example, FHA offers 100% insurance for the risk of principal loss as a result of foreclosure. Conversely, if the loan is subject to the same principal loss through cramdown, the lender (servicer) receives no insurance benefits. The servicer must absorb the entire principal loss. Servicers are not equipped to accept this level of principal loss (as shown above servicers are not compensated to have the liquidity to absorb this loss) and we fear cramdown severity (and frequency) could increase the risk of defaults on Ginnie Mae mortgage backed securities obligations. Such defaults have a ripple effect, but most notably result in Ginnie Mae having to take over the financial responsibility of the servicer and thus the principal cram down risk. A Ginnie Mae MBS default also triggers defaults on all other securities, including Fannie Mae and Freddie Mac MBS. These entities may be forced to take over servicing of these obligations as well.

Even if these product types were carved out of the bankruptcy proposals, lenders and investors are likely to incur greater losses due to an intervening bankruptcy. Lenders would be required to accept reduced payments as a result of the bankruptcy cramdown. If, however, the borrower fails to pay according to the plan, the lender reverts to the original terms of the mortgage and the deferred principal and interest payments become due and payable. Unfortunately, these amounts accrue but rarely get paid back. Approximately 2/3 of all Chapter 13 plans fail and these loans progress to foreclosure with larger principal balances and accrued interest than without an intervening bankruptcy. Moreover, a delay in foreclosure could cause the lender to sell the REO in worsened market conditions than were present at the time of filing. Given that the borrower will be in the house for a longer period with little incentive to do maintenance or improvements, it is likely that repair costs will be much higher.

Bankruptcy administrative costs would add 10 basis points to mortgage rates.

When dealing with foreclosures, lenders face high administrative costs, which are not always recoverable from private mortgage insurers. In addition to the foreclosure costs, cramdown would force lenders to take on the additional cost of protecting their legal interests in the event of a bankruptcy filing. For example, lenders would have to order separate appraisals to defend against appraisals ordered by the bankruptcy judge or other claimants and hire attorneys. Such costs could run into thousands of dollars for one loan, but would vary as a percentage of the loan amount. In order to cover these new administrative costs, lenders would have to add an average of 10 basis points to individual mortgages.

Market uncertainty and increased political risk would result in an additional 50-60 basis points.

Market uncertainty over new default and severity rates would drive up interest rates until the market is reasonably comfortable with the incidence rates associated with the new legal regime. Mortgage interest rates would increase considerably for several years until investors have some comfort in the new overall loss rates. Rates might then narrow somewhat but would still remain above traditional levels. In the short-term, the market would overprice this risk. At a time when the real estate finance industry and mortgage rates are already under stress, this would be especially difficult on borrowers and mortgage originators.

Additionally, a change to the bankruptcy laws would increase political risk and further alienate international investors. The U.S. has always been a safe haven for international investment because contracts are honored and are free from political influence. It would take the markets years to reverse the effects of Congress stepping in to alter financial contracts ex post for perceived short-term benefits. Not only would it have an effect on the appetite for mortgage paper, it would raise the question of what other steps Congress might take and would add a political risk premium to all U.S. debt.

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In order to protect against an increase in political risk and market uncertainty, international and domestic investors would likely demand an additional risk premium that would add an additional 50-60 basis points to each mortgage.

Using the low end of the range from these factors, we arrive at 150 basis points (assuming zero or low downpayment requirements). The number is an approximation, as there is no market parallel from which we can make exact comparisons. Cramdowns on non-primary residences are not fair comparisons because such debt if modified must be repaid in it entirety within 3-5 years. This drastically limits frequency and severity of cramdowns to almost zero. Legislation proposed to date on primary residences removes this critical creditor protection thus allowing more borrowers to qualify and thus greater loss frequency and severity from cramdown. Many of our member companies' risk officers, credit specialists, economists and production experts believe this number is too conservative. Others believe that our number is too large. Again, the actual number will be a function of property type and downpayment. We believe that the range we have presented is based on today's market and supportable assumptions about how the market will respond.

2. Over the past 15 months since I introduced the Helping Families Save Their Homes in Bankruptcy Act, the Mortgage Bankers Association has claimed at various times that the change would lead to a mortgage rate increase for all borrowers equal to 200 or 150 basis points.

(a) What is your current position regarding the impact my legislation would have on mortgage rates?

The Mortgage Bankers Association estimates there would be an increase in cost in the range of 150-200 basis points to borrowers if S. 2136, the "Helping Families Save their Homes in Bankruptcy Act of 2008," is enacted.

As you are aware, the costs of a mortgage are determined by a number of factors, including a borrower's credit profile, their payment history on other debts, employment status. A borrower's mortgage rate is also influenced by the amount of funds available for a downpayment, market conditions and any points or fees they may pay to buy-down that rate.

Enactment of S. 2136 could result, for example, in an increase in downpayment requirements and smaller increases in interest rates, similar to the case in today's market for second homes and investment properties. Some riskier borrowers who in today's market depend on mortgage insurance (either public or private), may not have access to mortgage credit at all, if insurance is not available for the amount of the cramdown. In particular, FHA and VA programs were created by Congress to encourage lending for those borrowers who do not have the financial means to provide a larger downpayment. These programs do not protect lenders against a cramdown

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(also known as a lien-strip). These factors create uncertainties and risks that lenders will pass on to borrowers in the form of higher costs.

MBA is not alone in its analysis that cramdown will increase the cost of mortgages. Following the December 5, 2007, hearing on S. 2136, Professor Joseph Mason was asked: "*Do you have any statistical evidence to support your claim that higher interest rates would result from bankruptcy code changes?*" Professor Mason's response was:

> 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 downpayments) 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 a financial economic perspective it would be foolish to expect the effect to be benign[2].

The Chief Economist of Fiserv Lending Solutions, the company that produces the Case-Shiller Home Price Index, David Stiff, determined that:

> During market downturns, home prices fall the least in the most desirable areas of a metropolitan region. As housing affordability improves, homebuyers who were previously priced out of their preferred towns and neighborhoods will be able to purchase properties in these areas. So, even as overall sales volume drops, relatively stronger demand for housing will limit price declines in neighborhoods with shorter work commutes, better schools, and easier access to parks, recreation, and retail centers...[T]his shift in preferences will mean that prices for homes in outlying neighborhoods will continue their more rapid decline and will be slower to rebound when housing markets finally start to recover.[3]

Should cramdown legislation pass, lenders would need to examine a number of new factors in their underwriting analysis. No longer would they simply have to assess whether the borrower will be able to repay the loan, they will have to assess the future price of the home. If an assessment is made that the price of the home could go down, the lender will be unlikely to make a loan for more than the possible future value of the property. Lenders will be unwilling to originate loans with little to no money down without mortgage insurance or guarantees. Government lending, GSE programs and

[2] The Looming Foreclosure Crisis: Hearing Before the Senate Committee on the Judiciary, 110th Congress (2007) (statement of Joseph R. Mason, Associate Professor, Drexel University). Accessed at http://judiciary.senate.gov/hearings/testimony.cfm?id=3046&witlid=6812 .

[3] "Housing Bubbles Collapse Inward," (2008) David Stiff, Chief Economist, Fiserv Lending Solutions. Accessed at http://www2.standardandpoors.com/spf/pdf/index/052708_Housing_bubbles_collapse.pdf .

areas that experience the greatest fluctuation in home values – rural areas, inner cities and new developments – would be impacted most. Lenders would be forced to offset this risk by increasing the loan's cost and/or requiring higher downpayments.

(b) Can you provide a detailed justification for your past and current positions?

MBA's position has been consistent throughout the debate. MBA has consistently said that the costs of a loan will increase by 150 to 200 basis points. That estimate represents all of the possible costs (higher downpayments, higher rates, higher fees, etc.) capitalized into the rate alone.

Bankruptcy is enshrined in the Constitution to help borrowers and lenders work together through a disinterested third party (the judge) to clear the record for someone who can no longer meet his or her obligations. When Congress specifically exempted primary residence mortgages from the bankruptcy estate, they did so to keep the cost of credit as low as possible. Adding bankruptcy risk into the risk equation for home lending will result in higher costs. At his June 17, 1999, confirmation hearing, Treasury Secretary Nominee Lawrence H. Summers, was asked, "[*w]ould you agree that debt discharged in bankruptcy results in higher prices for goods and services as businesses have to offset losses?*" Mr. Summers responded:

> I think the answer is -- it's a complicated question, but certainly there's a strong tendency in that direction and also towards higher interest rates for other borrowers who are going to pay back their debts.[4]

In addition, the impact that the Chapter 12 bankruptcy laws had on family farms is clear. A United States Department of Agriculture (USDA) study found that a change in the treatment of family farms led to an increase in costs:

> Lenders have adopted tiered interest rate structures and increased the interest rate spread to riskier borrowers partially in response to Chapter 12.[5]

S. 2136 would have the same impact on primary residence mortgages – an increase in costs. The bill would permit a judge to reduce the loan principal to the current market value of the home, lower interest rates and lengthen the payment term. In order for a loan to be subject to a cramdown (lien-strip), the value of the home must be less than the outstanding balance of the mortgage contract. To protect against future home

[4] NOMINATION OF LAWRENCE SUMMERS TO BE TREASURY SECRETARY: Hearing Before the Senate Committee on Finance, 106th Congress (June 17, 1999).

[5] "Do Farmers Need a Separate Chapter in the Bankruptcy Code?," Jerome Stam (October 1997) United States Department of Agriculture, Economic Research Service.

depreciation, lenders would require larger downpayments. With this larger equity stake, the home would not be subject to a cramdown until the home value dropped below what percentage the borrower initially put down.

Downpayments are one of the biggest obstacles to home ownership. In today's market, the only low-downpayment options available to many borrowers are through FHA insurance and VA guarantee programs. These credit enhancements provide lenders with the insurance protection should the borrower default on the loan. Congress created these programs to encourage the lending community to provide affordable credit to first-time and low-income borrowers and, in return, the federal government provides insurance should the borrower default. These programs do not cover the lender's losses from a lien-strip (cramdown), and S. 2136 would remove the key incentive for using the FHA and VA programs.

The same is true for private mortgage insurance (PMI). This is a similar private market protection that lenders and the GSE's require for loans without a 20 percent downpayment. PMI, FHA and VA programs only provide lenders/investors with protection from default, therefore lenders would not recover their losses from a lien strip. Without the protection from PMI, FHA or VA programs, lenders would be less willing to make low-downpayment loans. Congress specifically created FHA and VA programs to encourage the mortgage industry to provide affordable options to homeownership. The same programs that Congress created to promote home ownership, would no longer provide the incentive or protection should bankruptcy cramdown legislation pass.

(c) Is there mortgage interest rate data (for primary residences and, separately, for investor properties) from before and after the implementation of the 1978 bankruptcy code that validates your claim?

(d) Is there default rate data (for primary residences and, separately, for investor properties) from before and after the implementation of the 1978 bankruptcy code that validates your claim?

The data requested in Question 2(c)(interest rate) and (d)(default rate) related to investor properties have not historically been compiled and recorded by MBA. After an exhaustive search of MBA files, Federal Reserve databases and a number of other sources, we were unable to find interest rate or default rate data regarding investor properties dating before and/or after the 1978 Bankruptcy Code. Additionally, default rate data on primary residences has not been recorded or maintained prior or subsequent to 1978 and is therefore not available. While there are interest rate data on primary residences for the time period requested, the 1978 changes to the Bankruptcy Code did not impact primary residences (their treatment was not altered under the statute).

As a market participant in 1978, however, I can assure you that my experience in dealing with first and second properties was that there were no differences. The increased costs of obtaining a mortgage for a second property occurred on enactment of the 1978 Bankruptcy Code.

3. You testified that "From July 2007 to September 2008, the mortgage industry has helped an estimated 2.47 million borrowers avoid foreclosure through repayment plans and loan modifications."

(a) How many of those homeowners have had their mortgage principal reduced?

(b) How many of those homeowners ended up with a modification or repayment plan that simply reallocates debt to the back of the loan?

As of the date of submission of these answers, these more specific and detailed numbers have not been compiled by the HOPE NOW Alliance. MBA remains in constant contact with leadership of the HOPE NOW Alliance and has been informed they are currently in the process of collecting data for a significant number of new fields. We expect this more comprehensive data to be available in the coming months. The industry continues to improve its data collection in these areas and is working on more specific loan level information. As soon as MBA is apprised of this and more specific data, MBA will ensure it is transmitted to you.

4. If the law is changed to permit modifications of mortgages on primary residences in bankruptcy court:

(a) Do you believe that this would provide incentive for your member banks to negotiate voluntary workouts for troubled homeowners out-of-court, rather than go through the time and expense of bankruptcy proceedings?

We do not believe that cramdown will provide further incentive to negotiate voluntary workouts. Servicers would be unable to compete with the benefits of proposed cramdown legislation. Today, servicers reach affordability through interest rate reduction, extensions of maturity dates and deferral of principal. These options simply cannot compete with the lure of a principal write down. Despite the fact that interest rate reductions can have a greater impact on reducing monthly payments than a substantial principal write down, the bankruptcy legislation forces lenders and investors into the most damaging resolution – a principal write down. The option is punitive in nature especially combined with the removal of all creditor protection offered on other debts in Chapter 13. Because borrowers will seek out bankruptcy over loss mitigation, we anticipate loss mitigation requests will slow down substantially and servicing personnel will be necessarily transferred to bankruptcy administration.

Also, cramdown could encourage lenders to move toward foreclosure more quickly, to avoid the possibility that a borrower's financial condition will deteriorate further to the point of bankruptcy.

MBA member banks and servicers measure success through their efforts to avoid foreclosure and by helping borrowers remain current on their mortgage. Servicers have no incentive to foreclose, because they incur a financial loss on each foreclosure. In the case of an FHA loan, the servicer would lose anywhere from $2500 to $4000 in attorney fees alone during a foreclosure. They also would not get the full reimbursement of interest advances to the bond holders. In addition, servicers have added incentives to provide loss mitigation efforts under FHA, VA and GSE loans. They are paid a fee for performing loss mitigation, because it is recognized as labor and cost intensive. Current incentives are aligned to provide assistance to borrowers who can afford reasonable mortgage payments. Companies maintain their profitability by collecting payments. In the case of a foreclosure, lenders not only lose money on attorney's fees, but they must also pay real estate taxes and upkeep of the foreclosed home until it is sold. Most importantly, they lose the economic value of the loan.

In cases where a borrower's financial situation has deteriorated to a point where they cannot afford a reasonable mortgage payment, foreclosure becomes inevitable. Reasons for this continue to be the economy, job loss, death in the family, divorce or taking on additional debt.

The industry has been engaged in unprecedented efforts to assist distressed homeowners, and we believe these have proven successful in stemming foreclosures. We agree more programs can be implemented to provide additional loan modification assistance, however bankruptcy cramdown is not such a program.

It is worth noting the efforts industry has been engaged in to date:

- Servicers have assisted a record number of borrowers through various loss mitigation efforts. From July 2007 to September 2008, an estimated 2.47 million repayment plans and modifications have been executed. Foreclosure sales for the same period were approximately 1 million, resulting in a 71 percent workout-to-foreclosure ratio.

- The Federal Housing Finance Agency and the HOPE NOW Alliance announced a major streamlined loan modification program for GSE and financial institutions' portfolio loans to get struggling homeowners affordable mortgage payments.

- Investors and mortgage insurers are introducing a greater number of helpful options including Fannie Mae's HomeSaver Advance, which allows the borrower to cure a delinquency by placing the arrearage in a subordinate loan that carries no interest or a low interest rate. Mortgage insurers and FHA also have similar programs.

- HOPE NOW in concert with NeighborWorks and the Homeownership Preservation Foundation have assisted in promoting the HOPE™ Hotline, a national counseling network which is available 24 hours a day, 7 days a week, and 365 days a year. The Homeowner's HOPE™ Hotline receives an average of more than 6,000 calls a day. There is no cost to homeowners for contacting a nonprofit counselor.

- Servicers and many of their investor partners are paying for borrowers to have one-on-one counseling sessions with HUD-approved counselors.

- Servicers implemented the American Securitization Forum's (ASF) Streamlined Foreclosure and Loss Avoidance Framework for Securitized Adjustable Rate Mortgages which provides systematic criteria that servicers can use to streamline the evaluation of borrowers in subprime hybrid ARMs in private label mortgage backed securities facing interest rate resets. Approximately 111,000 subprime ARMs have been modified with over 73 percent of these modifications having duration of five years or longer.[6]

- Participants in the HOPE NOW Alliance announced Project Lifeline, which is a targeted outreach to seriously delinquent homeowners (90 days or more late) who are currently facing the greatest risk of losing their home. Servicers under this program have agreed to "pause" foreclosure for 30 days while loan modification packages are evaluated.

(b) Once bankruptcy judges establish a template for how to sensibly modify mortgages, do you expect that servicers would follow that template to craft voluntary workouts out-of-court?

The mortgage industry continues to work diligently with borrowers, the Treasury Department, the Federal Reserve and a number of consumer groups to help borrowers stay in their homes. During the past year, there have been a number of successful streamlined modification proposals that have been and are currently being used. Federal Deposit Insurance Corporation Chairman Sheila Bair has used a template to modify loans currently held my IndyMac Federal Bank and the industry continues to examine her approach in their efforts. The government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, have updated their templates and process for assisting troubled borrowers. We welcome any and all assistance in determining the best way possible to help keep families in their homes. Should the judges devise a workable system, we would, of course, work with our servicer members to implement it.

[6] HOPE NOW Alliance Data Release, October 27, 2008.

5. In your testimony, you predict that if my proposed change is made to the bankruptcy law, bankruptcy filings will overwhelm courts.

The President of the National Conference of Bankruptcy Judges has submitted a letter for the record that states:

> **In my personal opinion, which I am confident is shared by nearly all of my 338 colleagues, if Congress determines to allow modification of home mortgages, the bankruptcy courts would be able to implement that policy efficiently, and, in contrast to other proposals for dealing with this issue, without imposing new costs, without requiring a new structure and without incurring any delay in implementation... we would not anticipate an unworkable volume of new activity in our courts as a result of the mortgage modification provisions.**

Do you agree?

We do not agree, particularly in the short term, and would suggest that there is little consensus on this point. For example, at a Senate Committee on the Judiciary hearing held on December 5, 2007[7], when asked a similar question, U.S. Bankruptcy Judge Thomas Bennett indicated that "on the volume in the short term it would be difficult," though in the longer-term the courts would eventually be able to handle the caseload.

The letter you reference goes on to indicate that "we would not anticipate an unworkable volume of new activity in our courts as a result of the mortgage modification provisions." However, in a February 5, 2008 Congressional Budget Office report[8] discussing the budget impact of cramdown legislation, the proposal would "result in a 4 percent to 5 percent increase in annual filings over the number expected under current law," suggesting filings would increase by 15,000 per year.[9] Others have said that this legislation would help 600,000 borrowers, which would represent a 75% increase in Chapter 13 filings. We believe both estimates are understated. We are attempting to quantify this numbers and would appreciate sharing it with you; however, we note above that borrowers are likely to favor bankruptcy over lender offered workouts. Given that 25% of the 72 million loans outstanding are underwater (loan exceeding the current fair

[7] Senate Judiciary Hearing on "The Looming Foreclosure Crisis: How to Help Families Save Their Homes," December 5, 2007.

[8] Congressional Budget Office Report, February 5, 2008.

[9] The most recent report for the U.S. Courts reports that "Chapter 13 filings rose 14 percent, from 310,802 in FY 2007 to 353,828 in FY 2008." http://www.uscourts.gov/Press_Releases/2008/BankruptcyFilingsDec2008.cfm

market value of the property) and protections against abuse of creditors are removed, estimates stated above deserve additional scrutiny.

Regardless of how many new bankruptcy cases would occur at a national level, it is certain that the caseload would not be distributed evenly. Given that mortgage delinquencies are highest in such states as California, Florida and Nevada, it could reasonably be expected that some courts would be overwhelmed while others would see little new activity.

Yet another issue deals with the experience level of judges in this particular field. During the December 2007 hearing, Judge Bennett responded to a question about the proposed legislation "putting a lot of police pressures on bankruptcy judges to make decisions that that's not their training or their normal requirement." His response included the following:

> "….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."

The Honorable Jacqueline P. Cox, a Bankruptcy Judge for the U.S. Bankruptcy Court for the Northern District of Illinois offered an additional comment responding to a question for the record from the same hearing: "Do you typically order appraisals on your own to assess the value of a property? Or, do you typically review the two competing appraisals that the lender and borrower have already ordered to judge the value of the property?"

> "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 the 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 a mortgage

debt is not now permitted, as lenders are entitled to full payment of the mortgage obligation without regard to the value of the home".

Some may point to Chapter 13 treatment of second or vacation property as an area that has given Courts experience that would be required to implement primary residence cramdown. Judge Cox, responding to another question said the following:

"You ask if cram down is rarely permitted on second homes and vacation home ... cram down rarely occurs on second homes or vacation homes because few debtors have two homes... 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."

While current law permits second property cramdown, because it is not essential, bankruptcy judges often require the sale of the property or the borrower would sell it before he or she even enters bankruptcy. Moreover, few borrowers in bankruptcy can afford to pay off non-primary residential loans in 3-5 years. As a result, those assets are lifted from the stay and proceed to foreclosure. Therefore, the courts have little experience or expertise in evaluating properties and dealing with the 600,000 or more borrowers that proponents of cramdown legislation claim. Becoming expert enough to handle these new responsibilities and dealing with the valuation disputes that will ensue will require additional administrative resources for the courts.

6. You claim in your testimony that if the rules regarding mortgages in bankruptcy are loosened, it will increase the cost of credit.

(a) When the bankruptcy code was tightened in 2005, did that directly produce lower costs of credit for borrowers?

The 2005 changes to the Bankruptcy Code did not change the previous modification treatment of primary residences. As such, there would not have been a corresponding change, in either direction, for interest rates on primary residence mortgages.

(b) Can you demonstrate that changes to the costs of credit are directly attributable to changes in bankruptcy law, or is it possible that other factors in the financial markets play a much more determinative role?

The market for primary residence mortgages is very different from how it looked when this debate began. In today's market, subprime lending has been virtually eliminated. In addition, virtually all loans today have some sort of government backing, whether through Fannie Mae or Freddie Mac, currently being overseen through federal conservatorship, or through the FHA and VA. The "private label" mortgage market has seized up and as a result, mortgage rates have not behaved as would have been predicted previously.

Many different factors play a role in the cost of credit. There are two major drivers for pricing: the cost of capital and risk. Cramdown legislation would introduce significant new risks for lenders, servicers and securitizers of primary residence mortgages. Higher default incidence rates, higher loss severity rates, administrative costs, increased political risk and additional market uncertainty represent new risks and those risks will be passed on to consumers in the form of higher mortgage costs, including larger down payments, higher rates and other fees, tighter credit standards and possibly the loss of credit opportunities in declining or volatile markets.

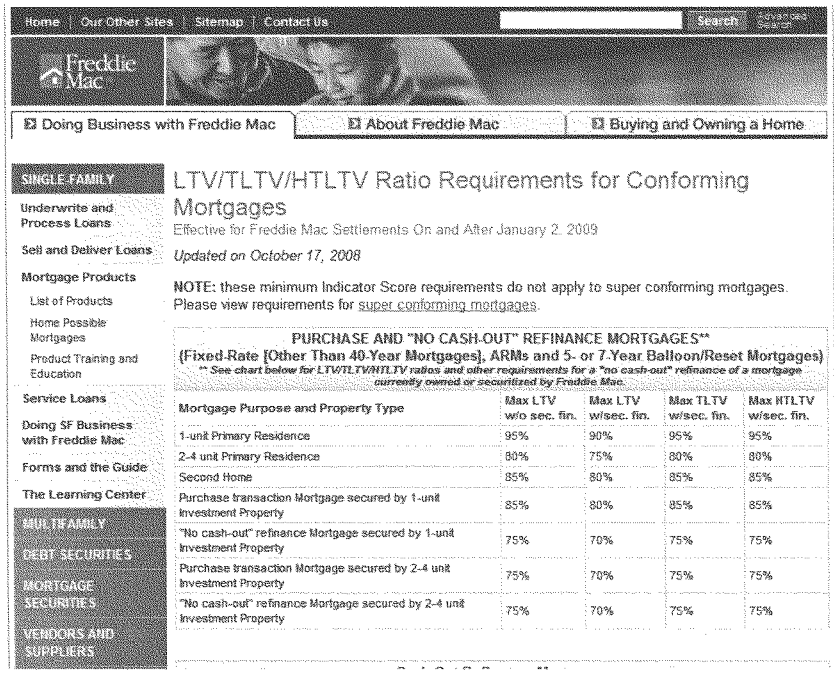
(c) How do you explain the lack of a mortgage rate differential between single-family and two-family owner-occupied properties, despite the difference in bankruptcy modification risk?

Mortgage costs come in different forms, such as interest rate, points/fees and downpayment. There is a significant cost difference to the borrower between a single-family and two-family owner-occupied property. The loan-to-value (LTV) minimum requirements for Freddie Mac conforming mortgage purchases effective January 2, 2009 are illustrative (http://www.freddiemac.com/sell/factsheets/ltv_tltv_200901.html detail of which is transposed below).

A borrower could receive a mortgage on a single-family owner-occupied property that would be purchased by Freddie Mac, with a 5 percent downpayment, or a 95 percent loan-to-value (LTV). If that same borrower were to purchase a 2-unit owner-occupied property, he or she would be required to make a minimum 20 percent downpayment (80 percent LTV). That is a significant cost difference to the borrower. On a $200,000 loan, in the case of a single-family property, the borrower would only need to have $10,000 for the downpayment. In the 2-unit scenario, the borrower would need a downpayment of $40,000 to purchase the property.

By examining the entire cost of the mortgage, and not just the interest rate, it is clear that there is a significant increase in cost to the borrower. A number of borrowers would be completely priced out of the ability to afford a home if downpayment requirements were to increase to 20 percent.

In addition, the risk from a bankruptcy lien-strip is greatly reduced by having the 20 percent downpayment requirement. With 20 percent down, should the owner file for bankruptcy, the home value would need to decline 21 percent before a bankruptcy judge would have the ability to cramdown the mortgage. By requiring 20 percent down, lenders would be protecting themselves from the possibility of cramdown.



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LTV/TLTV/HTLTV Ratio Requirements for Conforming Mortgages

Effective for Freddie Mac Settlements On and After January 2, 2009

Updated on October 17, 2008

NOTE: these minimum Indicator Score requirements do not apply to super conforming mortgages. Please view requirements for super conforming mortgages.

PURCHASE AND "NO CASH-OUT" REFINANCE MORTGAGES**
(Fixed-Rate [Other Than 40-Year Mortgages], ARMs and 5- or 7-Year Balloon/Reset Mortgages)
*** See chart below for LTV/TLTV/HTLTV ratios and other requirements for a "no cash-out" refinance of a mortgage currently owned or securitized by Freddie Mac.*

Mortgage Purpose and Property Type	Max LTV w/o sec. fin.	Max LTV w/sec. fin.	Max TLTV w/sec. fin.	Max HTLTV w/sec. fin.
1-unit Primary Residence	95%	90%	95%	95%
2-4 unit Primary Residence	80%	75%	80%	80%
Second Home	85%	80%	85%	85%
Purchase transaction Mortgage secured by 1-unit Investment Property	85%	80%	85%	85%
"No cash-out" refinance Mortgage secured by 1-unit Investment Property	75%	70%	75%	75%
Purchase transaction Mortgage secured by 2-4 unit Investment Property	75%	70%	75%	75%
"No cash-out" refinance Mortgage secured by 2-4 unit Investment Property	75%	70%	75%	75%

For the complete Freddie Mac Ratio Requirements, go to (http://www.freddiemac.com/sell/factsheets/ltv_tltv_200901.html)

As a final matter, it is important to point out that the modification risk proposed by S. 2136 is not the same as applied to investor properties. As stated in our testimony, a modified investor property loan must be fully repaid in 3-5 years of the Chapter 13 plan. The modified debt cannot be repaid over the origination term of the loan (i.e., 30 years). This substantially curbs the frequency of cramdowns and their losses on investors properties.

Yet current legislation would remove this key creditor protection and allow only home mortgage debt to survive discharge despite being modified. As a result, the lender experiences the loss of cramdown and remains subject to foreclosure loss if the loan redefaults after the Chapter 13 is complete. No other asset is treated this badly in bankruptcy. In fact other assets such as car loans have major creditor protections including a prohibition against cramdown for 2 ½ years from loan origination. This ensures that the car loan and the depreciating asset are effectively correlated. A home loan is historically an appreciating asset and yet provides no recapture or other protection to avoid windfall profits to the borrower at the expense of the lender.

Responses of Professor Adam J. Levitin to
Written Questions from Senator Richard J. Durbin
Senate Judiciary Committee Hearing on
"Helping Families Save Their Homes: The Role of Bankruptcy Law"
November 19, 2008

1. **Do you agree with Mr. Kittle's assertion in his testimony that my proposed change in the bankruptcy law is not necessary because "Current Chapter 13 bankruptcy law already plays an important role in saving the borrower's home" and "once unsecured debts are reduced, borrowers generally have sufficient funds to afford their mortgage payments"? Do those statements align with your analysis of today's mortgage market?**

No. I strongly disagree with Mr. Kittle's assertion. Your proposed change in bankruptcy law is necessary to help financially distressed consumers save their homes in bankruptcy. Chapter 13 bankruptcy is currently very limited in the way it can help a homeowner retain his or her home. Chapter 13 currently allows the borrower to deaccelerate and cure a defaulted mortgage, which can help a borrower who has fallen behind on the mortgage due to an unanticipated, temporary decline in income. If the borrower's financial problems stem from an unaffordable mortgage—such as from payment reset shock on an adjustable rate mortgage that cannot be refinanced into a fixed rate mortgage because it is underwater—rather than a temporary dip in income, then Chapter 13 is of no help to the homeowner at all.

If the homeowner cannot afford to make the mortgage payments in the first place, the homeowner will be unlikely to confirm, much less consummate a Chapter 13 plan. Without the discharge of debts that occurs only upon plan consummation (absent a finding of extreme hardship), the borrower's unsecured debts are not reduced. Mr. Kittle's repeated emphasis that approximately two-thirds of bankruptcy plans are not consummated shows that in most cases there is no reduction of unsecured debts.

The inability of homeowners to deal with unaffordable mortgages in bankruptcy is itself a factor of why many Chapter 13 plans fail. Thus Mr. Kittle's assertion is actually upside-down: if mortgages could be modified in Chapter 13, then those modifications would be much more likely to be successful because plans would be more likely to be consummated which would reduce unsecured debts and free up income to pay off the modified mortgage more easily. Your proposal is needed to help homeowners save their homes in bankruptcy.

2. **Based on your own research, do you agree with Dr. Mayer's conclusion that changing the bankruptcy code will increase the cost of borrowing for other families who are not in bankruptcy?**

I disagree with Dr. Mayer's conclusion that changing the bankruptcy code will increase the cost of borrowing for other families who are not in bankruptcy. A key point that many economists, including Dr. Mayer, miss is that bankruptcy modification of mortgages does not exist in a vacuum. They view bankruptcy modification as an alternative to no lender loss whatsoever, and therefore conclude that because lenders would incur losses from modification of

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mortgages in bankruptcy, they will react by increasing cost of mortgages for other borrowers. As Dr. Mayer observed in his written testimony, "Economists often point out that there is no such thing as a free lunch."

The problem with this analysis is that the relevant comparison for a lender is not between losses from bankruptcy modification and no losses. Instead, the tradeoff is between losses due to modification in bankruptcy and losses due to foreclosure. Basic price theory of demand economics says that the mortgage market will respond to this trade-off by pricing against the outcome that results in smaller losses.

So which loss will be smaller? The answer is clearly that bankruptcy modification losses will generally be less than foreclosure sale losses. By definition a lender cannot do worse in bankruptcy than in foreclosure; bankruptcy law provides that a secured lender must receive at least what the lender would receive in foreclosure, namely the value of the collateral.[1] At worst, then, bankruptcy only imposes a *de minimis* time delay on the lender (which may itself be helpful, depending on the housing market). The adequate protection provisions of the Bankruptcy Code, however, ensure that the mortgagee is protected against declines in the house's value.[2] Bankruptcy modification will result in a lender receiving at least as much as in foreclosure, and often more.

There is no evidence one way or another as to whether bankruptcy judges' valuations of property are higher or lower than foreclosure sales returns. My own empirical research, however, indicates that losses due to cramdown would generally be in the 20%-25% range,[3] which is less than typical foreclosure losses and far less than foreclosure losses in the current market. In any case, to the extent that bankruptcy judges' valuations would sometimes be lower, it will be offset by higher returns on modified loans for creditors in some cases. As long as losses in bankruptcy are no greater than those in foreclosure, there should not be any effect on mortgage credit from allowing bankruptcy modification. That said, I would expect that lenders would curtail credit extensions to the riskiest borrowers if the mortgages could be modified in bankruptcy. Bankruptcy forces lenders to be cognizant of credit risk. This is a good thing; had lenders been less cavalier with their lending in the first place, we would not be facing the current mortgage crisis.

The other study that Dr. Mayer mentions in his written testimony, a study by Dr. Karen Pence, an outstanding household economist with the Federal Reserve Board, simply does not address the question of the impact of bankruptcy modification on mortgage credit cost or availability. Dr. Pence's study looks at the impact of judicial versus non-judicial foreclosures on mortgage credit availability. It is an excellent study, but it does not attempt to address the question of bankruptcy modification losses versus foreclosure losses. However, Dr. Pence's finding that reduced creditor rights impact mortgage credit availability is actually consistent with bankruptcy modification not impacting mortgage credit rates or availability because it is the lesser reduction in their right to receive payment than foreclosure.

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[1] 11 U.S.C. § 1325(a)(5).
[2] 11 U.S.C. § 361.
[3] Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WISC. L. REV. (forthcoming).

Dr. Mayer bases his argument on fundamental economic theory, which I believe he misapplies by asking the wrong question: namely bankruptcy losses versus no loss, rather than bankruptcy losses versus foreclosure losses. Notably, he does not and indeed cannot cite any empirical evidence to support a conclusion that permitting modification of mortgages in bankruptcy would have anything other than a *de minimis* impact on the cost or availability of mortgage credit, except for the most risky borrowers. At best bankruptcy modification will have no impact, and at worst it will ensure more prudent and sustainable underwriting standards.

3. **Do you agree with Mr. Stengel's testimony that my proposal would lead to less stability in the financial sector during this time of crisis?**

No, I disagree with Mr. Stengel's testimony because permitting modification of all mortgages in bankruptcy will actually help restore financial stability. The instability in the financial sector comes from unprecedented and unpredicted losses on mortgages. Unless some action is taken to stop mortgage foreclosures, the instability will continue. Fixing the foreclosure crisis will not solve the broader economic crisis, but there can be no fix for the economy without fixing foreclosures.

Moreover, bankruptcy modification will play an important role in getting credit flowing again in financial markets. Bankruptcy not only gives debtors a fresh start; it can also provide a fresh start for creditors. Many lenders are insisting on carrying non-performing mortgage loans on their books, and this puts their solvency in question, which makes counterparties hesitant to deal with them. Bankruptcy modification would force lenders to recognize losses and clean up their balance sheets, which is a necessary step for a liquid financial market, rather than carrying non-performing loans on their books.

4. **As you know, Treasury has adjusted its plans for using the $700 billion in taxpayer bailout money such that it would no longer buy troubled assets. The shift was due at least in part to the difficulty in valuing these securitized assets, because no one knows how much value these mortgage-backed securities will lose as more of the underlying mortgages fail. Though Treasury may have moved on to other approaches, these assets are still clogging balance sheets around the world.**

   Would my proposal—which would facilitate the restructuring of mortgages in these pools that might otherwise fail and therefore restore predictability to the revenue streams—help stabilize these balance sheets and therefore help get banks back lending again?

Yes, your proposal to permit bankruptcy modification of mortgages would help restore credit flows in financial markets and to consumers. As you note, many lenders are insisting on carrying non-performing mortgage loans on their books. This puts their ultimate solvency in question, which makes counterparties hesitant to deal with them, and thus freezes up credit markets. Bankruptcy modification would force lenders to recognize losses and clean up their balance sheets, which is a necessary step for a liquid financial market, rather than carrying non-performing loans on their books. The way to stabilize and restart credit markets is to clean up suspect balance sheets, and bankruptcy modification would mandate that.

5. **In his oral testimony, Mr. Kittle said: "If someone in bankruptcy were to have a $400,000 mortgage on a vacation property and the judge were to reduce that to $350,00, the debtor would be required to pay off the entire $350,000 in equal monthly payments during a three- to five-year repayment plan, not over the course of 30 or 40 years." Please comment on Mr. Kittle's statement.**

Mr. Kittle is correct that many bankruptcy courts require a debtor to either cure defaults and reinstate the original mortgage or modify the mortgage and pay it off over the 3- to 5-year course of the plan.[4] This limitation means that Chapter 13 is currently of limited help for financially distressed homeowners who can modify their mortgages in bankruptcy.

6. **Mr. Kittle offered several criticisms of your study that focused on the impact of changing the bankruptcy code with respect to mortgages on primary residences. Do you agree with those criticisms?**

No. I disagree with Mr. Kittle's criticisms, which are quite revealing about the misleading nature of the Mortgage Bankers Association's claims about the impact of permitting bankruptcy modification of mortgages.

The only substantive criticism that Mr. Kittle offered of my study was its use of Internet mortgage rate quotes (which were only one of several data sources I used). Mr. Kittle questioned the reliability of these quotes. I agree with Mr. Kittle that Internet mortgage rate quotes are a less than perfect source, and I had some misgivings about using them in my study. Because of this, when I prepared my study, I consulted with experienced former mortgage brokers regarding the reliability of the Internet rate quotes, and they assured me that the quotes are in fact reliable. Indeed, the Internet rate quotes all produce exactly the same 37.5 basis point spread in mortgage rates between single-family owner-occupied properties and investor properties that Mr. Kittle relies upon for his claims about the impact of bankruptcy modification.

Nonetheless, I am willing to take Mr. Kittle at his word that the Internet rate quotes published by mortgage banks are not reliable. If the head of the Mortgage Bankers Association is willing to testify under oath that the mortgage industry routinely publishes inaccurate and deceptive rate quotes on which no academic, much less a consumer, should rely, I will not dispute him. If that is how the mortgage industry operates, it has much more serious issues to worry about than the data by a scholarly study, like potential violations of state and federal unfair and deceptive acts and practices (UDAP) statutes. I wish I could say that I am shocked, shocked, that the mortgage industry publishes misleading rate quotes, but in light of the Mortgage Bankers

[4] In my opinion, however, these courts read the law incorrectly. 11 U.S.C. § 1325(a)(5), the provision regarding the treatment of secured creditors in Chapter 13, merely requires that a secured lender receive "value," on account of the claim, not "cash." Congress knew how to require cash payments in the Bankruptcy Code, and it does not for mortgage creditors in Chapter 13. (*cf.* 11 U.S.C. § 1322(a)(2), providing that section 507 propriety claims receive "full payment, in deferred cash payments".) Therefore, "value" could be in the form of a new note for the amount outstanding, as is typically provided in Chapter 11 reorganization plans under the parallel Chapter 11 provision of 11 U.S.C. § 1129(a)(7)(A)(ii). The new note could have a term of longer than 3- to 5-years.

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Association's outlandish claims about the impact of bankruptcy modification on mortgage rates, Mr. Kittle's admission is hardly surprising.

I will, however, point out that Mr. Kittle had absolutely nothing to say about the validity my other data sources—the Federal Housing Finance Board's Monthly Interest Rate Survey, private mortgage insurance rate quotes, Fannie Mae/Freddie Mac delivery fee schedules, and bankruptcy filing schedules—nor could he. These sources all confirmed the finding from the Internet mortgage rate quotes, namely that mortgage pricing does not reflect bankruptcy modification risk—there is no price difference between some property types that can already be modified in bankruptcy, such a two-family residences, and those that cannot be, like single-family owner-occupied residences. These sources are all either subject to regulatory oversight or provided under penalty of perjury. The eighteen years of loan-level Federal Housing Finance Board data are regulatory submissions to the FHFB, which regulates the Federal Home Loan Banks, and Mr. Kittle has not suggested any reason why these detailed regulatory submissions would not be reliable. The rate quote schedules of the seven major private mortgage insurers are fixed and filed with state regulators; they are not subject to manipulation, unlike the quotes offered by mortgage banks, nor are they negotiable for borrowers. They are simply take-it-or-leave-it offers. Likewise, Fannie Mae and Freddie Mac's delivery fee schedules are filed with the Federal Housing Finance Authority (previously Office of Federal Housing Enterprise Oversight) and are fixed and non-negotiable. Mr. Kittle would surely know and not be silent if Fannie Mae or Freddie Mac tried to bait-and-switch mortgage banks on delivery fees. Finally, bankruptcy filing schedules of assets and liabilities are filed under penalty of perjury as part of bankruptcy cases. While there may be some good faith errors in the schedules, I do not believe that they can be systematically written-off as inaccurate, nor has Mr. Kittle challenged them.

Mr. Kittle also questioned the reliability of my article because it had not been "peer-reviewed." Standard legal academic publications are not peer-reviewed. Nonetheless, my study has been accepted for conferences based on peer-review, including the American Law and Economics Association's Annual Conference, the Conference on Empirical Legal Studies, and the Harvard-Texas Joint Conference on Commercial Realities. The article was also been presented before the faculties at Georgetown University Law Center and the University of Virginia School of Law, and at the Federal Reserve Board. My professional reputation and career success as an academic (and particularly as an untenured one) depends on the quality of my research. Presentation before my colleagues at Georgetown and at other peer institutions is itself a form of peer-review, and ensures a high level of quality to my work.

The academic review process to which my work is subject underscores an essential contrast between my critique of the MBA's claims and Mr. Kittle's criticism of my study. All the data and sources that support my article are publicly available and can easily be verified, in contrast to the numbers in the MBA's ever-changing claim about the impact of bankruptcy modification on mortgage credit.[5] The MBA's provides numbers that are not verifiable, much less even a general sense of its methodology in generating its numbers.

The unverifiable and indeed, wholly concocted nature of the MBA's claims can be seen

[5] I refer you to my written testimony, which details the astonishing changes in the Mortgage Bankers Association's claim and methodology.

in Mr. Kittle's response to your written follow-up questions. In his response, Mr. Kittle attempts to support the MBA's concocted 150-basis point mortgage rate increase claim by providing a breakdown of the 150 basis points. But nothing in Mr. Kittle's submission explains how he arrived at the specific numbers in the breakdown, much less the total sum. As far as I can discern, they are pure inventions.

For example, Mr. Kittle claims "[h]igher default incidence rates would increase mortgage rates by 70-85 basis points." Mr. Kittle however, provides no basis whatsoever for this calculation. In order to reach such a conclusion, it would be necessary, at the very least, to determine how many additional mortgagors would declare bankruptcy, who would not otherwise default. It is also necessary to determine what lenders' losses on those mortgages would be. And it is necessary to determine what additional losses could be attributable to bankruptcy modification for those mortgages on which the borrower would default anyway.

Mr. Kittle and the MBA have no idea what those numbers are. Although Mr. Kittle claims "Higher severity rates would increase the cost of a mortgage by 20-25 basis Points," he presents no basis for this range. There is no evidentiary basis for the Mr. Kittle's assertions. The same goes for his claims about higher administrative costs, increased political risk, and increased market uncertainty. Mr. Kittle's and the MBA's claims about rate increases due to bankruptcy modification are simply made up.

Finally, I wish to point out that Mr. Kittle has never, at any point, been able to respond to my criticism of that the MBA's numbers are the result of a cherry-picked comparison and that a non-cherry-picked analysis contradicts the MBA's claims.

Mr. Kittle correctly recognizes in his response to your written follow-up questions that "[S]ingle-family, owner-occupied residences are protected from bankruptcy cramdown under current law. Bankruptcy cramdown is, however, allowed for investor properties, vacation homes and multifamily residences in which the owner occupies a unit." Accordingly, he notes, "A comparison between loans for properties protected from cramdown and loans for properties without this protection is useful."

Mr. Kittle gives lip service to the usefulness of this comparison, but he never provides a full comparison. He never compares mortgage rates on single-family owner-occupied properties and multifamily properties. If Mr. Kittle discussed multifamily property mortgage rates, he would have to admit that they show that mortgage markets are simply not sensitive to bankruptcy modification risk (nor should we expect them to be so long as bankruptcy losses are less than foreclosure losses).

Instead, Mr. Kittle, having declared the usefulness of a comparison between property types, cherry-picks his comparison. He compares only investor properties and single-family owner-occupied properties. There is a rate spread between mortgages on these property types. Mr. Kittle attributes an unspecified part of the spread in rates to bankruptcy modification risk. This is a change from Mr. Kittle's prior Congressional testimony, such as to the House Judiciary Committee, where he attributed the *entire* spread to bankruptcy modification risk. In light of this change, however, it is not clear how Mr. Kittle can argue that the impact of permitting bankruptcy modification would be a 150-basis point increase in rates.

In a change from his previous Congressional testimony to the House Judiciary Committee, Mr. Kittle now correctly recognizes that:

> "[T]here are differences among these property types beyond vulnerability to cramdown. For example, investment properties have a higher risk of default and foreclosure, especially during economic downturns, because investors are quick to divest themselves of bad investments. There is also greater loss severity on each foreclosed investment property due to the increased wear and tear commonly experienced on rental properties. These factors lead to higher costs, regardless of the bankruptcy situation."

In other words, there are factors beyond bankruptcy modification risk that affect the rate spread between investor properties and single-family owner-occupied properties. Mr. Kittle has no way of determining how much of the spread is due to non-bankruptcy factors and how much is due to bankruptcy modification risk. As I note in my response to your written question number 12 (below), there is actually very little risk of bankruptcy modification for investor properties because of the current safeguards in bankruptcy law. Moreover, there are no rate spreads between two-family properties and single-family owner-occupied properties. Therefore, it is not clear how Mr. Kittle can conclude that any, much less most or all of the rate spread between investor property and single-family owner-occupied property mortgages is related to differences in bankruptcy modification risk.

Even accepting Mr. Kittle's criticism of one of my study's five data sources, my study's conclusions rest soundly on the other four data sources. Mr. Kittle has not produced any evidence that undermines the ultimate strength of my study's conclusions, much less provides legitimacy to his patently fabricated claims. Simply put, there is no evidence whatsoever that would support a conclusion that permitting modification of mortgages in bankruptcy would have anything other than a *de minimis* impact on the cost or availability of mortgage credit, except for the most risky borrowers. At best bankruptcy modification will have no impact, and at worst it will ensure more prudent and sustainable underwriting standards.

7. **Do you believe that changing the bankruptcy code related to mortgage or primary residences should be limited only to existing loans or should be limited in some other way?**

I believe that all mortgage loans, existing and future, should be modifiable in Chapter 13 bankruptcy without any limitations on the type of property. Mortgage debt should not be treated any differently than any other type of secured debt. There is no principled basis on which to distinguish between a single-family owner-occupied residence and a two-family owner-occupied residence or between a single-family owner-occupied residence, and a car or a yacht or farmland. These collateral types should all be treated the same in bankruptcy.

Moreover, Congress has arguably expressed a preference for Chapter 13 bankruptcies over Chapter 7 bankruptcies, as part of the Bankruptcy Abuse Prevention and Consumer

Protection Act of 2005. Making Chapter 13 bankruptcy a viable restructuring method necessitates the modification of home mortgages, the single largest debt of most consumers. Chapter 13 cannot be fully effective unless all mortgages can be modified under its provisions.

Lastly, permitting bankruptcy modification of mortgages is important not only for resolving the current foreclosure crisis and broader financial crisis, but also for preventing future mortgage-driven financial crises. The mortgage market is uniquely vulnerable to bubbles because it is impossible to short real estate. It is also very difficult to short mortgage-backed securities because they are insufficiently liquid. As a result, there is only optimism, not pessimism reflected in real estate prices, and the real estate market lacks the market discipline of other more liquid markets. Not surprisingly, nearly every financial crisis in United States history has been driven, at core, by a real estate bubble.[6]

The inherent nature of real estate lending to result in bubbles, panics, and failures argues strongly for permitting modification of all mortgages in bankruptcy. Bankruptcy modification both encourages better and more sustainable underwriting standards and provides a safety release for consumers caught in burdensome and unrealistic contracts. Permitting modification of all mortgages in bankruptcy would provide an important safeguard against systemic risk and a stabilizer to the United States financial system.

8. **Do you believe that permitting modification of all mortgages in bankruptcy will encourage better and more sustainable underwriting standards in the future?**

Yes. When creditors are aware that bankruptcy is an option for consumers, they respond with more careful underwriting. The current inability to modify mortgages in bankruptcy was an important factor contributing to the reckless underwriting that caused the current financial crisis.

9. **Do you believe that permitting modification of all mortgages in bankruptcy will encourage more flexible servicing arrangements in the future?**

Yes. As between modifying a loan and foreclosing on it, modification generally provides the efficient outcome for a lender. A modification can be either voluntary or involuntary (as with bankruptcy). Lenders would always prefer the control of the voluntary modification. Going forward, the possibility of mortgage modification in bankruptcy will encourage more flexible servicing arrangements for mortgage-backed securities because the economic lenders (the MBS investors) will want the servicers who manage the mortgage loans to be able to engage in voluntary modifications where it would be efficient.

10. **What role do you see bankruptcy modification as playing in protecting against systemic financial risk?**

Bankruptcy plays a crucial, but often overlooked role in preventing systemic financial risk. Systemic financial risk is a product of unpredictable (or more precisely, unpredicted) losses; predictable losses do not cause systemic risk.

[6] *See* JAMES GRANT, MONEY OF THE MIND: BORROWING AND LENDING IN AMERICA FROM THE CIVIL WAR TO MICHAEL MILKEN 296 (1992).

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Predictability is key to stable financial markets. The nature of systemic risk is that it stems from unpredictable issues. Therefore, reforms aimed at solving this crisis's problems, like changes to the securitization process or to mortgage finance in general, are no protection against future crises. It is the "unknown unknowns" that present systemic risk.

Bankruptcy provides an important protection against these unknown unknowns by making losses more predictable. It does so in two ways. First, it provides a loan modification mechanism that can preserve greater value for lenders than state law debt collection. By limiting losses, bankruptcy narrows the range of potential lender losses. Bankruptcy makes the peaks lower and the valleys higher. Restricting the volatility of consumer debt losses makes thee losses more predictable. Second, for consumer debt, bankruptcy allows for a constant (and reasonably predictable) trickle of losses, rather than a build-up and sudden explosion of defaults. In this sense, bankruptcy provides a safety valve for the consumer economic boiler.

Bankruptcy is not just the social safety that protects middle class consumers. It is also a catchall stabilizer for the entire economy. Ensuring widely available bankruptcy relief both in terms of consumers' eligibility and the range of debts that can be modified in bankruptcy is a key financial system safety reform regardless of private market improvements or specific regulatory reforms. Permitting all mortgages to be modified in bankruptcy is an important step in bolstering this bulwark against systemic risk from consumer debt.

11. **Mr. Kittle testified that approximately two-thirds of Chapter 13 plans are not consummated. Can bankruptcy help a homeowner even if a plan is not consummated?**

Mr. Kittle correctly observed that approximately two-thirds of Chapter 13 plans re not consummated. But just because a Chapter 13 plan "fails" to reach discharge, does not make it a failure in terms of a debtor retaining the home. Even if a Chapter 13 plan is not consummated, it is still possible for the debtor to deaccelerate a defaulted mortgage and cure any arrearage and keep the house by then staying current on payments.

Mr. Kittle fails to recognize, however, that the inability to deal with burdensome home mortgage debt is a major factor in the failure of Chapter 13 plans. The home mortgage is by far the largest single debt for most consumers. Indeed, for many consumers, home mortgage debt is greater than all other debts aggregated. It is simply not realistic to expect most consumers to be able to successful complete a Chapter 13 plan when they are incapable of modifying their single largest debt. Permitting modification of mortgages in bankruptcy will make Chapter 13 a much more effective method of reorganizing consumer finances and providing consumers with a true fresh start so they can return to productivity.

12. **Since investment property mortgages can currently be modified in Chapter 13 bankruptcy, are speculators typically able to benefit from mortgage modification in Chapter 13?**

No. Although investment property mortgages can, in theory, be modified in Chapter 13 bankruptcy, speculators are almost never able to benefit from mortgage modification in Chapter 13. There are several reasons for this.

First, many speculators will not be eligible for Chapter 13. 11 U.S.C. § 109(e) limits the amount of noncontingent, liquidated secured debt a debtor may have and still be eligible for Chapter 13 to $1,010,650.00.[7] This limit will keep many speculators out of Chapter 13. The parts of the country where there has been the most real estate speculation are also the parts of the country with the highest home prices. In California, where the average loan amount is, according to the Mortgage Bankers Association, $331,926,[8] three of these mortgages plus a $15,000 car loan would make a debtor ineligible for Chapter 13. Thus, a speculator with a fairly average car, a mortgage on his own home, and two investment properties would not be eligible for Chapter 13 bankruptcy.

Second, even if the speculator is eligible for Chapter 13, the automatic stay will likely be lifted on an investor property if it is underwater, under 11 U.S.C. § 362(d)(2), as the debtor does not have equity in the property and it is not necessary for an effective reorganization (unless the debtor's business is being a small-time landlord). Moreover, in order to prevent the stay from being lifted under 11 U.S.C. § 362(d)(1), the speculator would have to provide adequate protection, which would be roughly equivalent to rent or mortgage payments, and in a falling market additional protection against collateral depreciation would be needed. Speculators either cannot or will not make these payments, which are essentially a "buy-in" to modifying the mortgage. As a result the stay will be lifted. Once the stay is lifted, the mortgagee is free to foreclose. The areas that have been hardest hit by the decline in housing prices are areas where there had been prices run ups fueled by speculation. These are the parts of the country where investor properties are most likely to be underwater and where the mortgagee would most likely be able to have the stay lifted.

Third, if the speculator were able to avoid the lifting of the automatic stay, plan confirmation might not be possible because of a good faith objection under 11 U.S.C. § 1325(a)(7) or a disposable income objection under 11 U.S.C. § 1325(b). Creditors could well argue that it is not good faith for a debtor to keep an investment (and keep building up equity in the investment) when they are not getting paid in full. Likewise, unsecured creditors could argue that the debtor is not paying all disposable income to them if they are instead paying the investment property mortgagee.

Finally, even if the plan is confirmed, the speculator will, in most courts, have to pay off the modified mortgage within the 3- to 5-year term of the plan, and this may not be feasible. Thus, it is extremely unlikely that a speculator would be able to take advantage of bankruptcy modification.

[7] This corrects my original written testimony, which incorrectly cited the non-inflation adjusted Chapter 13 eligibility limit.

[8] *See* Mortgage Bankers Association, Stop the Bankruptcy Cramdown Resource Center, *at* http://www.mortgagebankers.org/StopTheCramDown.

13. **What happens to private mortgage insurance when a loan is modified consensually and what would happen if the loan were modified in bankruptcy?**

Private mortgage insurance policies may be terminated at the insurer's option if a loan is modified. Private mortgage insurers frequently permit modifications within specified guidelines. Insurers are willing to permit these modifications because otherwise lenders would not do modifications and would just foreclose, with the first loss being borne by the mortgage insurer. Private mortgage insurers are willing to permit modifications because they recognize that they will incur smaller losses from loan modification than from foreclosure, and they do not want to drive homeowners into foreclosure.

Most, but not all private mortgage insurers have a coverage exclusion for bankruptcy modification. Under policies with these exclusions, if a mortgage is modified in bankruptcy, the loss is not covered by private mortgage insurance. The variation in exclusions among mortgage insurers, however, shows that lenders can insist on insurance to cover themselves in the event of bankruptcy. This is a risk insurers are willing to cover. Many lenders, however, especially on subprime loans, chose to forgo private mortgage insurance. (Fannie Mae and Freddie Mac, however, require mortgage insurance for loans they purchase or securitize). The willingness of some mortgage insurers to continue coverage even if the mortgage is modified in bankruptcy also shows that these insurers know that bankruptcy modification will likely result in smaller losses to them than foreclosure, which would happen if the bankruptcy stay were lifted because the mortgage was too burdensome on the homeowner.

Potential impacts on mortgage insurance are not a valid reason to refrain from permitting mortgage modification in bankruptcy.

RESPONSE OF CHRISTOPHER J. MAYER TO QUESTIONS POSED BY SENATOR RICHARD J. DURBIN
COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE
HEARING: HELPING FAMILIES SAVE THEIR HOMES: THE ROLE OF BANKRUPTCY LAW
NOVEMBER 19, 2008

Thank you for the opportunity to respond to some additional questions.

1. Lenders have borne great losses in this crisis. In my proposal, I suggest that lenders should have to share in future losses as well. I always proposed that lenders bear the costs of their actions. Yet it is also true that driving lenders into the ground will harm future credit availability and likely force the government into future bailouts that are quite expensive to taxpayers. Borrowers must also bear some consequences of their actions. The vast majority of homeowners took on debt that they could afford and are not in financial trouble. As well, my testimony clearly states that I believe we need to help homeowners and stop foreclosures. However, there are tradeoffs.

   I am most sympathetic with homeowners who took out option ARMs or adjustable subprime ARMs that they did not understand and could not afford once rates reset. My testimony suggests that IF we are going to purse a policy of allowing cram downs, the policy should be limited to those homeowners who receive such misleading mortgages. I think we should try to help those homeowners. Many friends and relatives have commented to me that they did not take on too much debt to live in a house that they could not afford and they think it is unfair that borrowers are rewarded by remaining in a house they could not afford.

   The issue of tradeoffs surely comes up in that applying judicial cram downs has the great likelihood of restricting credit availability in the future. The more narrowly constructed the program of cram downs, the smaller the likelihood that the program will raise rates on future borrowers.

2. I respectfully disagree that there is an inconsistency in my argument. There are two distinctions between the proposed legislation on "cram downs" and my proposal. First, my proposal is voluntary, although I expect that many lenders would go along with it. The voluntary nature is important in determining whether policy would raise the cost of borrowing in the future. Second, in my proposal, the losses are shared between the servicer and taxpayers. One major reason for the failure of Hope for Homeowners is that lenders must bear 100% of the losses from principal write downs. In my proposal, lenders would share losses with the government, so the lenders share of the losses would be much lower than in Hope for Homeowners and thus lenders are much more likely to participate. As well, taxpayers would receive a share of future appreciation in houses that participate in the program. The shared appreciation component is

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key in giving taxpayers something in return for their investment, but also in having homeowners give up something in return for remaining in their home. It is not unreasonable to expect that homeowners who took on too much leverage should give up something.

3. As stated in my testimony, I believe evidence strongly suggests that mortgage cram downs will raise the cost of borrowing in the future. This means that we should think carefully about pursuing a judicial approach to the crisis. That is my comment about "no free lunch." I would especially reiterate my written testimony which highlights Table 2a and 4a in Professors Levitin and Goodman's study. Those tables show that credit is reduced and is more expensive with cram downs. Karen Pence from the Federal Reserve finds the same evidence in her research.

   (a) I would prefer that we find ways to modify loans where ever possible, but that those modification efforts avoid bankruptcy in order to limit the impact on future borrowing costs. In my testimony, I list a number of recent private market proposals to modify loans and support those efforts. I think it is an important to better understand whether efforts to modify loans are successful or not. Recent evidence suggests that loan modifications often fail. Similarly, bankruptcy payback programs also fail at high rates. So there are times when it is not possible to work out troubled loans and foreclosure is necessary. From a lender's perspective, it would be enormously costly to undergo a cram down and a period of receiving limited payments, only to have the borrower re-default and then end up having to sell the house years later for even lower prices. So lenders could lose even more in a cram down situation relative to a foreclosure.
   (b) I would respectfully disagree that banks are getting a free lunch when they foreclose. Banks lose large amounts of money in a foreclosure; no one wins. In some cases, servicers on securitizations may not be taking enough effort to modify loans and we need to find ways to more strongly encourage third-party servicers to modify loans. I do not think that strip downs are appropriate to apply to all mortgages so that we can impact only loans managed by third party servicers.

4. Many mortgage modification plans are going to fail. It is not likely to be possible to keep all homeowners in their homes. As noted above, bankruptcy plans often fail as well. Private efforts to modify loans are improving rapidly, especially those by portfolio lenders for their own mortgages. My testimony listed a new generation of loan modification plans by portfolio lenders. The failures in studies are based on the previous generation of less aggressive mortgage modifications. The new private programs are very aggressive in attempting to modify loans, but nonetheless, most of these programs also rely on forbearance rather than cram downs. Portfolio lenders have strong incentives to modify their loans relative to foreclosure. I continue to believe the bankruptcy process will slow down these private resolutions and encourage additional borrowers who could now pay their mortgage to stop paying. I believe this will delay resolution of the mortgage crisis.

However, I strongly agree with your goal of reducing foreclosures. My work hopes to achieve the same goal. Lower mortgage rates and loss sharing are my preferred approach. I believe that recent rate reductions will help enormously.

SUBMISSIONS FOR THE RECORD

Testimony of Michael D. Calhoun
Center for Responsible Lending

Before the U.S. Senate Judiciary Committee

"Helping Families Save Their Homes: The Role of Bankruptcy Law"

November 19, 2008

Good morning Chairman Leahy, Ranking Member Specter, Senator Durbin and other members of the Committee. Thank you for holding this hearing on judicial loan modifications and for inviting me to testify.

Introduction

I serve as president of the Center For Responsible Lending (CRL), (www.responsiblelending.org), a not-for-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of Self-Help (www.self-help.org), a nonprofit community development financial institution that consists of a credit union and a non-profit loan fund.

For close to thirty 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 total, 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 America.[1]

With the constant barrage of statistics and staggering dollar figures that have become commonplace during this financial crisis, it is easy to become numb to the depth and scope of the financial pain American families are experiencing today. However, the numbers paint a picture we cannot ignore. Using recent data from the Mortgage Bankers Association, we calculate that foreclosures on all types of mortgages are occurring at an annual rate of 2.3 million.[2] On subprime mortgages alone, the "spillover" costs are massive. At least 40 million homes—households where, for the most part, people have paid their mortgages on time every month—are suffering a decrease in their property values of $352 billion.[3] And these figures only consider spillover for subprime foreclosures, let alone prime and Alt A, which will drive the losses much higher. These losses, in turn, are infiltrating nearly every part of American life, from police and fire protection to community resources for education.

The most pressing need today is to help homeowners stay in their homes and, by extension, support their neighbors' property values and the financial system as a whole, since financial institutions will not survive if their mortgage-related portfolios continue to fail. As we have become accustomed to hearing about the losses stemming from foreclosures,[4] we also hear on a regular basis that the foreclosure epidemic is being addressed through the voluntary efforts of servicers and lenders. Notwithstanding these efforts and results published by HOPE NOW,[5] the foreclosure problem is getting worse, not better. In fact, the voluntary efforts have typically *raised* a distressed family's mortgage payment instead of lowering it, resulting only in a temporary fix with a high probability of failure.[6]

We have been encouraged by more recently proposed streamlined modification programs that include systematic affordability thresholds to better ensure sustainability. We have urged the Treasury Department to promptly implement a streamlined program using its authority under the Troubled Asset Repurchase Program (TARP).[7] In particular, we have recommended that Treasury adopt the FDIC's proposed loan modification guarantee program and provide guarantees to modifications from servicers with streamlined affordable modification protocols based on the FDIC/IndyMac model under the authority provided by Section 109 of the Emergency Economic Stabilization Act (EESA).[8] However, even a well-designed streamlined program has its limitations. While a strong step in the right direction if implemented, certain aspects of a streamlined program are potentially problematic, and it may not be able to reach sufficient numbers of loans held in private label securities.

Given the challenges of even the most promising voluntary efforts, something more is needed: a mechanism (1) to maximize the effectiveness of existing and proposed voluntary efforts by inducing lenders and investors to make sustainable modifications; and (2) to serve as a last resort for those homeowners who could afford market rate loans but who will fall through the cracks of voluntary programs when the servicer either cannot or will not modify. The most efficient and cost-effective way to accomplish this is to lift the ban on judicial modification of primary residence mortgages so that a court can provide an economically rational solution when the investors or servicers do not. Working through the existing infrastructure of the bankruptcy court system, the solution could take effect immediately, leveraging the expertise of the bankruptcy courts. And the plan would be implemented at no cost to the taxpayer.

Judicial loan modifications will provide a strong incentive for servicers and investors to make voluntary programs work, since they will have clear authority to avoid judicial modifications by offering their own workout solutions outside of bankruptcy.

Bankruptcy courts already modify loans for all manner of other debts, including mortgages on vacation homes and investment properties. They should be permitted to do so for a homeowner's primary residence, which is typically the asset most critical to a family's financial and physical security.

Congress provided this solution during the farm crisis of the 1980s, when it enacted the Family Farmer Bankruptcy Act of 1986 to help distressed farmers avoid foreclosure, including on their primary residence. At that time, family farmers were facing declines in property values and unaffordable mortgages, and the bill did for them what court-supervised loan modifications would do for ordinary homeowners facing the same issues.

Consider one homeowner, Candace Weaver, a schoolteacher from Wilmington, North Carolina. Ms. Weaver refinanced her mortgage in 2005 to meet financial obligations after her husband had a heart attack. She received what seemed like a reasonable if pricey loan at 8.9% from a lender named BNC Mortgage. She was not told that two years later, the rate on her loan (a 2/28 ARM) would jump to 11.9%. She could barely afford this higher payment, and after being diagnosed with kidney cancer requiring surgery, she could not make the payment the month of the surgery. Before surgery, she called her servicer to say she would not be able to make her payment that month. The servicer said it couldn't help her until she was delinquent. After her surgery, and after becoming delinquent, Ms. Weaver called again. This time, the servicer said it couldn't help her until she was in foreclosure. Once foreclosure was commenced, the servicer offered her a repayment plan that required her to make the monthly payments at 11.9% <u>and</u> make up any payments she had missed. This was obviously not achievable for her. Yet, even though she could afford a market rate loan, she cannot have her debt restructured.

By contrast, consider Lehman Brothers. Lehman Brothers earned hundreds of millions of dollars in fees purchasing and securitizing the very type of loan aggressively marketed to Ms. Weaver. In the process, it leveraged itself 30 to 1, causing its own failure and harming the entire global financial system. Lehman Bros, in fact, owned BNC, the very same lender that may cost Ms. Weaver her home. The Wall Street Journal investigated BNC and found widespread falsification of tax forms, forging of signatures, and otherwise ignoring of underwriters' warnings.[9] Lehman Brothers, of course, filed Chapter 11 bankruptcy in September. It can have its debts restructured —but Ms. Weaver cannot.

Or consider AIG. Less than two months ago, the Federal Reserve loaned it an $85 billion lifeline when the company appeared on the brink of collapse. Since then, AIG has incurred larger than the then-projected losses on its credit default swap contracts—the profitability of which always essentially rested on an irresponsible bet that doomed-to-fail subprime mortgages wouldn't ultimately fail. Last week, the Fed responded to AIG's continued woes by writing down the $85 billion debt to $60 billion, lowering the interest rate, and extending the repayment term from two to five years.[10] Certainly borrowers, for whom the difference between keeping their home or losing it is often only hundreds of dollars per month, should be afforded the opportunity for a reasonable, modest modification. This would not only help individuals, but is crucial to preventing the downward spiral in housing prices that continues to weaken the entire economy.

The cost of lifting the ban on court-supervised modification is worth noting again. To date, the government has spent or committed well over a trillion dollars bailing out the financial industry with no slowdown in foreclosures to show for it.[11] It has spent only pocket change—if that—to help keep homeowners in their homes. *Lifting the ban on court-supervised modifications wouldn't cost the U.S. Treasury a dollar.* And it would help keep approximately 600,000 families in their homes, helping to stabilize the broader economy as a result.[12]

In this testimony, I will focus on the following points:

I. Abusive lending practices, driven by Wall Street's appetite for them, caused this foreclosure crisis.

II. Foreclosures are occurring at staggering rates, and they are only projected to get worse.

III. Voluntary, loan-by-loan modification efforts are not effectively stemming the tide of foreclosures due to structural, legal, and financial obstacles.

IV. While proposed streamlined modification efforts hold promise, lifting the ban on court-supervised modification is crucial to the success of any voluntary effort for at least two reasons. Primarily, availability of court-supervised modifications will provide incentive for investors to modify loans because homeowners will have the ability to obtain reasonable modifications when lenders and servicers do not provide them. In addition, homeowners who can afford market-rate loans but whose servicers cannot or will not modify their loans should have an avenue of last resort to remain their homes—benefiting not only themselves but their neighbors, their communities, and the economy as a whole.

I. Abusive lending practices, driven by Wall Street's appetite for them, caused this foreclosure crisis.

The flood of foreclosures we see today goes beyond the typical foreclosures of years past, which were precipitated by catastrophic and unforeseen events such as job loss, divorce, illness or death. The current foreclosure crisis is characterized by losses triggered by the unsustainability of the mortgage itself, even without any changes in the families' situation, and even where the family qualified for, but was not offered, a loan that would have been sustainable.

From 2000 to 2005, only 16% of subprime mortgages being securitized were relatively straightforward fixed-rate mortgages. In contrast, 40% were 30-year ARMs, 17% were interest-only loans, 19% were 40-year ARMs, and 8% were balloon loans.[13] The three particularly tricky aspects of the subprime ARMs made during this period are the following: first, the rate jumps up, often sharply, at the end of the initial period, and often without regard to whether interest rates in the economy stay the same or even decline; second, lenders typically made these loans with the understanding that the borrower could not afford the rate increase, and would have to refinance before the rate reset; and third, refinancing before reset entails the payment of a steep prepayment penalty—typically equaling three to four percent of the loan balance.[14]

The number of subprime loans made without full documentation of income climbed from 26% of subprime mortgages in 2000 to 44% in 2005,[15] while a staggering 9 out of 10 Alt-A option ARMs made in 2005 were without full documentation.[16] Failure to escrow for taxes and insurance was yet one more way families were fooled into thinking they could afford what were in fact unsustainable loans, occurring mainly in the subprime market,[17] and contributing to higher rates of foreclosure.[18]

When Federal regulators finally proposed to require lenders to underwrite loans to the fully-indexed, fully-amortizing payment schedule that would apply after expiration of initial rates, interest-only periods, and negative amortization, the response from industry was telling. In fact, at the time, Countrywide estimated that 70% of their recent borrowers would be unable to meet this common-sense standard.[19] Industry's response represented an admission that they had been making unsustainable loans that would eventually result in unaffordable payments.

Wall Street's appetite for risky loans incentivized mortgage brokers and lenders to aggressively market highly risky exploding ARM loans instead of the sustainable loans for which borrowers qualified.[20] As Alan Greenspan told Newsweek, "The big demand was not so much on the part of the borrowers as it was on the part of the suppliers who were giving loans which really most people couldn't afford. We created something which was unsustainable. And it eventually broke. If it weren't for securitization, the subprime loan market would have been very significantly less than it is in size."[21]

Loan originators—particularly independent mortgage brokers—specialized in steering customers to higher-rate loans than those for which they qualified, particularly minority borrowers. They also loaded up the loans with risky features, including prepayment penalties, and encouraged borrowers to take out "no doc" loans even when those borrowers had easy access to, and often provided, their W-2s.

A key driver of the upselling is a practice known as yield-spread premiums (YSPs), in which lenders pay independent brokers special bonuses if they place a customer into a higher-rate loan than that for which the customer qualifies. Generally, the maximum bonus also required the broker to sell the borrower a prepayment penalty to lock in the higher rate. Like other broker fees, the YSPs are paid to the broker upon settlement of the loan, so the broker has no interest in the performance of that loan thereafter.[22]

Market participants readily admit that they were motivated by the increased profits offered by Wall Street in return for risky loans. After filing for bankruptcy, the CEO of one mortgage lender explained it this way to the New York Times, "The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans," he said. "What would you do?"[23]

This upselling resulted in a huge percentage of borrowers paying more for their loans than they should have. A study for the Wall Street Journal found that of the subprime loans originated in 2006 that were packaged into securities and sold to investors, 61% "went to people with credit scores high enough to often qualify for conventional [i.e., prime] loans with far better terms."[24] And even those borrowers who did not qualify for prime loans 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 loans they were given.[25] Had these borrowers received the sustainable loans they qualified for, we would not be facing the foreclosure crisis we are in today.

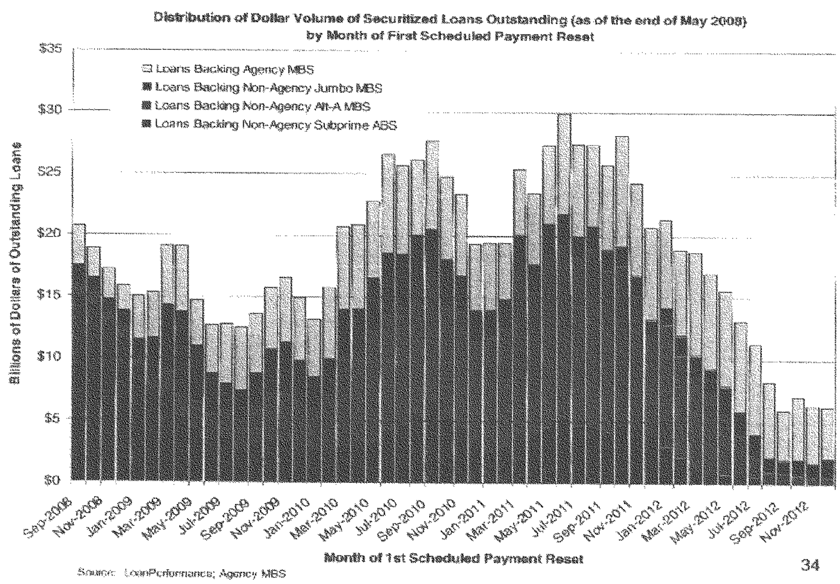
II. Foreclosure figures are mind-boggling, and they're getting worse.

A year ago, some mortgage lenders still insisted that the number of coming foreclosures would be too small to have a significant impact on the economy overall.[26] No one makes that claim today. Today, with foreclosures at an all-time high and projected to go higher,[27] the "worst case is not a recession but a housing depression."[28] According to Credit Suisse, at least two million

American families are expected to lose their homes to foreclosures on subprime loans, most of them by the end of 2009—and this is in addition to the 700,000 homes already in foreclosure or owned post-foreclosure by the mortgagee.[29] According to industry projections, all told (taking account of subprime, "Alt-A" and prime foreclosures), 6.5 million homes—that's one in eight homes with outstanding mortgages—will be lost to foreclosure over the next five years.[30]

Introductory periods on both subprime and nontraditional loans are expiring in astounding numbers, and it's only projected to get worse. Principal loan value on securitized loans scheduled to reset in September 2008 was a little over $20 billion, including $15 billion of subprime and approximately $1 billion of Alt A. Subprime resets are scheduled to decrease steadily between now and mid-2009 and trickle to near zero by late 2010 (with a couple of upticks in mid 2010 and 2011), but since these loans are ARMs, every six months the rates on the loans will change, and resets will potentially rise if currently very low short-term indexes do.[31] And we have not even seen the tip of the Alt A iceberg. Total scheduled resets skyrocket in 2010 and 2011, reaching about $27.5 billion per month in late 2010 and peaking at $30 billion per month in mid-2011. Approximately half of that $30 billion is attributable to Alt A.

Figure 1: Resets of Securitized Loans Outstanding as of May 2008



The decline in housing values, only precipitated by the foreclosures themselves, is leaving millions of homeowners underwater on their mortgages—increasing the likelihood of foreclosures still, in circular fashion. Currently, thirty percent of families holding recent subprime mortgages owe more on their mortgage than their home is worth.[32] These families are at higher risk of foreclosure because this "negative equity" precludes the homeowner from selling, refinancing or getting a home equity loan or other mechanism for weathering short-term financial difficulty.[33] Regulators and economists are increasingly cautioning that loan balance reductions may be needed to avoid unnecessary foreclosures.[34] Federal Reserve Chairman Ben Bernanke has noted: "In this environment, principal reductions that restore some equity for the homeowner may be a relatively more effective means of avoiding delinquency and foreclosure."[35]

The negative effects of foreclosures are not confined to the families who lose their homes. Forty million neighbors of families who face subprime foreclosures—those who are paying their mortgages on time—will see their property values decline as a result by $352 billion. And these are just the effects of *subprime* foreclosures; foreclosures on prime and Alt-A loans will push the losses much higher. Other ripple effects include a reduced tax base, increased crime, further downward pressure on housing prices, and loss of jobs in the industry. Federal Reserve Chairman Ben Bernanke recently noted, "At the level of the individual community, increases in foreclosed-upon and vacant properties tend to reduce house prices in the local area, affecting other homeowners and municipal tax bases. At the national level, the rise in expected foreclosures could add significantly to the inventory of vacant unsold homes—already at more than 2 million units at the end of 2007—putting further pressure on house prices and housing construction."[36]

Not surprisingly, this cycle of foreclosures is also having a dramatic impact on homeownership rates and, by extension, the ability to build wealth, for millions of families. Robert Shiller recently noted that the meltdown and resulting crisis has erased any gains in the homeownership rate made since 2001, and the rate stands to fall further yet.[37]

III. Current voluntary modification efforts have failed to stem the tide of foreclosures.

For over a year, Congress and the Administration have urged lenders to modify troubled mortgage loans where a reasonable modification would be affordable for the homeowner, would avoid foreclosure, and would lead to a recovery for the lender that is as good as or better than what could be recovered at a foreclosure sale. Despite the loss mitigation encouragement by HOPE NOW, the federal banking agencies, and state agencies, the voluntary efforts undertaken thus far by lenders, servicers and investors have failed to stem the tide of foreclosures. Moreover, servicers still face significant obstacles in making modifications.

A. *The number of modifications is inadequate.*

Seriously delinquent loans are at a record high for both subprime and prime loans,[38] and all available data have consistently indicated that (1) continuing foreclosures far outpace total loss

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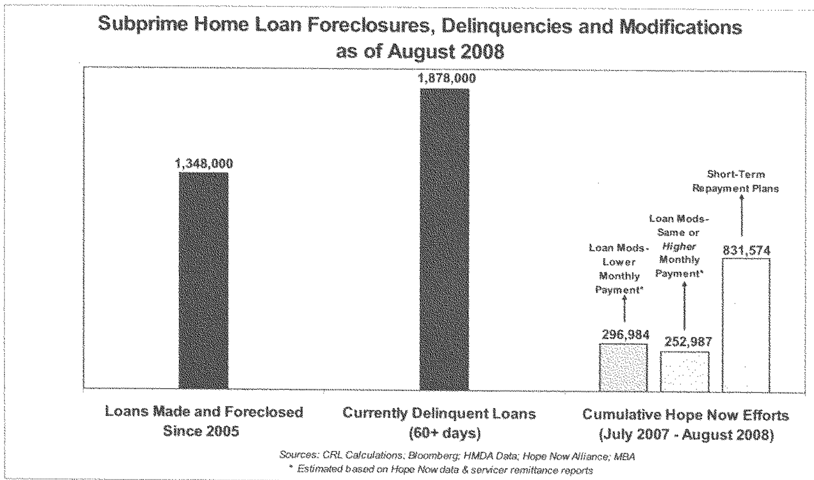
mitigation efforts, and (2) only a small share of loss mitigation efforts result in true loan modifications that are likely to result in sustainable loans.[39]



In October, Credit Suisse reported that only 3.5 percent of delinquent subprime loans received modifications in August 2008.[40] Similarly, the most recent report from the State Foreclosure Working Group of Attorneys General and Banking Commissioners (which covers 13 servicers, 57% of the subprime market, and 4.6 million subprime loans) confirms that progress in stopping foreclosures is "profoundly disappointing."[41] Their data indicate that nearly eight out of ten seriously delinquent homeowners are not on track for any loss mitigation outcome, up from seven out of ten from their last report.[42] Even the homeowners who receive some kind of loss mitigation are increasingly losing their house through a short sale or deed-in-lieu rather than keeping the home through a loan modification or workout.[43]

What's more, when modifications and other workouts are made, they are frequently temporary or unsustainable, leading to re-default and placing homeowners and financial institutions in an even worse economic position than when they started. Data through September 2008 indicate that the large majority of HOPE NOW efforts rely on repayment plans,[44] which typically require financially burdened households to add previously unpaid debt to their current mortgage payments. Not surprisingly, we now see very high rates of re-default on loan modifications, primarily because most loan modifications or workouts do not fundamentally change the unsustainable terms of the mortgage to make the loan affordable to borrowers over the long term.

According to Credit Suisse, when interest rates or principal are reduced, the re-default rate is less than half of those for these other modifications.[45]

The most recently implemented government effort to induce voluntary loan modifications is not off to a very promising start. The FHA's Hope for Homeowners program has experienced underwhelming interest from lenders, receiving less than 100 applications during its first month of operation and lowering its estimate of how many homeowners it will help during its first year to 13,300[46]—out of 2.3 million projected foreclosures.

B. *Numerous legal and structural obstacles stand in the way of modifications.*

A recent Federal Reserve Staff Working Paper identifies a number of obstacles that limit the scale of modifications.[47] These obstacles help explain why voluntary loss mitigation cannot keep up with demand.

- *Investor Concerns:* Servicers may shy away from modifications for fear of investor lawsuits.[48] While most Pooling and Servicing Agreements (PSAs) provide adequate authority to modify loans, these modifications may cause disproportionate harm to certain tranches of securities over other classes. Investors are also particularly concerned about re-default risk, where their short term losses from modifications will be compounded by future foreclosure costs, which will increase as housing prices continue to fall, if the borrower cannot sustain payments under the modified terms. In addition, when servicing securitized loans, some PSAs limit what servicers can do by way of modification. For example, some limit the number or percentage of loans in a pool that can be modified.[49]

- *Second Liens:* Additional liens on a property pose a structural obstacle that is often impossible for servicers of the first lien to overcome. Between one-third and one-half of the homes purchased in 2006 with subprime mortgages have second mortgages,[50] and many more homeowners have open home equity lines of credit secured by their home. The holder of the first mortgage will not generally want to provide modifications that would simply free up homeowner resources to make payments on a formerly worthless junior lien, nor to modify a loan where there is a second mortgage in default. But as Credit Suisse reports, "it is often difficult, if not impossible, to force a second-lien holder to take the pain prior to a first-lien holder when it comes to modifications," thereby dooming the effort.[51]

- *Servicer Incentives*: The way servicers are compensated by lenders creates a bias for moving forward with foreclosure rather than engaging in foreclosure prevention. Servicers are often not paid for modifications but are reimbursed for foreclosure costs.[52] The Federal Reserve concludes, "Loan loss mitigation is labor intensive and thus raises servicing costs, which in turn make it more likely that a servicer would forego loss mitigation and pursue foreclosure even if the investor would be better off if foreclosure were avoided."[53]

- *Limited Servicer Staff and Technology:* With few but welcome recent exceptions, servicers have continued to process loan modifications in a labor-intensive, case-by-case review. While they have added staff and enhanced systems, the lack of transparent, standardized formulas has limited the number of modifications that have been produced.[54]

IV. The key to inducing voluntary modifications is the availability of court-supervised modifications.

The most promising voluntary program proposed to date is the FDIC's proposal that Treasury use its TARP authority under Section 109 of EESA to guarantee 50% of investor losses on loans modified under streamlined affordable modification protocols.[55] This program, which would tap up to $50 billion—or 7%—of the total $700 billion authorized by EESA, has the potential to facilitate modification of three million loans. We have urged Treasury to implement it immediately, and we hope Congress will urge or require Treasury to do the same.

However, we are also keenly aware that even a well-designed voluntary program is still voluntary and will not be 100 percent effective. Certain aspects of a streamlined program are potentially problematic, and it may not be able to reach sufficient numbers of loans held in private label securities. So despite what voluntary programs are implemented, an additional mechanism is critical for two reasons—to induce voluntary modifications and to provide a critical backstop for borrowers who could afford market-rate loans but are not assisted by voluntary efforts.

A. The primary goal of lifting the ban on court-supervised modifications is to induce voluntary modifications.

We estimate that lifting the ban on judicial modification of mortgages on principal residences could help approximately 600,000 families at risk of foreclosure remain in their homes[56]—not because 600,000 families would file for bankruptcy, but because knowing that homeowners who aren't offered conforming modifications have the option to file for bankruptcy will induce servicers to voluntarily modify loans, allowing homeowners to keep their homes.

The mediocre results of voluntary efforts so far have demonstrated that servicers and investors often need every reasonable incentive possible to be encouraged to modify loans. If investors know that homeowners who can afford market-rate mortgages will ultimately receive modifications whether or not they are offered voluntary ones, they will have every incentive to authorize voluntary modifications and servicers will have the assurance that they are acting in the investors' best interests by administrating them. In addition, bankruptcy judges, who are extremely skilled at debt workouts, could help develop modification templates that could be used by servicers outside of the bankruptcy court context.[57]

The Family Farmer Bankruptcy Act of 1986 provides an informative precedent, demonstrating how the availability of bankruptcy would increase voluntary modifications. That legislation enacted what is now Chapter 12 of the Bankruptcy Code for the specific and express purpose of permitting bankruptcy judges to modify mortgages on family farms, including primary residences located on these farms, permitting adjustment of interest rates and the adjustment of secured principal balance to the fair market value of the property. The allowance of court-supervised modifications induced more voluntary modifications outside of bankruptcy because everyone knew the alternative. After being extended several times, the Family Farmer Bankruptcy Act was made a permanent part of the Bankruptcy Code in 2005. In addition, as Richard Levin, Vice Chair of the National Bankruptcy Conference, has said, the success of Chapter 12 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 by the courts.[58]

B. Court-supervised modifications also provide a last resort to homeowners whose servicers won't modify their loans, even though they can afford a market-rate loan.

Even if a streamlined voluntary program is implemented, a significant number of troubled homeowners who could sustain a mortgage on economically rational terms will nonetheless be forced into foreclosure because the loan servicer cannot or will not agree to modify the loan. Often this result will be to the clear detriment of investors as a whole. In such cases, what is needed as a last alternative to foreclosure is a mechanism that enables a court to break the deadlock and provide an economically rational solution that avoids foreclosure and nets the lender at least as much as would be recovered through a foreclosure sale.

C. The proposed plan to lift the ban on court-supervised modifications is narrowly tailored to prevent borrower windfall and minimize the downside for lenders—and it comes at no cost to the taxpayer.

Currently, judicial modification of loans is available for owners of commercial real estate and yachts, as well as subprime lenders like New Century or investment banks like Lehman Bros., but is denied to families whose most important asset is the home they live in. In fact, current law makes a mortgage on a primary residence the only debt that bankruptcy courts are *not* permitted to modify in Chapter 13 payment plans. Removing this exclusion would help homeowners (but not speculators) who are committed to staying in their homes, without bailing out investors and without imposing costs on the taxpayers.

The bankruptcy legislation currently proposed is in fact narrower than the Family Farmer legislation in that the current proposal applies only to people who meet a strict means test to establish their inability to make their mortgage payments, whereas the Family Farmer legislation applied to all family farmers. The proposal also provides substantially greater guidance to (i.e., limitations on) bankruptcy judges in setting the new loan terms. These limitations provide greater certainty and protection for lenders, ensuring them control over the homeowner's ability to obtain such relief at all, as a sustainable loan modification offered by the lender will disqualify the homeowner for bankruptcy relief.

Following are several key elements of the proposed plan:

1. Induces voluntary loan modifications. As noted above, voluntary modifications and refinancings are the goal, and we continue to encourage promising streamlined efforts aimed to facilitate them. Regardless of what voluntary plans gain momentum, court-supervised modifications are a critical tool in the toolbox, making any voluntary

modification program more likely to succeed. Lenders would hold the keys to the courthouse, and can avoid court-supervised modification through voluntary modification. If the servicer agrees to a sustainable modification, the borrower will not qualify for bankruptcy relief because they will fail the eligibility means test. The American Securitization Forum fast-track modification process enables lenders to modify loans in borrowers' favor even without borrower consent.

The availability of court-supervised loan modifications removes the threat of investor lawsuits—investors would have no reason to sue over a modification if the same or more costly modification could be made by a judge. Moreover, as Lewis Ranieri, founder of Hyperion Equity Funds and generally considered the father of the securitized mortgage market,[59] has recently noted, judicial modification is the only way to break through the problem posed by second mortgages.[60]

2. Narrowly targets families who would otherwise lose their homes and excludes families who do not need assistance. The proposal ensures that loan modifications are available only where the homeowner's income is insufficient, after deducting modest IRS-approved living expenses, to cover the existing mortgage payments. In addition, there is a good faith requirement that allows courts to exclude anyone who wrongly makes it through existing hurdles. These requirements ensure that judicial modification will only be available for those loans that would otherwise end in foreclosure. In foreclosure, the lender cannot recover any more than the market value of the home and typically recovers far less after a one- to two-year process. Moreover, homeowners' own self-interest will provide strong incentive not to attempt to seek judicial loan modifications except as a very last resort. Filing for bankruptcy looms for seven years on individuals' credit reports, dramatically limiting their access to affordable credit and often affecting their property rental and employment options as well.

3. Limits judicial discretion and downside for lenders. The proposal would require courts to set interest rates at a commercially reasonable rate – the current 30-year conventional fixed rate plus a reasonable "risk premium." Senator Durbin's proposal also provides that the principal balance cannot be reduced below the value of the property and that the term cannot exceed 40 years. It also makes relief available only to those families who have sufficient income to afford their loans as modified; if not, the judge would lack the authority to modify the mortgage terms.

4. Costs the U.S. Treasury nothing. Unlike many plans to reduce foreclosures under consideration, this one comes at no cost to the U.S. Treasury.

5. Helps maintain property values for families who live near homes at risk of foreclosure. Preventing 600,000 foreclosures translates to saving $89 billion in wealth for families who aren't facing foreclosure, but whose neighbors are.

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D. Industry arguments against lifting the ban are not supportable.

Industry typically attempts to justify its opposition to lifting the ban on judicial loan modifications with claims that doing so will increase the cost of credit and cause disruption in the market. Neither claim is tenable.

1. *Availability of judicial loan modifications will not increase the cost of credit.*

Several data points demonstrate that lifting the ban on judicial loan modifications will not significantly impact the cost of credit.

First, decades of experience in which bankruptcy courts have been modifying mortgage loans on family farms in Chapter 12,[61] commercial real estate in Chapter 11,[62] vacation homes and investor properties in Chapter 13,[63] demonstrate there were 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.[64]

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 principal reductions experienced no adverse effects on the cost or availability of credit, either as compared with jurisdictions that did not permit principal reductions, or as compared with the period after 1993, when principal reductions were no longer permitted.[65]

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 proposal 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 proposal imposes no additional risk, and hence, no further cost. As noted earlier, the proposal imposes a strict means test that limits relief to those homeowners whose income is insufficient, after deducting modest living expenses allowed by the IRS, to cover their mortgage obligations, and there is a good faith requirement that allows courts to exclude anyone who wrongly makes it through those hurdles. The result of these requirements is that judicial modification will only be available for those loans that would otherwise end in foreclosure. In foreclosure, the lender cannot recover any more than the market value of the home, and typically recovers far less, in a process that typically takes one to two years. Judicial modification guarantees that the lender will recover the value of the property —without the cost or delays of foreclosure.[66]

2. ***Availability of judicial loan modifications will not cause further disruptions to a market already disrupted – by the reckless practices of Wall Street and loan originators.***

Industry has also claimed that lifting the ban on judicial loan modifications will cause market disruption. In late 2007, Mark Zandi, Chief Economist at Moody's Economy.com, testified before this Committee that there was simply no evidence lending credibility to that position. He noted that other consumer loans already covered under Chapter 13 have well-functioning secondary markets.[67] He further noted that the secondary market for non-conforming loans had 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." Lifting the ban on judicial modifications, he stated, was "immaterial by comparison."[68]

Today, nearly a year later, it is difficult to imagine a market more disrupted than the current one. Changes in the securitization process now seem even more inevitable, and lifting the ban on judicial modifications seems even more "immaterial by comparison." As we and others have advocated for lifting the ban on judicial loan modifications, industry has said, "Don't intervene in the credit markets." Recently, though, industry has found itself on the doorstep of the U.S. Treasury, begging for intervention—to the tune of over a trillion dollars, courtesy of the U.S. taxpayers. In evaluating the credibility of the positions taken on this proposal, Congress must not lose sight of the reality that the driving force behind this market disruption – the worst since the Great Depression – is a wave of foreclosures showing no sign of slowing down. Nor should it lose sight of the fact that the foreclosures were caused by the reckless practices of Wall Street and loan originators, many of whom are the very same lenders arguing that allowing judges to modify loans on reasonable, sustainable terms will disrupt the market. To the contrary, judicial modification will slow foreclosures and help stabilize it.

Conclusion

The foreclosure crisis will get worse before it gets better, harming neighbors, communities and the economy as a whole. Our economic recovery depends upon stabilizing the housing sector, and this requires urgent measures to stop the flood of foreclosures. Voluntary loan modification efforts are not sufficient. Investors and servicers need greater incentive to agree to voluntary modifications, and court-supervised modification, as history has demonstrated through the Family Farmer legislation, is the mechanism that will offer that incentive. Further, it provides a critical backstop to enable courts to implement economically rational loan modifications where the parties are unwilling or unable to do so. Court-supervised loan modifications will slow foreclosures on a sufficient scale and time frame to have a meaningful impact. Congress should lift the ban on judicial modification of primary residence mortgages in order to help stem the tide of avoidable foreclosures and stabilize the housing market and the broader economy.

We applaud this Committee for its leadership in pursuing this urgently needed relief.

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[1] Self-Help's lending record includes our secondary market program, which encourages other lenders to make sustainable loans to borrowers with blemished credit. Self-Help buys these loans from banks, holds on to the credit

risk, and resells them to Fannie Mae. Self-Help's loan losses have been under 1% per year, and its programs have increased these families' wealth.

[2] MBA National Delinquency Survey, 2nd quarter 2008. The 5.5 million reported by survey, divided by 0.85 to scale up to market size (accounting for underreporting), multiplied by 0.047, the 2Q 2008 foreclosure start rate, multiplied by 4 to annualize. Another 1.2 million were delinquent but not in foreclosure, and another 492,000 were sitting in foreclosure from previous quarters' foreclosure starts.

[3] These new projections, representing only property value declines caused by nearby foreclosures, not other price drops associated with the slowdown in local housing markets, are based on CRL research combined with data from Merrill Lynch, Moody's Economy.com, and the Mortgage Bankers Association. CRL Issue Brief, *Updated Projections of Subprime Foreclosures in the United States and Their Impact on Home Values and Communities*, Rev. Aug. 2008, *available at* http://www.responsiblelending.org/issues/mortgage/research/updated-projections-of-subprime-foreclosures-in-the-united-states-and-their-impact-on-home-values-and-communities.html.

[4] On October 16, 2008, Eric Stein, senior vice president of the Center for Responsible Lending, testified before the U.S. Senate Committee on Banking, Housing and Urban Affairs regarding the causes of the crisis. While more details can be found in his testimony, it is clear that dangerous lending greatly inflated the housing bubble, and the resulting foreclosures of patently unsustainable mortgages are magnifying the damage of the bubble's collapse. His testimony is *available at* http://www.responsiblelending.org/pdfs/senate-testimony-10-16-08-hearing-stein-final.pdf.

[5] HOPE NOW is "an alliance between HUD approved counseling agents, servicers, investors and other mortgage market participants that provides free foreclosure prevention assistance." *See* http://www.hopenow.com.

[6] "Subprime Loan Foreclosures & Delinquencies versus Lender Workouts," Center for Responsible Lending (September 2008), *available at* http://www.responsiblelending.org/issues/mortgage/quick-references/subprime-loan-foreclosures-delinquencies-versus-lender-workouts.html.

[7] *See* Testimony of Martin Eakes, Center for Responsible Lending, Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Nov. 13, 2008, *available at* http://www.responsiblelending.org/pdfs/martin-testimony-11-13-08-final.pdf.

[8] The proposed FDIC program would require lenders, in exchange for a 50% government guarantee of the loan, to modify the loan such that it carries a housing debt-to-income (DTI) ratio of 31%. This DTI is appropriately lower than those required by other programs, such as the FDIC/IndyMac program, since taxpayer dollars would be at stake. To achieve this affordability ratio, the FDIC proposal applies a three-step approach: 1) Servicers first reduce interest rates for five years, potentially to as low as 3%, to meet the DTI target. Thereafter the rate rises by 1% per year until it reaches a market rate, which is defined as the Freddie Mac survey rate. 2) If this rate reduction is not enough to reach the target DTI, the servicer would increase the loan term to a maximum of 40 years from date of origination. 3) If the loan still isn't affordable, then a portion of principal would be deferred until the loan becomes due or pays off early, with no interest accruing. Monthly payments would be calculated on the lower balance, which would make the loan more affordable.

We have also recommended that the Federal Housing Finance Agency direct the GSEs to facilitate modifications to the greatest extent possible and that Treasury require banks and thrifts that participate in Treasury's equity investment program to adopt streamlined modification protocols.

[9] *See* Michael Hudson, *How Wall Street Stoked the Mortgage Meltdown*, Wall Street Journal, June 28, 2007.

[10] Mary Williams Walsh, *A.I.G. Secures $150 Billion Assistance Package*, N.Y. Times, Nov. 10, 2008.

[11] *Financial Crisis Tab Already in the Trillions*, CNBC.com, Nov. 17, 2008, *available at* http://www.cnbc.com/id/27719011. This tally calculates nearly $4.3 trillion, including the Federal Reserve's expanded discount window lending and stating "not every cent [of the $4.3 trillion] is direct[ly] a result of what's

called the financial crisis, but it [is] arguably related to it." It's easy to reach over a trillion – AIG: $112.5 billion; Bear Stearns $28.5 billion; TARP $700 billion; GSEs $300 billion, totaling over $1.14 trillion.

[12] We have estimated 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%). For a complete explanation of our calculation, *see* Eric Stein, Center for Responsible Lending, Testimony Before the U.S. Senate Judiciary Committee, Appendix A, Dec. 5, 2007, *available at* http://www.responsiblelending.org/pdfs/stein-statement-to-senate-judiciary-looming-foreclosure-crisis.pdf.

[13] Sharad Chaudhary, "An Introduction to the Subprime Mortgage Sector", Bank of America RMBS Trading Desk Strategy (June 27, 2007).

[14] Additionally, subprime lenders generally did not escrow for taxes and insurance as prime lenders do, which left many families reeling when those bills came due. This practice gives the borrower the impression that the payment is affordable when, in fact, there are significant additional costs. A study by the Home Ownership Preservation Initiative in Chicago found that for as many as one in seven low-income borrowers facing difficulty in managing their mortgage payments, the lack of escrow of tax and insurance payments was a contributing factor. Partnership Lessons and Results: Three Year Final Report, p. 31, Home Ownership Preservation Initiative, (July 17, 2006) *at* www.nhschicago.org/downloads/82HOPI3YearReport_Jul17-06.pdf.

[15] Wei Li and Keith Ernst, "Do State Predatory Lending Laws Work?", Housing Policy Debate, Vol. 18, Issue 2 at page 361 (2007), *available at* http://www.mi.vt.edu/data/files/hpd%2018.2/6.hpd_wei-ernst_web.pdf.

[16] *Id.* Moreover, a huge portion of so-called "stated-income" loans were underwritten using dramatically inflated incomes when compared to IRS documents (Mortgage Asset Research Institute, Inc., *Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association*, p. 12, *available at* http://www.mari-inc.com/pdfs/mba/MBA8thCaseRpt.pdf (April 2006)) and lenders routinely failed to verify income even when they could have done so easily. *See, e.g.*, Gretchen Morgenson, *Inside the Countrywide Spending Spree*, New York Times, Aug. 26, 2008; Mike Hudson, Center for Responsible Lending, *IndyMac: What Went Wrong: How an "Alt-A" Leader Fueled Its Growth With Unsound and Abusive Mortgage Lending*, June 30, 2008, *available at* http://www.responsiblelending.org/pdfs/indymac_what_went_wrong.pdf (hereafter IndyMac Report).

[17] Most homeowners with prime mortgages maintain escrow accounts. *See, e.g.,* Fannie Mae "Single Family Selling Guide" Part VII, Section 104.05 ("First mortgages generally must provide for the deposit of escrow funds to pay as they come due taxes, ground rents, premiums for borrower-purchased mortgage insurance (if applicable), and premiums for hazard insurance and flood insurance...")

[18] *See* Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest, *Losing Ground*, Center for Responsible Lending (Dec. 2006), *available at* http://www.responsiblelending.org/pdfs/FC-paper-12-19-new-cover-1.pdf.

[19] Countrywide Financial Corporation, "3Q 2007 Earnings Supplemental Presentation," Oct. 26, 2007.

[20] Mortgage brokers play a key role in today's mortgage market. According to the Mortgage Bankers Association, in 2006, mortgage brokers originated 45 percent of all mortgages and 71 percent of subprime loans. See MBA Research Data Notes, "Residential Mortgage Origination Channels," September 2006.

[21] "The Oracle Reveals All," Newsweek (Sept. 24, 2007) pp. 32, 33.

[22] One look at a broker's rate sheet makes it clear that brokers had every financial incentive to make riskier, more expensive loans. As recently as February 2008, Bear Stearns' rate sheet told its brokers that their maximum 1% yield-spread premium would be cut in half on loans without a prepayment penalty. Bear Stearns, Wholesale Subprime Discount Rate Sheet, Feb. 19, 2008, on file with CRL. YSPs in earlier years were much larger.

[23] Vikas Bajaj and Christine Haughney, *Tremors At the Door – More People with Weak Credit Are Defaulting on Mortgages*, New York Times, Jan. 26, 2007 at C1, C4.

[24] Rick Brooks and Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy As Housing Boomed, Industry Pushed Loans To a Broader Market*, The Wall Street Journal at A1 (Dec. 3, 2007).

[25] Letter from CFAL to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner (Jan. 25, 2007) at 3.

[26] *See, e.g.*, Statement of John M. Robbins, CMB, Chairman, Mortgage Bankers Association at the National Press Club's Newsmakers Lunch – Washington, DC (May 22, 2007) (Speaking of predicted foreclosures, Mr. Robbins stated: "As we can clearly see, this is not a macro-economic event. No seismic financial occurrence is about to overwhelm the U.S. economy."); Julia A. Seymour, "Subprime Reporting , Networks blame lenders, not borrowers for foreclosure 'epidemic,'" Business & Media Institute (Mar. 28, 2007) ("[T]here are experts who say the subprime 'meltdown' is not the catastrophe reporters and legislators are making it out to be. 'We don't believe it will spill over into the prime market or the U.S. economy,' said [Laura] Armstrong [Vice President, Public Affairs] of the Mortgage Bankers Association.").

[27] Renae Merle, *Home Foreclosures Hit Record High*, Washington Post, March 6, 2008.

[28] David M. Herszenhorn and Vikas Bajaj, *Tricky Task of Offering Aid to Homeowners*, New York Times, Apr. 6, 2008 (quoting Susan M. Wachter, a real estate finance professor at the Wharton School of the University of Pennsylvania. According to Professor Wachter, "In the market that we have in front of us, prices decline and supply increases, driving prices down further.").

[29] Rod Dubitsky et al., Foreclosure Trends – A Sobering Reality, Credit Suisse, Fixed Income Research, (Apr. 28, 2008); *see also* Written Testimony of Mark Zandi, Moody's Economy.com before House Subcommittee on Commercial and Administrative Law (Jan. 28, 2008), *available at* http://judiciary.house.gov/media/pdfs/Zandi080129.pdf; *See also* Center for Responsible Lending, *Subprime Spillover*, (Rev. Jan. 18, 2008), *available at* http://www.responsiblelending.org/issues/mortgage/research/subprime-spillover.html.

[30] Rod Dubitsky et al., Foreclosure Trends – A Sobering Reality, Credit Suisse, Fixed Income Research (Apr. 28, 2008) at 2.

[31] *See* Jody Shenn, *Libor Rise to Boost Subprime ARM Defaults 10%, Citigroup Says*, Bloomberg News, Oct.7, 2008.

[32] Edmund Andrews, *Relief for Homeowners is Given to a Relative Few*, New York Times (Mar. 4, 2008) (loans originated in 2005 and 2006).

[33] Kristopher Gerardi, Adam Hale Shapiro & Paul S. Willen, Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures, Federal Reserve Bank of Boston Working Papers, No 07-15 (Dec. 3, 2007) at 3-4 (this otherwise good article misses the fact that certain loans themselves can create the cash flow shortfall that cause underwater loans to fail, when they are structured with initial low payments that are scheduled to rise, such as subprime 2/28 hybrid ARMs, and that certain loan terms have been statistically demonstrated to increase foreclosures, such as prepayment penalties).

[34] Federal Reserve Chairman Ben Bernanke recently said, "When the mortgage is 'underwater,' a reduction in [loan] principal may increase the expected payoff by reducing the risk of default and foreclosure." "Preventable foreclosures" could be reduced, he said, by enabling loan servicers to "accept a principal writedown by an amount at least sufficient to allow the borrower to refinance into a new loan from another source." This would "remove the downside risk to investors of additional writedowns or a re-default." See Bernanke statement.; see also, Edmund L. Andrews, *Fed Chief Urges Breaks for Some Home Borrowers*, New York Times (Mar. 4, 2008); John Brinsley, *Bernanke Call for Mortgage Forgiveness Puts Pressure on Paulson*, Bloomberg.com (Mar. 5, 2008); Phil Izzo,

Housing Market Has Further to Fall, Wall Street Journal (Mar. 13, 2008) ("Last week, Federal Reserve Chairman Ben Bernanke suggested that lenders could aid struggling homeowners by reducing their principal – the sum of money they borrowed – to lessen the likelihood of foreclosure. Some 71% of respondents [i.e., economists surveyed by the NYT] agreed with the suggestion.")

[35] Statement of Federal Reserve Chairman Ben Bernanke on March 4, 2008, note 8, reprinted by Bloomberg.com, *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=apeU.0IaETdM ("Bernanke statement").

[36] Bernanke Statement.

[37] Robert J. Schiller, *The Scars of Losing a Home*, New York Times, May 18, 2008 (noting that the homeownership rate has fallen from 69.1 percent in 2005 to 67.8 percent in the first quarter of 2008, nearly the 67.5 percent rate at the beginning of 2001).

[38] *See* HOPE NOW Data for all periods, *available at* http://www.hopenow.com/upload/data/files/July%202008%20Industry%20Extrapolations.pdf.

[39] *See, e.g.*, "Subprime Loan Foreclosures & Delinquencies versus Lender Workouts," at note 4; HOPE NOW Data, July 2008, *available at* http://www.hopenow.com/upload/data/files/July%202008%20Industry%20Extrapolations.pdf (reporting 197,000 foreclosure starts and 192,000 repayment plans initiated and modifications completed combined in July 2008).

Hope Now reports that from July 2007 to September 2008, servicers have performed 2.47 million workouts. 1.5 million of these are either repayment plans or modifications of subprime loans and the balance of about 966k are repayment plans or modifications of prime loans (*see* HOPE NOW Loss Mitigation National Data July 07 to September 08, last page, HOPE NOW Alliance (October 2008) *available at* http://www.hopenow.com/upload/data/files/HOPE%20NOW%20Loss%20Mitigation%20National%20Data%20July%2007%20to%20September%2008.pdf). The chart included herein shows subprime foreclosures to date (on loans made since 2005), subprime delinquencies at present (on all outstanding), and then dissects the Hope Now workout figure as of August 2008 of 1.4 million.

[40] Credit Suisse Fixed Income Research, Subprime Loan Modifications Update, Oct. 1, 2008, p.2, *available at* http://www.credit-suisse.com/researchandanalytics.

[41] State Foreclosure Prevention Working Group, Analysis of Subprime Servicing Performance, Sept. 2008, at 2, *available at* http://www.mass.gov/Cago/docs/press/2008_09_29_foreclosure_report_attachment1.pdf.

[42] *Id.* at 6.

[43] *Id.* at 7-9.

[44] HOPE NOW Loss Mitigation National Data July 07 to September 08, p. 9 HOPE NOW Alliance (October 2008) *available at* http://www.hopenow.com/upload/data/files/HOPE%20NOW%20Loss%20Mitigation%20National%20Data%20July%2007%20to%20September%2008.pdf.

[45] Credit Suisse, Subprime Loan Modifications Update, p.1.

[46] E. Scott Reckard, *Government's Mortgage Relief Program Gets Few Takers*, L.A. Times, Nov. 5, 2008, *available at* http://www.latimes.com/business/la-fi-mortgage5-2008nov05,0,923240.story.

[47] The Incentives of Mortgage Servicers: Myths and Realities, Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang and Eileen Mauskopf, Federal Reserve Staff Working Paper, Finance and Economics Discussion Series, 2008.

[48] *See* Bajaj, Vikas and Meier, Barry, *Some Hedge Funds Argue Against Proposals to Modify Mortgages*, New York Times, Oct. 23, 2008.

[49] *See* Credit Suisse, The Day After Tomorrow: Payment Shock and Loan Modifications, Apr. 5, 2007 (noting specific examples of PSAs with various modification restrictions, including 5% by balance, 5% by loan count, limits on frequency, and limits on interest rate).

[50] Credit Suisse, Mortgage Liquidity du Jour: Underestimated No More, Mar. 12, 2007 at 5.

[51] Credit Suisse, Subprime Loan Modifications Update, Oct. 1, 2008, at p. 8.

[52] *See* Testimony of Eric Stein, Center for Responsible Lending, Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Oct. 16, 2008, at fn 30, *available at* http://www.responsiblelending.org/pdfs/senate-testimony-10-16-08-hearing-stein-final.pdf.

[53] The Incentives of Mortgage Servicers: Myths and Realities, Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang and Eileen Mauskopf, Federal Reserve Staff Working Paper, Finance and Economics Discussion Series, 2008-46, at p. 15.

[54] *Id.* at pp. 3, 9, 23.

[55] *See* Testimony of Martin Eakes, Center for Responsible Lending, Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Nov. 13, 2008, *available at* http://www.responsiblelending.org/pdfs/martin-testimony-11-13-08-final.pdf.

[56] *See, supra*, note 11.

[57] *See* statement by J. Rich Leonard, US Bankruptcy Judge, Eastern District of North Carolina, *at* http://www.responsiblelending.org/pdfs/leonard-letter.pdf

[58] Richard Levin, Vice Chair on behalf of the National Bankruptcy Conference, Testimony Before the U.S. House Judiciary Committee's Subcommittee on Commercial and Administrative Law, Oct. 30, 2007, at 4-5, *available at* http://www.nationalbankruptcyconference.org/images/NBC%20Testimony.pdf.

[59] Lewis Ranieri to deliver Dunlop Lecture on Oct. 1, Harvard University Gazette, Sept. 25, 2008, *available at* http://www.news.harvard.edu/gazette/2008/09.25/06-dunlop.html.

[60] Lewis S. Ranieri, "Revolution in Mortgage Finance," the 9th annual John T. Dunlop Lecture at Harvard Graduate School of Design, Oct. 1, 2008, *available at* http://www.jchs.harvard.edu/events/dunlop_lecture_ranieri_2008.mov (last visited Oct. 13, 2008). Ranieri, is "chairman, CEO, and president of Ranieri & Co. Inc. and chairman of American Financial Realty Trust, Capital Lease Funding Inc., Computer Associates International Inc., Franklin Bank Corp., and Root Markets Inc. He has served on the National Association of Home Builders Mortgage Roundtable since 1989. . . ." Harvard University Gazette, Sept. 25, 2008.

[61] *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.").

[62] 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.")

[63] 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.

[64] *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").

[65] 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.

[66] For more on why the proposal will not increase the cost of credit, *see* Mark Zandi, Chief Economist and Co-Founder, Moody's Economy.com, Testimony Before the U.S. Senate Judiciary Committee, Dec. 5, 2007, *available at* http://judiciary.senate.gov/hearings/testimony.cfm?id=3046&wit_id=6807 ("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.")

[67] *Id.*

[68] *Id.*

APPENDIX A: Objections to Judicial Loan Modifications—Myth v. Reality

Some industry representatives have raised objections to the Durbin proposal, 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: Durbin proposal 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] demonstrate there were 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 principal writedowns experienced no adverse effects on the cost or availability of credit, either as compared with jurisdictions that did not permit principal writedowns, or as compared with the period after 1993, when principal writedowns 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 proposal 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 proposal imposes no additional risk, and hence, no further cost. The proposal imposes a strict means test that limits relief to those homeowners whose income is insufficient, after deducting modest living expenses allowed by the IRS, to cover their mortgage obligations. In addition, relief is limited to borrowers who have received notice from their servicer that foreclosure is imminent. Finally, there is a good faith requirement that allows courts to exclude anyone who wrongly makes it through those hurdles. The result of these requirements is that judicial modification will only be available for those loans that would otherwise end in foreclosure. In foreclosure, the lender cannot recover any more than the market value of the home, and typically recovers far less, in a process that typically takes one to two years. Bankruptcy modification guarantees that the lender will recover the value of the property—without the cost or delays of foreclosure.

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<u>Myth No. 2</u>: **The Durbin proposal 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.**

<u>Reality:</u> **The Durbin proposal 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.**

By making modification available only to loans that would have ended in foreclosure, the proposal ensures that no new risk or cost will be imposed on lenders. Credit pricing models already capture the risk and cost of a loan ending in foreclosure, and the proposal adds no new risk or cost. 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 proposal 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 proposal.

<u>Myth No. 3:</u> **(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."**

<u>Reality:</u> **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).

[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 they 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 proposal will let speculators and investors off the hook for bad investments.

Reality: The opposite is true: The Durbin proposal will benefit ordinary homeowners only. *It will not have any impact at all on speculators or investors.*

Current law – not the Durbin proposal – allows mortgage loan modifications by speculators and investors. The Durbin proposal 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 proposal will benefit wealthy homeowners and could provide a windfall to the rich.

Reality: The only homeowners who will qualify for relief are those who meet the rigorous standards of Chapter 13 bankruptcy. No one who could keep their home without subjecting themselves to the supervision of a Chapter 13 bankruptcy judge would ever choose this route.

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.

Moreover, under Chapter 13, 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.

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 proposal is designed so that lenders will recover *more* from the modification than from the lender's available alternative (foreclosure). Moreover, modifications have been called for both Senator Dodd's May 2007 Homeownership Preservation Principles (endorsed by industry leaders), President Bush, and 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 proposal 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 proposal 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 proposal, 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.

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<u>Myth No. 7</u>: The Durbin proposal is unnecessary as lenders and servicers are already working with borrowers to help them save their homes.

<u>Reality</u>: Industry data establishes that these modifications are hardly happening at all.

Seriously delinquent loans are at a record high for both subprime and prime loans,[13] and all available data have consistently indicated that (1) continuing foreclosures far outpace total loss mitigation efforts, and (2) only a small share of loss mitigation efforts result in true loan modifications that are likely to result in sustainable loans.[14]

In October, Credit Suisse reported that only 3.5 percent of delinquent subprime loans received modifications in August 2008.[15] Similarly, the most recent report from the State Foreclosure Working Group of Attorneys General and Banking Commissioners (which covers 13 servicers, 57% of the subprime market, and 4.6 million subprime loans) confirms that progress in stopping foreclosures is "profoundly disappointing."[16] Their data indicate that nearly eight out of ten seriously delinquent homeowners are not on track for any loss mitigation outcome, up from seven out of ten from their last report.[17] Even the homeowners who receive some kind of loss mitigation are increasingly losing their house through a short sale or deed-in-lieu rather than keeping the home through a loan modification or workout.[18]

What's more, when modifications and other workouts are made, they are frequently temporary or unsustainable, leading to re-default and placing homeowners and financial institutions in an even worse economic position than when they started. Data through September 2008 indicate that the large majority of HOPE NOW efforts rely on repayment plans,[19] which typically require financially burdened households to add previously unpaid debt to their current mortgage payments. Not surprisingly, we now see very high rates of re-default on loan modifications, primarily because most loan modifications or workouts do not fundamentally change the unsustainable terms of the mortgage to make the loan affordable to borrowers over the long term. According to Credit Suisse, when interest rates or principal are reduced, the re-default rate is less than half of those for these other modifications.[20]

<u>Myth No. 8</u>: The proposal is unnecessary because the FHA's Hope for Homeowners plan will accomplish the same things that the proposal would do.

<u>Reality</u>: The Hope for Homeowners plan is entirely voluntary and will have an impact only to the extent lenders and servicers agree to modify the loans. The plan does not address or alleviate many of the problems that have prevented lenders and servicers from modifying loans to date (see point 7 above), and many borrowers will not qualify. The program is not off to a very promising start: it received less than 100 applications during its first month of operations and lowered its estimate of how many homeowners it will help during its first year to 13,300[21]—out of 2.3 million projected foreclosures.

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Myth No. 9: The Durbin proposal could slow down loan modifications or otherwise interfere with servicers' efforts to voluntarily modify loans.

Reality: The opposite is true. Voluntary modifications by lenders and servicers have been extremely slow in coming, and only a tiny percentage of resetting subprime loans have been modified to date. To the extent lenders and servicers have been hindered by fear of investor law suits, judicial modification would speed the process. In many instances, the mere knowledge that judicial modification is available will motivate lenders and servicers to offer modifications without the necessity of resort to bankruptcy courts.

Myth No. 10: Lenders and servicers are prevented from modifying these loans by securitization vehicles, and the objections of the holders of second liens.

Reality: This is true only some of the time; in many 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 proposal is necessary. Bankruptcy judges can order modifications where lenders and servicers cannot not make them voluntarily.

Myth No. 11: Lenders should be given the opportunity to approve (or veto) any proposed principal writedown.

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 so few modifications are being made.

Myth No. 12: 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 the banks and Wall Street did.

As 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."[22]

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 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 14 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. 13: Bankruptcy modifications are inappropriate because they would shield borrowers from the impact of their poor decisions, thereby creating a moral hazard.

Reality: Historically, and, of course, 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. Most recently, Congress approved a $700 billion industry bailout. The moral hazard has been 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 neighbors as well.[23] 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. Moreover, and critically, lifting the ban on judicial modifications would cost the taxpayers zero.

Myth No. 14: 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.[24] 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.[25]

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 on a loan at the full value of the house; if this is more house than the family could afford, Chapter 13 would not be able to help them.

Myth No. 15: 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 proposal would do for ordinary homeowners today: it empowered bankruptcy courts to modify farmers' secured and unsecured debts—including all mortgage debts.[26] The Family Farmer Bankruptcy Act was applied to existing loans without any constitutional impediment.

The Durbin proposal 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."[27] SIFMA's claim ignores this authority, and relies instead on the earlier case of *Louisville Joint Stock Land Bank v. Radford.*[28] *Radford* has no bearing here, because in *Radford*, the relevant statute provided the lender with "*much less* than the appraised value" of the property.[29] The Durbin proposal avoids this impediment entirely, and so *Radford* has no bearing here.[30]

The constitutionality of the Durbin proposal is not subject to serious dispute.[31]

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").

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* HOPE NOW Data for all periods, *available at* http://www.hopenow.com/upload/data/files/July%202008%20Industry%20Extrapolations.pdf.

14 *See, e.g.*, "Subprime Loan Foreclosures & Delinquencies versus Lender Workouts," at note 4; HOPE NOW Data, July 2008, *available at* http://www.hopenow.com/upload/data/files/July%202008%20Industry%20Extrapolations.pdf (reporting 197,000 foreclosure starts and 192,000 repayment plans initiated and modifications completed combined in July 2008).

15 Credit Suisse Fixed Income Research, Subprime Loan Modifications Update, Oct. 1, 2008, p.2, *available at* http://www.credit-suisse.com/researchandanalytics.

16 State Foreclosure Prevention Working Group, Analysis of Subprime Servicing Performance, Sept. 2008, at 2, *available at* http://www.mass.gov/Cago/docs/press/2008_09_29_foreclosure_report_attachment1.pdf.

17 *Id.* at 6 .

18 *Id*. at 7-9.

19 HOPE NOW Loss Mitigation National Data July 07 to September 08, p. 9 HOPE NOW Alliance (October 2008) *available at* http://www.hopenow.com/upload/data/files/HOPE%20NOW%20Loss%20Mitigation%20National%20Data%20July%2007%20to%20September%2008.pdf.

20 Credit Suisse, Subprime Loan Modifications Update, p.1.

21 E. Scott Reckard, Government's Mortgage Relief Program Gets Few Takers, L.A. Times, Nov. 5, 2008, available at http://www.latimes.com/business/la-fi-mortgage5-2008nov05,0,923240.story.

22 Mark Landler, *European Banker Sees More Bad News Ahead from Lending Crisis*, The New York Times (Nov. 27, 2007) at C1.

23 *See* Center for Responsible Lending, *Subprime Spillover* (Nov. 13, 2007), showing that *available at* http://www.responsiblelending.org/issues/mortgage/research/subprime-spillover.html

24 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.

25 Rick Brooks and Ruth Simon, Subprime Debacle Traps Even Very Credit-Worthy As Housing Boomed, Industry Pushed Loans To a Broader Market, The Wall Street Journal at A1 (Dec. 3, 2007).

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26 Jim Monke, Agricultural Credit, Congressional Research Service Agricultural Policy Briefing Book, http://www.cnie.org/nle/crsreports/briefingbooks/Agriculture/Agricultural%20Credit.htm

27 Id., 311 U.S. at 278 (emphasis supplied).

28 295 U.S. 555 (1935).

29 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).

30 Moreover, whatever Radford's continued viability for propositions not in issue here, in light of SIFMA's reliance on the case, it merits noting 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, 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)).

31 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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APPENDIX B: Experts Support Judicial Loan Modification

- Jack Kemp, a former Republican secretary of Housing and Urban Development, in an LA Times editorial, said: "Bankruptcy law is wildly off-kilter in how it treats homeownership. Under current law, courts can lower unreasonably high interest rates on secured loans, reschedule secured loan payments to make them more affordable and adjust the secured portion of loans down to the fair market value of the underlying property -- all secured loans, that is, except those secured by the debtor's home. This gaping loophole threatens the most vulnerable with the loss of their most valuable assets -- their homes -- and leaves untouched their largest liabilities – their mortgages."[1]

- Lewis Ranieri, founder of Hyperion Equity Funds and generally considered the father of the securitized mortgage market, has recently noted that such relief is the only way to break through the problem posed by second mortgages. For this reason, even though he was the one "who wrote the bankruptcy exemption for first mortgages," he "finally gave up" and now publicly supports permitting bankruptcy courts to modify mortgages on the primary residence.[2]

- Robert J. Shiller, Professor of Economics and Finance at Yale University, Chief Economist and co-founder of MacroMarkets LLC, Research Associate at the National Bureau of Economic Research, and a principal in creating the Standard & Poor's Case-Shiller® Home Price Index supports a change in bankruptcy law because "it will enable the courts to adjust mortgage terms to make it possible for homeowners who are experiencing difficulties making mortgage payments so that they can continue to stay in their homes."[3]

- Former Treasury Secretary Lawrence Summers supports amending the Bankruptcy Code to permit the modification of home mortgages, noting that, "there has been an adequate supply of capital and ability to securitize in the market for vacation and rental housing, where debtors are protected [i.e., able to modify their mortgages in bankruptcy]; and moreover, chapter 12 of the bankruptcy code enacted in the mid-1980s, which applied these principles to family farms, helped to resolve great financial distress without long-term costs in terms of reduced farm lending - despite protestations much like those that are heard today."[4]

- Professor Adam J. Levitin of Georgetown University Law Center recently published a study that examined the potential impact of modification of home mortgages on interest rates and concluded that **"permitting unlimited strip-down would have no or little effect overall on mortgage interest rates."**[5]

- United States Bankruptcy Judge J. Rich Leonard recommends that bankruptcy judges be given the authority to modify residential mortgages stating, "reamortizing and restructuring secured debt is the heart and soul of the bankruptcy process. I do it daily with factories, farms, boats, motor vehicles, vacation homes, investment property – any debt but that secured solely by the principal residence."[6]

- Professor Neil E. Harl, an agricultural economist at Iowa State University, noted the similarities between the current crisis and the farm crises of the 1980s. In response to the latter, Congress created Chapter 12 of the Bankruptcy Code to allow family farmers to modify the mortgages on the family home and farm. The relief provided by Chapter 12 is far broader than current proposals. Nevertheless, Professor Harl found that, "the Chapter 12 provisions **did not have a significant effect on interest rates** (contrary to the arguments by lenders at the time) and did not have a significant negative effect otherwise."[7]

- Professor Susan Schneider, an expert in agricultural law and farm finance and bankruptcy, noted that the concerns raised in opposition to lifting the ban on judicial modifications also were raised in opposition to Chapter 12 during the farm crisis. Yet, "[t]he concerns raised in opposition to Chapter 12 did not materialize in any respect. The availability of credit to the agricultural sector has increased over time, not decreased. **Interest rates did not increase** because of the availability of Chapter 12. Instead, like other loans they have consistently reflected over-all market conditions."[8]

- Richard Levin, Vice Chair of the National Bankruptcy Conference, testified before the House Judiciary Committee last year that, if claims like the MBA's here were true, "the converse also would be true—tightening bankruptcy laws against families and consumers should reduce the price of credit and increase its availability. Yet there is no evidence that the adoption of the 2005 Amendments [to the Bankruptcy Code] did anything to reduce the price or increase the availability of credit."[9]

- <u>Other experts supported lifting the ban on judicial modifications</u>. Also supporting the change in the bankruptcy law are 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 Robert Reich, former Secretary of Labor. The New York Times, USA Today and other editorial boards support it as well.

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[1] Jack Kemp, *Bringing Bankruptcy Home*, Los Angeles Times (January 18, 2008), http://www.latimes.com/news/opinion/la-oe-kemp18jan18,0,2977830.story?coll=la-opinion-rightrail.

[2] Lewis S. Ranieri, "Revolution in Mortgage Finance," the 9th annual John T. Dunlop Lecture at Harvard Graduate School of Design, Oct. 1, 2008, available at http://www.jchs.harvard.edu/events/dunlop_lecture_ranieri_2008.mov (last visited Nov. 13, 2008). Ranieri, is "chairman, CEO, and president of Ranieri & Co. Inc. and chairman of American Financial Realty Trust, Capital Lease Funding Inc., Computer Associates International Inc., Franklin Bank Corp., and Root Markets Inc. He has served on the National Association of Home Builders Mortgage Roundtable since 1989. . . ." Harvard University Gazette, Sept. 25, 2008.

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[3] October 29, 2007 Letter to Senators Leahy, Specter, Durbin, and Schumer from Robert J. Shiller, Stanley B. Resor Professor of Economics and Professor of Finance at Yale University, Research Associate at the National Bureau of Economic Research, and Chief Economist and co-founder of MacroMarkets LLC.

[4] Lawrence Summers, "Prevent US foreclosures," Financial Times (Feb. 24, 2008).

[5] Adam J. Levitin & Joshua Goodman, "The Effect of Bankruptcy Strip-Down on Mortgage Interest Rates," Georgetown University Law Center, Business, Economics and Regulatory Policy Working Paper Series, Research Paper No. 1087816 (Feb. 6, 2008) at 41 (The authors studied both historical data (relating to a period in which some courts believed that home mortgages could be modified in bankruptcy, and comparing mortgage rates in those jurisdictions that permitted modification with those that did not), and current data, including mortgage rates for vacation homes, investor properties multi-family buildings, and family farms, all of which can be modified in bankruptcy.).

[6] April 28, 2008 Letter to Congressmen John Conyers, Jr. and Lamar S. Smith from J. Rich Leonard, U.S. Bankruptcy Judge for the Eastern District of North Carolina.

[7] Feb. 25, 2008 Letter to Members of the U.S. Senate From Professor Neil E. Harl, Distinguished Professor In Agriculture and Emeritus Professor of Economics, Iowa State University (emphasis supplied). Professor Harl was deeply involved in efforts to address farm debt crisis of the 1980s, and wrote a book on the proposals and their consequences (The Farm Debt Crisis of the 1980s, Iowa State University Press, 1990). He was also the principal investigator for two research studies on Chapter 12 Bankruptcy: Faiferlick and Harl, "The Chapter 12 Bankruptcy Experience in Iowa," 9 J. of Agr. Tax'n & Law 302-336 (1988); and Hippen and Harl, "The Experience of Chapter 12 Bankruptcy Filers in Iowa," Iowa Agriculture and Home Economics Experiment Station, Iowa State University, Nov., 1995, 53 pp. Professor Harl notes further that, "It is critically important to recognize that both in the 1980s in the agricultural sector, and in 2007-2008 in the housing sector, the losses have already occurred because the borrowers who receive relief would otherwise have been unable to pay their loans."

[8] Feb. 24, 2008 Letter to Senators Blanche Lincoln and Mark Pryor from Professor Susan A. Schneider, University of Arkansas School of Law.

[9] http://judiciary.house.gov/media/pdfs/Levin071030.pdf at 7-8.

Testimony of Sheriff Tom Dart
Sheriff of Cook County, Illinois
before the U.S. Senate Judiciary Committee
Hearing on "Helping Families Save Their Homes: The Role of Bankruptcy Law"
Wednesday, November 19, 2008

Good morning, Senator Durbin, Chairman Leahy, Ranking Member Specter, and committee members.

Let me first say what an honor it is to be here before you today and what a privilege it is to be able to represent the voices of the thousands of homeowners in Chicago and suburban Cook County who are currently facing foreclosure, as well as the thousands more who, despite their best efforts, know that foreclosure is just a few days away.

I'm here today because of the bold stand we took in Cook County, to stop all mortgage foreclosure evictions. It was the first move of its kind in the country and one that drew national attention to the crisis faced by so many Americans. That growing crisis in our county couldn't be ignored any longer and a drastic step had to be taken.

When I took office just two years ago, there were 18,916 mortgage foreclosure cases filed in Cook County. This year, we project 43,000 will be filed. And when I took office, we were evicting 1,771 families from their homes due to foreclosures. This year, we are on track to evict 4,500 families.

But we stopped all foreclosure evictions until protections could be built into the system. The result of that stand was the creation of new layers of protections for those living in foreclosed homes, as well as for taxpayers. But it was a solution that worked only for Cook County. It was a band aid that has helped problems locally, but what remains is a dire need for a more systemic solution.

Sen. Durbin's plan to allow for the restructuring of mortgage debt during a bankruptcy proceeding is exactly the type of bold stand American homeowners need.

And it's clear from the economy, as well as the continuing rise in foreclosure cases, that the time for talking has long passed. A solution – a bold stand - is needed now.

All you have to do is drive down one of the many blocks our eviction teams drive down each and every day – from the wealthiest suburbs to the inner-city neighborhoods – and the effects of this crisis are easy to see.

Consider a block in Chicago's poverty-ravaged Englewood neighborhood. Once home to 16 houses, that block now has just 4 homes standing. The rest have been demolished and two of the remaining homes are boarded up. A third is about to have a knock on the door from our deputies, explaining that everyone's got to get out.

There was a time when our eviction unit visited the exclusive Barrington Township – Cook County's wealthiest area – maybe one time a month. Today, we're in Barrington and its surrounding towns once a week, carrying out foreclosure evictions.

Boarded up and empty homes, as any law enforcement official will tell you, are a breeding ground for criminal activity. But they also represent a staggering loss in property taxes. Think about that Englewood block for a minute. What once was a thriving block with 16 houses adding to the city's tax base has wilted to just four. That means higher property taxes for everyone else – in addition to what could be a rising mortgage payment, thanks to an adjustable-rate mortgage some sign for without understanding.

Take for instance, Linda Gary – a mother of two living on the West Side of Chicago who took out a second mortgage to put her son and herself through college. She borrowed at 9.5 percent, but after her husband became terminally ill, she tried to re-finance it, but was told she couldn't. She filed for bankruptcy, thinking it would help solve her crisis. Instead, she learned there were no bankruptcy protections that could help her in her situation for the long-term – something she says she was never told before filing.

Or the 74-year-old widow who had to turn for help from the Chicago Coalition for the Homeless, after losing her South Side home to foreclosure in August. After her husband died in 2003, their son moved in to help pay the bills on a house that had been in their family for 20 years. When her son got sick, she re-financed the house, hoping to make ends meet, and was told an ARM was best for her. But when her son got sick again and her adjustable rate changed, she just couldn't keep up. She couldn't get any help from the bank and she lost her family's home in August.

These folks are just a few examples of the very hard-working people in this country whose lives have been destroyed and who simply need help to survive.

In October, Cook County's foreclosure filings were 31 percent higher than they were in October of last year. Right now, 1 in every 313 homes in Cook County is in foreclosure. And so many of those cases, if banks would just take a look, involve someone not thumbing their nose at the mortgage industry. More often than not, it's a hard-working family that simply needs a helping hand.

That's why I am so pleased to see the opportunity presented by Sen. Durbin's bill. It's the kind of helping hand so many people need at this time.

Not unlike the response I got when I stopped all foreclosure evictions, there are some who say Sen. Durbin's bill is not the answer - that it goes too far, that we should continue talking through this problem.

But the time for talking is done. It's time for a bold stand. And Sen. Durbin, your bill is exactly the kind of help that Americans need right now.

United States Senate
Committee on the Judiciary

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Statement of

The Honorable Richard J. Durbin

United States Senator
Illinois
November 19, 2008

Opening Statement of Senator Dick Durbin As Prepared for Delivery
Hearing on
"Helping Families Save Their Homes: The Role of Bankruptcy Law" November 19,2008

This hearing will come to order.
Good morning and welcome to this hearing of the Senate Judiciary Committee on "Helping Families Save Their Homes: The Role of Bankruptcy Law." I thank Chairman Leahy for permitting me to hold this hearing, and I thank my colleagues for attending.

After a few opening remarks, I will recognize Senator Specter, the Committee's Ranking Member, for an opening statement. Then we will turn to our panel of witnesses.
One year ago, I chaired a hearing before this Committee on the looming foreclosure crisis facing our nation.

At that hearing, we heard about how the combination of subprime loans, falling housing prices, and resetting adjustable rate mortgages had put thousands of families out of their homes and threatened millions more with foreclosure.

We heard frightening predictions about how these foreclosures would result in record decreases in home values, instability in the financial services industry, and finally a meltdown in the economy as a whole.

That was the crisis this committee was told we were facing last year. And last year I offered legislation to avert this foreclosure crisis by making a simple change in bankruptcy law.

My proposal was straightforward. Currently, a bankruptcy judge in a Chapter 13 proceeding can modify the structure of any secured debt except for a mortgage on a primary residence. I proposed removing this exception and permitting mortgages on primary residences to be modified in bankruptcy court, just like mortgages on vacation homes.

As we heard at last year's hearing, the benefits of this proposal are clear. We heard testimony that:

•My legislation would significantly reduce the number of foreclosures and help hundreds of thousands of families stay in their homes.

•Mortgage modification in bankruptcy benefits everyone - the homeowner, the lender, the neighboring homeowners and the economy - far more than foreclosure.

•My proposal would give lenders, servicers and investors a real incentive to voluntarily rework mortgages.

•My proposal would not significantly raise the cost of mortgage credit, since the costs associated with Chapter 13 bankruptcy are actually far less for lenders than the costs associated with foreclosure.
And we also discussed how many taxpayer dollars my proposal would cost: zero.

A long list of organizations - from the AARP to the Leadership Council on Civil Rights to the Consumer

Federation of America - agree with me that this bankruptcy proposal represents the best way to reduce the devastating effect of foreclosures on American families and communities.

Over the past year, I tried three times to pass this proposal - as part of Majority Leader Reid's housing bill in the spring, as part of the Senate Banking Committee's housing bill in the summer, and as part of the financial rescue bill this fall. Each time, the Mortgage Bankers Association and most of the financial services industry opposed my proposal, and nothing got done.

Here we are again, one year later. Now we are able to see that many of the dire predictions we heard at last year's hearing have not only come true, but in fact the situation has become far, far worse than anyone imagined.

The economic crisis we face today is as severe as any we have faced since the Great Depression. And the heart of this crisis continues to be the record-high foreclosure rate.
Proposal after proposal has been offered to try to fix our economy and to help keep families in their homes.

•We've seen billions go to prop up Bear Steams and AIG.

•We've seen the government take over Fannie Mae and Freddie Mac.

•We've seen the big $700 billion bailout, much of it going to the same banks that oppose my proposal.

•And we've seen a succession of voluntary housing programs like Hope Now and Hope for Homeowners ... and yet nothing has been successful in fighting the foreclosure crisis on the scale that is required.

The question that faces us now is this: after committing over one trillion dollars in taxpayer money to what has largely been an unsuccessful effort to address the foreclosure crisis and save our economy from a devastating recession, why don't we take a step that would indisputably reduce foreclosures and that would cost taxpayers nothing?

Today we will hear from our distinguished panel of witnesses about how bad the foreclosure crisis has become and how much worse it could get unless the Congress acts.

I want to note in particular that my friend Tom Dart, the Sheriff of Cook County, Illinois, is here to talk about the impact that the foreclosure crisis is having on communities like those in Cook County. I want to thank Sheriff Dart and all our witnesses for coming here today.

Make no mistake - the outlook for our economy is grim. But change is coming to Washington. I'm confident that early next year we will be able to take effective steps to address our economic crisis where it started - by helping families save their homes.
Now I will recognize Senator Specter for his opening statement.
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United States Senate
Committee on the Judiciary

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Statement of

The Honorable Russ Feingold

United States Senator
Wisconsin
November 19, 2008

Opening Statement of U.S. Senator Russ Feingold
Hearing on "Helping Families Save Their Homes: The Role of Bankruptcy Law" Senate Judiciary Committee
As Prepared For Delivery

"Mr. Chairman, thank you for holding this hearing. I want to start by noting that you sounded the alarm on this problem almost a year ago. Your hearing in December 2007 was entitled, 'The Looming Foreclosure Crisis.' And as we have seen the severe economic downturn take shape over the past several months, a significant cause of which has been the huge numbers of foreclosures on subprime mortgages, you have every reason to say: 'I told you so.' You tried to reduce the number of foreclosures, which might have had an effect on falling real estate prices. You tried to protect more Americans from losing their homes. But the lending industry said 'absolutely not' to letting these bad mortgages be modified in a bankruptcy proceeding. And the nation is now reaping what that self-centered and short-sighted position has sown.

"Even as late as October when the bailout package was being considered, this one simple and eminently reasonable change in the law, which is perhaps the only proposal out there that is guaranteed to have a significant effect on the number of foreclosures, was off the table. No, we were told, that would be going too far. No, it was said, the banking industry simply would not stand for that change. And from what we have heard today, it still won't.

"And what was the result? The voluntary loan modification efforts to date have completely failed to slow the rising number of homes going into foreclosure. Just last month, foreclosures increased in Milwaukee County by 41 percent compared to the previous month, and foreclosure rates across Wisconsin have increased by over 20 percent compared to last year. About a million home loans nationwide had gone into foreclosure at the end of 2007. By the end of this year, two million more may meet the same fate. One estimate is that over 10 percent of all residential borrowers could be in foreclosure by 2012. These are frightening numbers.

"There simply is no more time to waste. The next Congress must act very quickly to take your advice, Mr. Chairman. The ripple effects of rising foreclosures are enormous. Foreclosures lead to falling real estate prices which lead to more foreclosures. Local businesses are deeply affected as well, and empty houses lead to crime and greater costs for social services offered by local governments.

"I want to make one final point and then ask our witnesses a few questions. One thing that I think is not well understood is that because of the complex structure of these securitized mortgages that are at the root of the financial calamity the nation finds itself in, voluntary programs to readjust mortgages may simply be doomed to failure. The securities themselves in many cases prohibit reducing the principal owed or otherwise changing the terms of the mortgage. It's not just a matter of a $ingle lender deciding to take a little bit of a loss to save a homeowner from foreclosure. Many of these mortgages have long since been sliced and diced and sold and resold. So a voluntary program just won't help. Only a bankruptcy court has the power, if Congress would only grant it, to. rewrite these mortgages to prevent them from losing even more value.

"So I thank you, Mr. Chairman, for sticking with this issue. And I offer you my full support with the hope that we can finally prevail early next year."

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Leadership Conference on Civil Rights

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November 18, 2008

Honorable Richard Durbin
United States Senate
309 Hart Senate Office Bldg.
Washington, DC 20510

Dear Senator Durbin:

We, the undersigned organizations, write to reiterate our support for legislation that would allow for court-supervised mortgage modification as a way to help families stay in their homes and avoid foreclosure. We greatly appreciate your continuing commitment to finding solutions to this growing national crisis.

Home foreclosures today are at an all-time high, and are projected to go higher. The impact of the record number of foreclosures is felt not only by individual families, but by neighborhoods, communities, and indeed, the economy as a whole. As enormous as the losses to date have been, projections of what lies ahead are more devastating still. According to industry projections, and taking into account subprime, "Alt-A," and prime mortgages, the number of homes predicted to be lost to foreclosure will reach 6.5 million – that's one in eight homes with an outstanding mortgage – over the next five years.

Ever since the mortgage foreclosure crisis erupted into the public eye last year, our organizations have advocated Chapter 13 judicial modification relief as an effective approach to stemming the foreclosure crisis – and one with **no cost to U.S. taxpayers.** We are fully aware that the financial services industry has opposed giving homeowners this option, arguing that it would make loans more expensive and cause instability in the marketplace. While we take such concerns seriously, our economic recovery depends upon stabilizing the housing sector, and this requires urgent measures to stop the flood of foreclosures. Reckless lending by many of these same institutions is part of the problem that judicial modification is needed to help solve.

The very clear lesson of the last 18 months is that the foreclosure crisis will not be resolved through voluntary efforts on the part of the financial services industry alone. Courts must be empowered to implement economically rational loan modifications where the parties are unwilling or unable to do so on their own. Loan modifications through the bankruptcy courts can help accomplish this on a sufficient scale and timeframe to have a meaningful impact. Moreover, the mere availability of bankruptcy relief may encourage mortgage servicers to step up their voluntary modification efforts, thus keeping the homeowner from needing to file for bankruptcy.

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Congress should lift the ban on judicial modification of primary residence mortgages, as part of the solution to stemming the tide of avoidable foreclosures and stabilizing the housing market and the broader economy. The need is urgent. The time for action is now.

Thank you for your consideration. If you have any questions, please contact Rob Randhava of the Leadership Conference on Civil Rights at (202) 466-6058 or Maureen Thompson at (703) 276-3251.

Sincerely,

Leadership Conference on Civil Rights
AFL-CIO
Association of Community Organizations for Reform Now
Center for Responsible Lending
Central Illinois Organizing Project
Consumer Action
Consumer Federation of America
Consumers Union
Lawyers' Committee for Civil Rights Under Law
Leadership Conference on Civil Rights
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 Fair Housing Alliance
Opportunity Finance Network
Service Employees International Union
U.S. PIRG

cc: Senator Patrick Leahy, Chairman, Judiciary Committee
Senator Arlen Specter, Ranking Member, Judiciary Committee
Members, Senate Judiciary Committee

Statement of

David G. Kittle, CMB

Chairman, Mortgage Bankers Association

Before the

Committee on the Judiciary

United States Senate

November 19, 2008

Hearing on

"Helping Families Save Their Homes: The Role of Bankruptcy Law"

Mr. Chairman, Ranking Member Specter and members of the Committee, I am David G. Kittle, CMB, Executive Vice President of Vision Mortgage Capitol in Louisville, Kentucky and Chairman of the Mortgage Bankers Association (MBA).[1] I appreciate the opportunity to appear before you today to testify on behalf of MBA and the mortgage industry concerning the situation in today's housing market, efforts to help families save their homes and to identify the proper role for bankruptcy law.

Many families are facing hard economic times and all reasonable options should be explored to help them save their homes. The mortgage industry has been very active in promoting home retention alternatives to foreclosure for decades. The current crisis, however, has been unprecedented and has required extraordinary resources and new initiatives to help stem the rate of foreclosure. Congress has passed several critical pieces of legislation that have provided the industry with a number of new tools to assist in helping troubled borrowers. From July 2007 to September 2008, the mortgage industry has helped an estimated 2.47 million borrowers avoid foreclosure through repayment plans and loan modifications.[2]

Although these efforts are bold, we agree that additional work needs to be done to stimulate the economy and help those borrowers who are in trouble. MBA is working diligently with its members to look for new ways to overcome some of the obstacles that servicers currently face. We are examining various options, including FDIC Chairman Sheila Bair's proposal, which MBA believes has significant potential to assist more consumers.

At the same time, Congress and the Administration should move cautiously to ensure that any action is fully researched and vetted as to its potential consequences to consumers, financial institutions, the credit markets and the national economy. One of the greatest potential destabilizing initiatives is the topic of discussion today - allowing bankruptcy "cramdown"[3] for home mortgages.

MBA appreciates the opportunity to explain our concerns with legislative proposals to reform the bankruptcy code and to suggest other alternatives.

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[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 370,000 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.

[2] HOPE NOW Alliance Data Release, October 27, 2008.

[3] A cramdown is the modification of various terms of a credit agreement including the stripping or reduction of a lien to the fair market value, the reduction of interest rates or other terms. The term "cramdown" is often used to refer to lien stripping.

While my testimony goes into great detail with a number of concerns, I will focus the first half of my testimony on the following areas:

- The impact of cramdown on mortgage stability,
- Bankruptcy's impact on consumers,
- Cramdown treatment of second homes and vacation properties,
- Impact on inner cities, rural areas and new subdivisions,
- Efforts of the mortgage industry and the government to assist homeowners avoid foreclosure,
- Alternatives to bankruptcy cramdown that can curb foreclosures without damaging the credit market.

Market Stability

Clearly, one of Congress's key objectives is to determine how to unfreeze the credit markets, which has had a tremendous trickle-down effect to both consumers and businesses. Substantial discussion has occurred about the need to relieve the pressure on banks and other financial entities of their bad debt holdings and to stimulate additional lending at favorable terms and rates. Bankruptcy cramdown will not have this effect.

Among the most common bankruptcy reform provisions under consideration are the following:

- Removal of anti-modification protections for home loans, including permitting lien stripping (reduction of the mortgage to the fair market value of the property). Some bills, including S. 2136, limit lien stripping to "subprime" and "non-traditional products" and/or impose an income test. S. 2133 requires creditor approval;
- Allowing home loans to be repaid beyond the term of the Chapter 13 plan, which today cannot exceed three to five years;
- Eliminating the requirement to obtain credit counseling before the debtor can file for bankruptcy when the lender has notified the debtor that it may foreclose the loan; and
- Requiring that fees and charges, accruing during the bankruptcy proceeding be filed with the court, among other limitations.

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We understand the well intentioned goal of such legislation is to provide a back stop against the large numbers of foreclosures. However, the unintended result would be large numbers of bankruptcies, higher losses to servicers, lenders and investors, and reduced ability by the financial industry to extend affordable credit. Such bankruptcy reform will have a negative impact on individual borrowers, a housing recovery and the economy as a whole.

In recent weeks we have seen investors flee the GSE paper market. In the past, investors bought these securities because they had the "implicit backing" of the U.S. government. Investors are moving away from these investments due to the uncertain value of those assets. While proponents of cramdown continue to argue against our assertions that the lending community will increase costs due to added risk, investors are astute to the various factors of risk, and prefer predictable investments. Giving bankruptcy judges the ability to cram down mortgage debt does nothing to reassure investors as to the value of their investments.

Borrowers would see the costs of obtaining a mortgage increase. Not only would interest rates and other fees increase, lenders will require higher down payments. The only true way for a lender to protect itself from cramdown risk would be to require a down payment large enough to ensure the home value does not fall below the loan amount during a period of home depreciation. Would a 10 percent down payment be enough for lenders and investors to feel protected from cramdown? Given that the average U.S. home price in 2007 was $313,600,[4] borrowers would be required to come up with $31,000 for their down payment or more. Significantly, many borrowers could be required to put 20 percent down to protect from risk, leaving them in search of more than $62,000 for a down payment. These requirements would hit first-time homebuyers and low- to middle-income individuals the hardest.

Today, a number of borrowers use credit enhancements such as FHA insurance, VA guarantees and private mortgage insurance (PMI) to reduce down payments and lower rates. Proponents of cramdown fail to recognize that lien stripping will render useless these insurance protections for the amount of the cramdown, thus taking away the protections that allowed for lower rates and down payments. In this already fragile market, FHA and VA have become the only affordable, low-down-payment option for the very individuals that these proposals intend to help. (I have included a more detailed analysis of some of these concerns later in my testimony.)

Bankruptcy Is Not a Consumer Friendly Process

In addition to the impact on credit availability, prices and terms, proponents of bankruptcy reform fail to acknowledge the very real and severe consequences for individual consumers who declare bankruptcy. A declaration of bankruptcy

[4] http://www.census.gov/const/uspriceann.pdf

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stays on a consumer's credit report for 7 to 10 years, making it extremely difficult to acquire future credit, especially in the tighter credit environment. Bankruptcy makes it more difficult for borrowers to get credit cards, finance a home or car, or purchase insurance, and in some cases, even obtain employment. Bankruptcy costs consumers about $3,000 to $5,000 in attorney fees and court costs. Moreover, there is no guarantee that a filing will be granted by the judge. Nevertheless, just by filing, it will immediately be reported on the borrower's credit profile. In addition, student loans, child support and certain tax payments will not be reduced, and various options to make the mortgage payment more affordable through loss mitigation are immediately taken out of the hands of a servicer upon filing for bankruptcy. Professor Lynn M. LoPucki detailed the realities of bankruptcies (http://www.bankruptcyvisuals.com/viewcharts.html). Despite the negative effects of bankruptcy, the considerable financial gain mortgage cramdown proposals offer makes bankruptcy almost irresistible. We fear that borrowers would give up their good credit scores in order to eliminate substantial amounts of principal. It is difficult to understand why Congress would rather encourage people to seek bankruptcy than promote other effective and less burdensome ways to help consumers.

If cramdown were truly for the benefit of helping borrowers stay in their homes, why do current proposals remove or postpone the counseling requirement? 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. This is an essential step to protect borrowers from the automatic black mark on their credit profile and gives them an opportunity to meet with a trained financial counselor to review their finances and explain the consequences of filing for bankruptcy.

Proposals Remove Critical Mortgage Creditor Protection: The Myth of the Second/Vacation Home Cramdown.

During this entire debate over whether to change the bankruptcy laws, advocates for cramdown have engaged in misleading dialogue on the treatment of vacation/second homes and investor properties during a Chapter 13 bankruptcy proceeding. To advance their agenda, they would like everyone to believe that the current Bankruptcy Code allows loans secured by vacation homes and investor properties to be crammed down without consequence. This is a fundamental misrepresentation of the facts.

In truth, the current Bankruptcy Code generally allows secured debts[5] other than those secured by a principal residence to be crammed down. However, if they are crammed down, the debtor is required to pay off the *entire amount* of the

[5] The Bankruptcy Abuse Prevention and Consumer Protection Act prohibits car loans from being crammed down for 2 ½ years from origination, which is approximately half of the loan's term. This ensures that car values and principal values are relatively consistent.

secured claim within the three-to-five year duration of the Chapter 13 plan.[6] The debtor does not have 30 years to pay off a modified mortgage as the original loan term may provide. For example, under current law, if a mortgage contract of $120,000 gets stripped down to $100,000, the debtor must pay the entire $100,000 within three to five years in equal monthly installments.

So while the consumer bankruptcy attorneys and other groups would like Congress to believe that individuals with vacation homes or investment properties are given major advantages under the current Bankruptcy Code, in fact, they are required to pay the entire amount of the secured mortgage by the end of their payment plan. Moreover, since these assets are often deemed nonessential to the reorganization of the debtor, they are usually surrendered to the creditor to liquidate through foreclosure without cramdown.

Every legislative proposal introduced to date would remove the requirement that crammed down mortgages be paid off during the term of a Chapter 13 plan. This creates an entirely different risk profile. With the compounded problem of lost mortgage insurance protections due to cramdown, lender losses will mount as will the cost of credit.

Today, the requirement that borrowers pay off crammed down debt within the period of the bankruptcy plan, controls unbridled runs on the bankruptcy court whenever property values or rates decline. This control, however, would be stripped from the rights of home loan creditors. Modified home mortgages would be allowed to survive bankruptcy discharge and be paid over 30 or even 40 years. These proposals encourage borrowers to seek Chapter 13 bankruptcy at the exclusion of all other remedies.

The Impact of Cramdowns on Inner Cities, Rural Areas & New Developments

Not only will cramdown shut the door to financing people with less than perfect credit and limit the options for first-time homebuyers; but inner cities, rural areas, and new subdivisions, where prices are historically more volatile, could be subject to overly cautious lending.

Certain geographic areas hard hit by job losses and population outflows, or that have a high risk of natural disasters, could also suffer. By reforming the bankruptcy law to give judges the unilateral authority to alter the terms of a mortgage contract, Congress will increase the cost of getting and keeping a mortgage in the very same areas it has sought to stabilize.

Going forward, underwriting standards will be drastically changed. Lenders will be forced to engage not only in credit valuation for the borrower, but projections of real estate values. Such predictions will never be accurate and lenders are

[6] 11 USC 1322(d)(2007). See also In re Enewally, 368 F.3d 1165 (9^{th} Cir., 2004).

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likely to err on the side of caution. An appraisal representing current property value will no longer be sufficient to make a credit decision. Lenders will have to assume some level of market decline. If mortgage insurance is still available, it is likely to be curtailed for high loan-to-value loans, less creditworthy borrowers and volatile real estate markets.

Industry Efforts to Prevent Foreclosure

The industry has been engaged in historic efforts to assist distressed homeowners and we believe these have proven successful in stemming foreclosures. We agree more programs can be implemented to provide additional assistance, but it is worth noting what has transpired to date.

- Servicers have assisted a record number of borrowers through various loss mitigation efforts. From July 2007 to September 2008, an estimated 2.47 million repayment plans and modifications have been executed. Foreclosure sales for the same period were approximately 1 million, resulting in a 71 percent workout-to-foreclosure ratio.

- Last week, the Federal Housing Finance Agency and the HOPE NOW Alliance announced a major streamlined loan modification program for GSE and financial institutions' portfolio loans to get struggling homeowners affordable mortgage payments.

- Investors and mortgage insurers are introducing a greater number of helpful options including Fannie Mae's HomeSaver Advance, which allows the borrower to cure a delinquency by placing the arrearage in a subordinate loan that carries no interest or a low interest rate. Mortgage insurers and FHA also have similar programs.

- HOPE NOW in concert with NeighborWorks and the Homeownership Preservation Foundation have assisted in promoting the HOPE™ Hotline, a national counseling network which is available 24 hours a day, 7 days a week, and 365 days a year. The Homeowner's HOPE™ Hotline receives an average of more than 6,000 calls a day. There is no cost to homeowners for contacting a nonprofit counselor.

- Servicers and many of their investor partners are paying for borrowers to have one-on-one counseling sessions with HUD-approved counselors.

- Servicers implemented the American Securitization Forum's (ASF) Streamlined Foreclosure and Loss Avoidance Framework for Securitized Adjustable Rate Mortgages which provides systematic criteria that servicers can use to streamline the evaluation of borrowers in subprime hybrid ARMs in private label mortgage backed securities facing interest rate resets. Approximately 111,000 subprime ARMs have been modified with over 73 percent of these modifications having duration of five years or longer.[7]

- Participants in the HOPE NOW Alliance announced Project Lifeline, which is a targeted outreach to seriously delinquent homeowners (90 days or more late) who are currently facing the greatest risk of losing their home. Servicers under this program have agreed to "pause" foreclosure for 30 days while loan modification packages are evaluated.

Government and Industry Efforts Moving Forward

We urge Congress to consider other alternatives to bankruptcy cramdown that will have positive results in stemming foreclosures without the substantial impact to the credit markets. MBA suggests the following:

- **Allow GSE/HOPE NOW Initiatives To Work:** As stated above, last week, the Federal Housing Finance Agency, Fannie Mae, Freddie Mac and the HOPE NOW Alliance announced a streamlined loan modification program to get struggling homeowners affordable mortgage payments. The program targets certain high-risk borrowers who have missed three payments or more, own and occupy their properties as their primary residences, and have not filed for bankruptcy (bankruptcy bars lenders from communicating directly with customers or attempting to collect the mortgage debt, including through loss mitigation). The real benefit of the program is the systematic and uniform approach that lenders will now apply to modifications. The involvement of Fannie Mae and Freddie Mac is a substantial new development.

  By creating a fast-track method of getting troubled borrowers to an affordable first mortgage payment (including homeowners association/condo dues) of no more than 38 percent of the household's monthly gross income, the program is expected to ultimately help thousands of borrowers. Affordability will be achieved through a mix of reducing the mortgage interest rate, extending the amortization of the loan and/or deferring payment on part of the principal. This is a bold attempt to define a nationwide program that can reach many troubled borrowers quickly, thereby stabilizing those families and the communities and neighborhoods in which they live. This program becomes effective December 15, 2008. Congress must allow time for these programs to work.

[7] HOPE NOW Alliance Data Release, October 27, 2008..

- **Workable Refinance Program:** To date, there are two government created refinance programs available to delinquent borrowers: FHASecure and Hope for Homeowners (HFH). While, unfortunately, these programs have substantial barriers to participation from the servicer, investor and borrower perspectives, a viable refinance program is desperately needed. We believe with certain changes these programs can become viable loss mitigation tools.

  FHASecure is particularly attractive to lenders or servicers who want to cure distressed loans for long-term investment. There are several ways to enhance lender and borrower participation in this program. In particular, the program must include fixed rate loans, permit more borrowers with blemished payment histories to qualify, and expand underwriting requirements. Unfortunately, there is a significant risk that this program will be terminated at the end of 2008. To ensure the continued availability of this program, MBA recommends that Congress allow FHASecure (for delinquent borrowers and new subordinate financing only) to be funded through the pool of funds dedicated to Hope for Homeowners.

  The Hope for Homeowners program was created this past summer by the Homeownership and Economic Recovery Act of 2008 (HERA). The program was designed as a "rescue plan" to help distressed mortgage borrowers whose property values have declined below the outstanding amount of their mortgages. Participating lenders/investors generally will be limited to those who wish to divest themselves of the assets. FHA was given $300 billion in additional mortgage insurance authority for the purpose of refinancing eligible borrowers into new, affordable FHA-insured loans with lower fixed rates based on current property values. The program has numerous legal, financial and administrative impediments. Nonetheless, a refinance program that addresses all levels of borrower demand for refinance programs should be considered and we encourage Congress to revamp HFH to make it a workable product. MBA has already made recommendations on how to make the program more workable.

- **FDIC-Insured Modification Plan:** MBA also believes that the FDIC's guaranteed modification program has promise. Under this program, servicers offering modifications meeting the FDIC's criteria will receive a government guarantee covering a portion of the loan balance. MBA believes that this program will be favorable to borrowers in private label securities. While we would suggest some changes to the conditions of the plan, including a recognition that pooling and servicing agreements may not permit portfolio-wide adoption of the plan, we believe it is a concept that should be explored and we look forward to more details.

Role of Bankruptcy Today and Efforts by the Mortgage Industry to Stem Foreclosures

MBA would assert that cramdown is not necessary today. Current Chapter 13 bankruptcy law already plays an important role in saving the borrower's home. Today, borrowers declare bankruptcy to eliminate or reduce their unsecured debt obligations, such as credit cards or medical debt. This in turn frees up income to keep essential assets such as the home. Once unsecured debts are reduced, borrowers generally have sufficient funds to afford their mortgage payments.

Unfortunately, most bankruptcy proposals do not recognize this fact. To date, few bankruptcy reform bills distinguish between under-secured mortgage debt and unsecured debt. While S. 2136 appears to limit judges' ability to cram down debt if the borrower can afford the regular mortgage payment plus the arrearage during the term of the plan, it is unclear whether such a mortgage affordability test is taken after reducing unsecured debt or whether such analysis is performed treating under-secured portions of mortgage debt and unsecured debt together. Failure to treat under-secured mortgage debt more favorably than unsecured debt would be contrary to the basic legal premise of priority interests of secured creditors. The end result would be that the borrower's income, which today is prioritized to pay for the borrower's home mortgage, would be freed up to pay more credit card and other unsecured debts. Bankruptcy is generally a zero sum proposition. If funds are deducted from one set of debts – the priority debts, such as a home mortgage – it makes more funds available for non-priority and unsecured debts. While it may not be this committee's intent to shift the bankruptcy process to the advantage of credit card and other unsecured lenders, this would be the result.

Additional Points Highlighting our Concerns with Bankruptcy Cramdown

Moral Hazard of Permitting Cramdowns

One of the most inequitable results of bankruptcy reform proposals is the fact that debtors in depressed real estate markets or with damaged or destroyed properties would reap a windfall profit at the expense of lenders, servicers, investors and borrowers who honor their debts. This windfall would occur if the borrower is permitted to reduce the debt to the depressed value of the property, retain the property and realize future appreciation when market conditions improve (or repairs get made with insurance and government aid), while having no obligation to pay the lender for the amount originally borrowed. Cramdowns based on a snapshot of value ensures borrowers will make 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] Despite the current market

[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 cramdown. However

downturn, over the last 30 years home prices nationally have risen six percent per year on average.[9] Home values will return.

The unfair result this reform would create does not occur today when the servicer is allowed to foreclose on the property. The creditor would have the right to mortgage and hazard insurance to offset losses or could hold on to the property and rent it out as is more commonplace today. Furthermore, in the case of foreclosures, the servicer could seek a deficiency judgment for the difference between the value of the property and the contractual obligation when permitted by state law. This remedy is extinguished under the proposed changes to Chapter 13 filings for home loans.

Cramdowns Render Useless Mortgage Insurance Protections

As I discussed earlier in my testimony, bankruptcy cramdown would render mortgage insurance protections useless for the amount of the cramdown. This section provides you with a full analysis of the numerous legal and financial implications that would soon follow enactment of proposed legislation.

Proponents of bankruptcy reform argue creditors will take the same losses if the loan is stripped down to the fair market value as they would if the loan is foreclosed. This is simply inaccurate and demonstrates a lack of understanding of the credit markets. It is critical to understand that lien stripping renders ineffective certain portions of mortgage insurance, which historically allows lenders to require smaller down payments and grant favorable rates.

FHA and VA Programs

Today, FHA insurance and VA guarantees protect the servicer against principal loss due to foreclosure. FHA and VA staff, however, indicate that the agencies are not statutorily permitted to pay a claim for amounts stripped down in bankruptcy. Consequently, if lien strips are permitted, servicers that merely administer Ginnie Mae securities on behalf of passive investors will have to absorb principal losses they never contemplated. 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. Servicers are in no way capitalized to absorb these losses. This places Ginnie Mae at risk for increased servicer defaults and having to step into the shoes of the servicer to advance principal and interest payments to bond holders as guarantor.

Conversely, if those loans went to foreclosure sale, FHA insurance and VA guarantees (for which these agencies receive compensation through premium

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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' cramdown not been overturned on appeal, the debtors would have received a significant windfall.

[9] OFHEO House Price Index.

payments) would protect the servicer against principal loss. Without statutory changes to these programs, servicers who do not own the loans are being required to step into the mortgage insurer's shoes, or worse, being asked to provide property value guarantees.

FHA and VA loans are not insulated from the havoc bankruptcy reform would wreak. Despite some legislative proposals to limit cramdown to "subprime" and "non-traditional" products, "subprime" is defined as a loan with an APR three points over comparable Treasury securities, which ensures a significant number of government loans (and prime loans) would be eligible for lien stripping. This is most likely for loans originated after the first quarter of 2008 where the spreads between Treasuries and Ginnie Mae securities have widened. We believe that bankruptcy cramdown would cover the vast majority of FHASecure and Hope for Homeowners loans because higher mortgage insurance premiums and unfavorable Ginnie Mae pricing pushes these loans above the three percent threshold. Given Congress's interest in kick-starting these programs, bankruptcy cramdown seems counterproductive.

In this market environment, the FHA and VA programs have become the only sources of affordable, low down payment mortgage credit for a large number of home buyers. This is evidenced by the rise in Ginnie Mae issuances from 10 percent of total agency issuances in 2007 to more than 30 percent in 2008. In absolute terms, Ginnie Mae issuances have quadrupled from $20 billion in third quarter of 2007 to $80 billion in third quarter of 2008. Disrupting this vital source of mortgage credit will have dire consequences. FHA and VA serve low-income and first-time home buyers better than other programs.

Private Mortgage Insurance and GSE Lending

Private mortgage insurance operates similarly to FHA/VA insurance or guarantees. They are contracts to protect the creditor against first dollar losses associated with foreclosures. Similar to government insurance and guarantees, we believe private mortgage insurance will not be available to offset cramdown losses. As a result, private mortgage insurance contracts will be rendered useless in the event of a lien strip. Fannie Mae and Freddie Mac (and portfolio lenders) will, therefore, suffer greater losses in the event of a lien strip than in the event of a foreclosure. Both Fannie Mae and Freddie Mac are required by their charters to obtain credit enhancements on loans they originate with high loan to value ratios. Traditionally, this credit enhancement has been in the form of private mortgage insurance. If they are unable to file mortgage insurance claims, the losses these entities face will be significant. Given Fannie Mae's and Freddie Mac's conservatorships, these costs ultimately could be borne by the federal government and taxpayers.

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Hazard Insurance Claims

Lien stripping will likely impact the availability of hazard insurance proceeds in the event of loss or partial loss of the property. Based on case law associated with other secured debts, mortgage creditors will lose their secured interests in hazard insurance proceeds for the amount of the cramdown, with possibly no recourse to recover the value of the original debt. Bankruptcy reform would place lenders, servicers and investors in an inappropriate role of property insurers of last resort and/or guarantors of property values. Lenders and servicers did not price for the risk at origination, and would require cross-subsidization from new originations to avoid massive losses. That cross-subsidization would result in higher costs for new loans.

Borrowers should not be able to wipe out the security interests of creditors when their properties are destroyed by natural disasters, but unfortunately cramdown legislation would do just that. Imagine if properties damaged by Hurricanes Katrina and Rita were subject to cramdown. These properties could have their debt completely extinguished despite receiving Community Development Block Grant funds to rebuild their properties. Servicers should retain the full value of their insurance policies, but unfortunately this would not occur under the proposed bills. Mortgage creditors and investors may, therefore, reduce credit to geographic areas prone to natural disasters.

The Second Lien Market Will Be Harmed Without Corresponding Reduction in Foreclosures

Several bankruptcy bills would allow cramdown of second liens. The second mortgage market has been particularly hard hit by current declining real estate values. Many borrowers are not paying their second mortgages because the fair market value of their properties has declined below the combined principal balance of the first and second mortgages. In most cases, the second lien holder is left with no other option but to allow the delinquency to continue but retain the lien. They are not foreclosing on the second mortgages and thus borrowers retain their homes. Eventually home values will rise and these borrowers will begin repaying their second liens.

These second liens serve as credit enhancements for many first mortgages in the subprime market and should not be extinguished indiscriminately. Proponents claiming that second lien holders are no worse off in bankruptcy than in foreclosure fail to recognize that second lien lenders are not seeking foreclosure, and are thus preserving their assets for the long term. Bankruptcy reform would strip lien holders of this crucial right, effectively taking the asset from them.

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Impact on Investors and MBS Market

Securitization increases the availability of mortgage credit. Historically, banks and other lenders sell mortgage debt to 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. Due to the delinquency rate on loans serving as collateral for private label securities, private securitizations are frozen. Securitization must be revived regardless of whether such securitizations are through government or quasi-government agencies or through the private sector. Without the ability to securitize, fewer loans can be originated.

Granting bankruptcy judges the authority to prospectively or retroactively modify a mortgage in Chapter 13 proceedings would have a materially adverse impact on the mortgage contract and would do nothing to reassure investors seeking to invest in the U.S. mortgage or credit markets. If, with a stroke of a pen, the U.S. government could eliminate the secured nature of these investments whenever there is a cyclical downturn, why would investors return to our mortgage markets? They would simply take their money to other, more secure and predictable investments or demand a much higher return for the added risks. Existing MBS values would also decline as more investors dump MBS collateralized by subprime and at-risk assets and as credit rating agencies further downgrade securities.

Servicer Losses

Even if lien stripping was limited to existing debt and certain product types, the risk of uninsured losses and repurchase risk created 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 further exacerbate capital and liquidity problems for servicers. This disruption could also cause significant problems with voluntary mortgage workouts as bankruptcy cramdowns would consume the servicer's financial and personnel resources. The stated objective of encouraging more voluntary workouts would simply not materialize because (1) the reward in bankruptcy is far more lucrative to borrowers than what servicers could offer borrowers and (2) servicers may have to cut staff, including loss mitigation staff, to offset losses.

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Bankruptcy Filings Will Overwhelm Courts

An attempt to solve the foreclosure crisis in bankruptcy courts will result in millions of new filings. The logistical problems are compounded by the fact that these filings will be concentrated in a few states such as California, Florida, Nevada and Arizona. The system will simply clog-up by the onslaught of new filings putting lenders and borrowers in limbo status and putting loss mitigation efforts on hold. Servicers will have to continue to advance principal and interest (P&I) payments to private label investors despite borrowers not paying the mortgage. If backlogs continue for any extended period of time, servicers will be strained in their financial capacity to advance principal and interest payments.

Impact on Other Credit Segments

Losses will not be limited to the mortgage sector. As more consumers seek Chapter 13 to take advantage of the lien strip benefit, a lot of consumer debts will be wiped out as well, causing a fresh wave of losses to lenders, further impairing their ability to extend new credit. Large and geographically concentrated numbers of people in bankruptcy will depress local economies.

Interest Rate Reductions

Several legislative proposals combine principal reductions with interest rate reductions. I urge Congress to be cautious of the impact of modifying interest rates on loans serving as collateral for mortgage backed securities. In the case of FHA, VA, Freddie Mac and Fannie Mae (on older trusts) a modification of rate requires the issuer (i.e., GSE or servicer) to repurchase the loan from the pool and place it on the balance sheet (GSE) or redeliver it subject to current market prices.

In the case of the GSEs, they will bear the cost of repurchasing these assets from MBS pools and placing them in portfolio.[10] The result may be a diminished capacity to purchase new loans. In the case of FHA and VA loans, Ginnie Mae servicers will have to buy those loans at par (outstanding indebtedness) and face redelivery of the loan into a Ginnie Mae II possibly below par (depending on the note rate), meaning the servicer once again has to absorb significant losses. Independent mortgage companies currently borrow funds from commercial banks to repurchase loans from pools. Given that warehouse lines are constricting, it is possible that servicers will simply be unable to repurchase these loans, increasing the risk of servicer defaults.

[10] Fannie Mae's new trust agreement that became effective June 1, 2007 allows Fannie Mae to leave a loan subject to modification in bankruptcy in the pool. Section 2.5(2)(c) Fannie Mae's Single Family Master Trust Agreement. P. 26.

Conclusion

MBA opposes amending the bankruptcy law because of the harm it would cause to the mortgage industry, the mortgage market, the economy and future borrowers who seek home mortgages. While well-intentioned, bankruptcy reform would limit the availability of credit, increase down payments and raise interest rates. Mortgage insurance that protects lenders and investors from loss in the event of foreclosure would be void for the amount of the lien strip. Noteholders' interests in hazard insurance claims would be at risk. With investor appetite for U.S. mortgages waning, it is ill-advised to pass legislation that would further disrupt the mortgage market. Bankruptcy cramdown brings with it a number of additional risk factors that investors will take into account.

We strongly urge Members of this committee and all of Congress to look deeper into the implications of bankruptcy reform before passing harmful legislation. We urge Congress to consider other alternatives to bankruptcy cramdown that will help deserving homeowners avoid foreclosure and MBA looks forward to working with you through that process.

Thank you for this opportunity to share our concerns with this committee.

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United States Senate
Committee on the Judiciary

< Return To Hearing

Statement of

The Honorable Patrick Leahy

United States Senator
Vermont
November 19, 2008

Statement of Chairman Patrick Leahy
"Helping Families Save Their Homes: The Role of Bankruptcy Law"
Senate Judiciary Committee
November 19, 2008

I thank Senator Durbin for chairing today's hearing. This hearing is about the important issue of providing relief to struggling homeowners. It is a matter that Senator Durbin, Senator Specter and I all thought worthy of another hearing this week.

Everyone acknowledges that homeownership is a fundamental part of the American dream and that the housing crisis has contributed enormously to the current economic downturn. Homeownership is a primary source of financial well-being for families and individuals, and for most of us, the most valuable investment we will ever make. Through home ownership, Americans find security, community, stability, and pride. These are values that Federal policy should support and preserve.

In 2003, President Bush made increased home ownership a central part of his domestic policy, saying: "This Administration will constantly strive to promote an ownership society in America. We want more people owning their own home. It is in our national interest that more people own their own home. After all, if you own your own home, you have a vital stake in the future of our country." Five years later, as thousands of American families have been evicted from their homes, this administration has sided with banks -- not ordinary Americans -- through their opposition to our efforts to provide authority to bankruptcy judges to adjust the terms of mortgages on primary residences.

Sheila Bair, the Chair of the Federal Deposit Insurance Corporation, has proposed a relief program that would provide significant incentives for lenders to modify the interest rates for borrowers behind on their mortgage payments. This proposal would use a portion of the funds authorized in the bailout package to assist homeowners and protect lenders, and could compliment additional authority in the bankruptcy courts. Unfortunately, Secretary Paulson and the administration have not embraced this proposal, and continue to insist that the funds Congress provided be used only to help banks.

In December 2007, the Committee held a hearing on the Helping Families Save Their Homes in Bankruptcy Act of 2008, S.2136. A number of witnesses endorsed the measure as one of the more efficient, effective, and immediate measures for helping Americans stay in their homes. At that time, economist Mark Zandi estimated that such authority could keep nearly 600,000 people in their homes. Far from a bailout, it was a mechanism to help homeowners and turn troubled mortgages into productive assets. Homeowners who gained relief from a bankruptcy court would continue to pay each month toward the satisfaction of the debt. Halting mortgage defaults is a critical component of our economic recovery. The reality is that whether a bankruptcy court determines the value of a home to modify a mortgage, or a bank forecloses on that home, in both cases the home is worth only what the market will bear.

In March and April, this Committee considered and voted to report Senator Durbin's legislation to authorize bankruptcy courts to modify primary home mortgages to the Senate. The bill was reported in July and a Committee report in support was filed in September. Because the crisis persists and we have not been able to enact this measure, we are holding this follow-up hearing. It may serve to refocus on this measure now or in a few weeks when the Obama administration is left to resolve the foreclosure and economic crises.

Banks critical of providing this authority to bankruptcy courts claimed that doing so will cause interest rates to rise, and will make mortgages harder to obtain. What has caused the difficulty in obtaining mortgages is the unprecedented credit crisis that has seen enactment of a $700 billion rescue plan. The credit crisis did not stem from this bankruptcy authority, but from more fundamental and serious concerns about the practices of the financial institutions themselves.

I recently received a letter from the National Conference of Bankruptcy Judges expressing confidence that the bankruptcy courts are well-equipped to handle this authority and, further, that the existence of such authority may spur parties to come to agreement without judicial intervention. There has been too little meaningful progress in the private sector to modify home mortgages. Congress has given bankruptcy courts authority to modify mortgages on family farms and second homes. There is no reason not to do so for primary home mortgages, especially when so many Americans are struggling. I am confident that the men and women who serve as bankruptcy judges will exercise such authority responsibly and fairly.

The bottom line is that American families need relief. Fears of litigation have apparently hampered efforts in the private sector among financial institutions and investors. This bankruptcy court authority can provide protection for lenders as they proceed with mortgage workouts for homeowners and fewer foreclosures, and it can do so at no cost to taxpayers.

With all that Congress has done, and all that the administration is doing, to provide relief to the country's biggest banks and financial institutions, Americans are right to demand action from Congress that focuses on the needs of ordinary, hardworking people. As the new administration prepares to inherit the severe economic challenges and failed deregulatory policies left to it by the outgoing administration, this is authority that Congress should provide.

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GEORGETOWN UNIVERSITY LAW CENTER

Adam J. Levitin
Associate Professor of Law

Written Testimony of

Adam J. Levitin
Associate Professor of Law
Georgetown University Law Center

Before the
United States Senate
Committee on the Judiciary

Hearing: Helping Families Save Their Homes: The Role of Bankruptcy Law

November 19, 2008

Mr. Chairman, Members of the Committee:

I am pleased to testify in support of the Helping Families Save Their Homes in Bankruptcy Act, legislation proposed by Senator Durbin that would significantly help ease the nationwide foreclosure crisis.

There are four major points I wish to make in my written testimony:

1. Voluntary, private-market efforts to address the foreclosure crisis have all failed.
2. Bankruptcy is the *only* method that can fully address the contractual and incentive problems created by securitization.
3. Bankruptcy modification of mortgages will not result in higher mortgage interest rates or less credit availability.
4. Bankruptcy modification of mortgages does not create moral hazard.

I. Voluntary Private Market Efforts to Address the Foreclosure Crisis Have Failed

A. The Foreclosure Crisis and the Financial Crisis

The United States is in the midst of an unprecedented home foreclosure crisis. At no time since the Great Depression have so many Americans been in jeopardy of losing their homes. Over a million homes entered foreclosure in 2007[1] and another one to two million are expected to enter foreclosure in 2008.[2] We are on pace for 6.5 million homes, or 12.7% of all residential borrowers, to be in foreclosure by 2012.[3] Nearly a quarter of a million homes were actually sold in foreclosure or otherwise surrendered to lenders in 2007.[4] At the end of the first quarter of 2008, one in eleven homeowners was either past due or in foreclosure, the highest levels on record.[5] Already nearly 20% of homeowners

[1] RealtyTrac, Press Release, *U.S. Foreclosure Activity Increases 75 Percent In 2007*, Jan. 29, 2008, *at* http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=3988&accnt=64847.

[2] *Home Sick*, READERS DIGEST, June 2008, *at* http://www.rd.com/your-america-inspiring-people-and-stories/home-sick/article57836.html.

[3] Reuters, *Foreclosures to Affect 6.5 Mln Loans by 2012-Report*, Apr. 22, 2008, *at* http://www.reuters.com/article/bondsNews/idUSN2233380820080422.

[4] E-mail from Daren Blomquist, RealtyTrac, Inc. to author, March 7, 2008 (on file with author).

[5] Mortgage Bankers Association, Press Release, Delinquencies and Foreclosures Increase in Latest MBA National Delinquency Survey, June 5, 2008, *at* http://www.mortgagebankers.org/NewsandMedia/PressCenter/62936.htm. *See also* Vikas Bajaj & Michael Grynbaum, *About 1 in 11 Mortgageholders Face Problems*, N.Y. TIMES, June 6, 2008. Because of the steadily increasing level of homeownership in the US, *see* U.S. Census Bureau, *Housing Vacancies and Homeownership (CPS/HVS), Table 14*, higher percentages of past due and foreclosed mortgages means that an even greater percentage of Americans are directly affected by higher delinquency and foreclosure rates.

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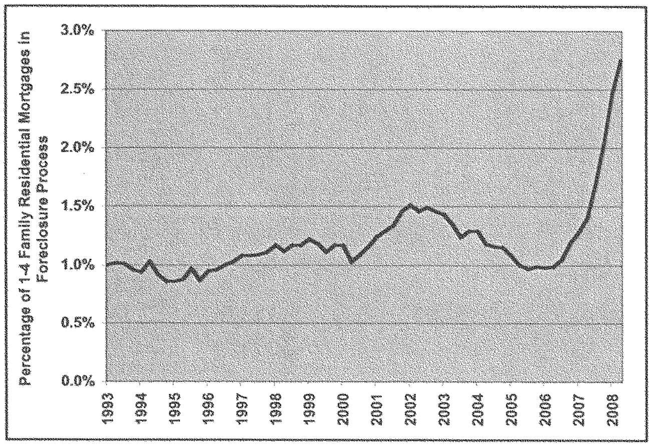
have negative equity in their homes,[6] and by the time the housing market stabilizes, 40% of homeowners will have negative equity positions.[7]

Chart 1: Percentage of 1-4 Family Residential Mortgages in Foreclosure Process[8]



The sheer number of foreclosures should be alarming because foreclosures create significant deadweight loss.[9] Historically, lenders are estimated to lose 40% - 50% of their investment in a foreclosure situation,[10] and in the current market, even greater losses are expected.[11] Borrowers lose their homes and are forced to relocate, often to new communities. Foreclosure is an undesirable outcome for borrowers *and* lenders.

Foreclosures also have major third-party externalities. When families have to move to new homes, community ties are rent asunder. Friendships, religious congregations, schooling, childcare, medical care, transportation, and even employment often depend on geography.[12] Homes root people in strong networks of community ties, and foreclosures destroy these key social bonds.

[6] James R. Hagerty, *Nevada Has Highest Percentage of "Under Water" Households*, WALL ST. J., Oct. 30, 2008; *see also* James R. Hagerty & Ruth Simon, *Housing Pain Gauge: Nearly 1 in 6 Owners "Under Water"*, WALL ST. J., Oct. 8, 2008.

[7] Ruth Simon, *Rescue Includes Steps to Help Borrowers Keep Homes*, WALL ST. J., Sept. 20, 2008.

[8] Mortgage Bankers Association National Delinquency Surveys.

[9] Anthony Pennington-Cross, *The Value of Foreclosed Property*, 28 J. OF REAL ESTATE RESEARCH 194-95 (2006) (surveying estimates of deadweight loss on foreclosure).

[10] Comments of Treasury Secretary Henry Paulson, Ask the White House, *at* http://www.whitehouse.gov/ask/20071207.html.

[11] Fitch Ratings, *Revised Loss Expectations for 2006 and 2007 Subprime Vintage Collateral*, Residential Mortgage Criteria Report, Mar. 25, 2008.

[12] *See* Phillip Lovell & Julia Isaacs, *The Impact of the Mortgage Crisis on Children*, *at* http://www.firstfocus.net/Download/HousingandChildrenFINAL.pdf (estimating two million children will be impacted by foreclosures, based on a projection of two and quarter million foreclosures).

Foreclosures also depress housing and commercial real estate prices throughout entire neighborhoods. There is, on average, a $3,000 property value decline for each of the closest fifty neighbors of a foreclosed property.[13] The property value declines caused by foreclosure hurt local businesses and erode state and local government tax bases.[14] Condominium and homeowner associations likewise find their assessment base reduced by foreclosures, leaving the remaining homeowners with higher assessments.[15]

Foreclosed properties also impose significant direct costs on local governments and foster crime.[16] A single foreclosure can cost the city of Chicago over $30,000.[17] Moreover, foreclosures have a racially disparate impact because African-Americans invest a higher share of their wealth in their homes[18] and are also more likely than financially similar whites to have subprime loans.[19]

The foreclosure crisis has also been at the root of a larger financial crisis. Because most residential mortgages are securitized into widely held securities, unprecedented default rates in the residential mortgage market affect not just mortgage lenders, but capital markets globally. The marketwide impact of defaults on mortgage-backed securities have been amplified by poorly understood and complex derivative

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[13] Dan Immergluck & Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, 17 HOUSING POLICY DEBATE 57 (2006); Mark Duda & William C. Apgar, *Mortgage Foreclosures in Atlanta: Patterns and Policy Issues*, A Report Prepared for NeighborWorks America, December 15, 2005, *at* www.nw.org/Network/neighborworksprogs/foreclosuresolutions/documents/foreclosure1205.pdf; Amy Ellen Schwartz *et al.*, *Does Federally Subsidized Rental Housing Depress Neighborhood Property Values?*, NYU Law School Law and Economics Research Paper No. 05-04; NYU Law School, Public Law Research Paper No. 05-02 (Mar. 2005).

[14] Laura Johnston, *Vacant Properties Cost Cleveland $35 Million, Study Says*, CLEVELAND PLAIN DEALER, Feb. 19, 2008; Global Insight, *The Mortgage Crisis: Economic and Fiscal Implications for Metro Areas*, Report Prepared for The United States Conference of Mayors and The Council for the New American City, 2007, *at* http://www.vacantproperties.org/resources/documents/USCMmortgagereport.pdf.

[15] Christine Haughney, *Collateral Foreclosure Damage for Condo Owners*, N.Y. TIMES, May 15, 2008.

[16] Dan Immergluck & Geoff Smith, *The Impact of Single-Family Mortgage Foreclosures on Neighborhood Crime*, 21 HOUSING STUDIES, 851 (2006); William C. Apgar & Mark Duda, *Collateral Damage: The Municipal Impact of Today's Mortgage Foreclosure Boom*, May 11, 2005, *at* http://www.995hope.org/content/pdf/Apgar_Duda_Study_Short_Version.pdf.

[17] William C. Apgar *et al.*, *The Municipal Cost of Foreclosures: A Chicago Case Study*, Feb. 27, 2005, Homeownership Preservation Foundation Housing Finance Policy Research Paper Number 2005-1, *at* www.995hope.org/content/pdf/Apgar_Duda_Study_Full_Version.pdf.

[18] MELVIN L. OLIVER & THOMAS M. SHAPIRO, BLACK WEALTH, WHITE WEALTH: A NEW PERSPECTIVE ON RACIAL INEQUALITY 66 (2006) (housing equity accounted for 62.5% of all black assets in 1988, but only 43.3% of white assets, even though black homeownership rates were 43% and white homeownership rates were 65%). *See also* Brian K. Bucks, Arthur B. Kennickell, & Kevin B. Moore, *Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances*, FED. RES. BULL. 2006, at A8, A12, A23 (noting that while there was only a $35,000 difference in median home equity between whites and nonwhites/Hispanics in 2004, there was a $115,900 difference in median net worth and a $33,700 difference in median financial assets. This suggests that for minority homeowners, wealth is disproportionately invested in the home.); Kai Wright, *The Subprime Swindle*, THE NATION, July 14, 2008.

[19] Bob Tedeschi, *Subprime Loans' Wide Reach*, N.Y. TIMES, Aug. 3, 2008; Mary Kane, *Race and the Housing Crisis*, THE WASHINGTON INDEPENDENT, July 25, 2008.

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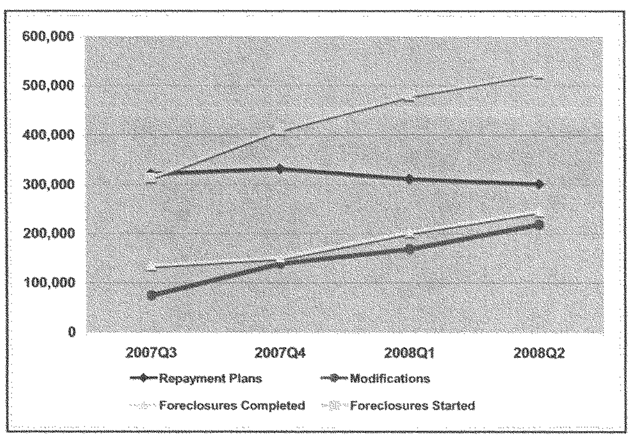
products that are bought and sold by financial institutions, which now find themselves insufficiently liquid or undercapitalized. This in turn has led to a global credit crisis as financial institutions have become hesitant to contract not knowing their counterparties' ultimate solvency.

As long as foreclosures continue at unabated rates, mortgage defaults will continue to rise as foreclosures depress real estate prices, fueling the cycle. Until housing prices stabilize, we will not see stability in the financial system, and housing prices cannot stabilize unless the tide of foreclosures is stemmed. In short, foreclosure is an inefficient outcome that is bad not only for lenders and borrowers, but for society at large.

B. Loss Mitigation Options on Defaulted Loans

Foreclosure, of course, is never mandatory. It is only one possibility among a set of loss mitigation options for a lender confronted with a defaulted loan. A lender always has the option of forbearing or of modifying the terms of a non-performing loan so that it can perform under less onerous terms.[20] Indeed, so long as the losses from a modification would be less than those from foreclosure, modification is the efficient economic outcome for a non-performing loan. Given the sizeable losses lenders incur in foreclosure, one would expect lenders to be making significant modifications to loans, including reduction of principal and interest.

Chart 2: Loan Modifications, Repayment Plans, and Foreclosures, HOPE Now Alliance Members, Third Quarter 2007-Second Quarter 2008[21]



[20] Refinancing, a traditional route of dealing with non-performing loans, is generally not possible because so many defaulting homeowners have negative equity. Other loss mitigation methods, such as short sales, however, have been widely used.

[21] State Foreclosure Prevention Working Group, Analysis of Subprime Mortgage Servicing Performance, Data Reports, *at* http://www.csbs.org/.

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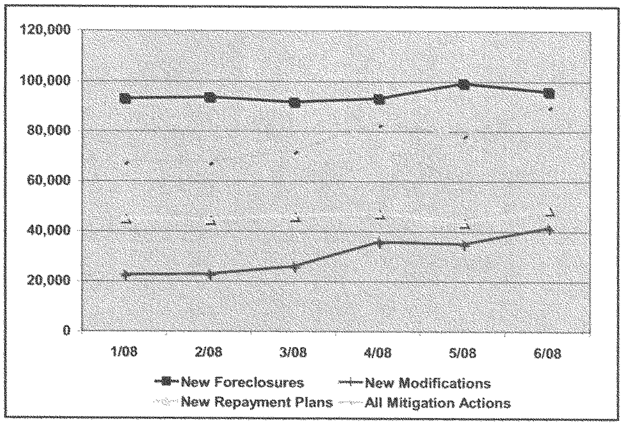
Chart 3: Loan Modifications, Repayment Plans, and Foreclosures in National Banks' and Federal Thrifts' Servicing Portfolios, 2008[22]



Yet, to date, there have been relatively few voluntary, private modifications of non-performing loans. As Chart 2 shows, the workouts performed by the HOPE Now Alliance have failed to keep pace with foreclosures. Chart 3 presents a similar picture for all national banks and federal thrifts. Moreover, as both Charts 2 and 3 show, most of the workouts have been repayment plans, in which the arrearage is simply reamortized into the remaining term of the loan or tacked on at the end, thereby increasing or at best holding steady the borrower's monthly payments. While repayment plans are sensible solutions to temporary disruptions in the borrower's cash flow, they are wholly inadequate responses to the key problems of the current mortgage market—payment reset shock and negative equity. Payment reset shock from an adjustable rate mortgage or negative amortization trigger in an option-ARM can only be addressed by modifications that freeze or lower monthly payments, which requires a reduction in the interest rate or principal of the loan. Likewise, negative equity positions can only be corrected through principal write-downs.

Even among the modifications, the vast majority have failed to reduce monthly payments, making them near worthless.[23] As the State Foreclosure Prevention Working Group has noted,

> one out of five loan modifications made in the past year are *currently* delinquent. The high number of previously-modified loans currently delinquent indicates that significant numbers of modifications offered to homeowners have not been sustainable.... [M]any loan modifications are

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[22] Office of Comptroller of the Currency and Office of Thrift Supervision, *OCC and OTS Mortgage Metrics Report*, Sept. 12, 2008, *at* http://www.occ.treas.gov/ftp/release/2008-105a.pdf.

[23] Testimony of Massachusetts Attorney General Martha Coakley before the U.S. House Financial Services Committee, Sept. 17, 2008 (noting that "virtually none" of the loan modifications reviewed by her office reduced monthly payments); Alan M. White, *Rewriting Contracts, Wholesale: Data on Voluntary Mortgage Modifications from 2007 and 2008 Remittance Reports*, FORDHAM URBAN L.J. (2009)

> not providing any monthly payment relief to struggling homeowners. ...[U]nrealistic or "band-aid" modifications have only exacerbated and prolonged the current foreclosure crisis.[24]

Unrealistic modifications have been a problem not just for the subprime loans examined by the State Foreclosure Prevention Working Group, but also for the predominantly non-subprime loans held in Fannie Mae's portfolio or securitized by Fannie Mae, the vast majority of loan workouts have been through Fannie's "HomeSaver Loan" program, which involves making defaulted homeowners a *new* unsecured loan for up to $15,000 to cover the deficiency on their mortgage loan. The HomeSaver program thus increases financially distressed homeowners' debt burdens while masking non-performing loans. At best, HomeSaver is a bridge-loan program that buys time until a modification can be done, but given that Fannie Mae is carrying the HomeSaver Loans on its books at about 2% of their face value,[25] it clearly expects near universal default and no recovery on these loans.

The federal government's foreclosure prevention programs have even more dismal results. The FHA's FHASecure program, which was intended to let borrowers with non-FHA adjustable rate and interest-only mortgages refinance into fixed-rate FHA loans has only helped a few thousand borrowers,[26] instead of the predicted 240,000.[27] FHA's Hope for Homeowners program, enacted in July 2008, as part of the Housing and Economic Recovery Act of 2008, has also been an absolute failure. Predicted to help 400,000 homeowners,[28] it has, to date, helped only around 100 homeowners[29] in large part because the cooperation needed from private lenders and servicers for homeowners to enter the program has been lacking. As the State Foreclosure Prevention Working Group has noted, "[n]early eight out of ten seriously delinquent homeowners are not on track for any loss mitigation outcome," and "[n]ew efforts to prevent foreclosures are on the decline, despite a temporary increase in loan modifications through the [second quarter] of 2008.[30]

II. BANKRUPTCY MODIFICATION IS THE ONLY WAY TO ADDRESS THE OBSTACLES TO MORTGAGE MODIFICATION CREATED BY SECURITIZATION

A major factor complicating private, voluntary loan modification efforts is securitization. The vast majority, somewhere upwards of 80%, of residential mortgages are securitized. Understanding securitization is key to understanding why private,

[24] State Foreclosure Prevention Working Group, *Analysis of Subprime Mortgage Servicing Performance*, Data Report No. 3, Sept. 2008, *at* http://www.csbs.org/Content/NavigationMenu/Home/SFPWGReport3.pdf, at 3.

[25] Kate Berry, *Lending Model Gets Reworked at Fannie Mae*, AM. BANKER, Nov. 11, 2008 ($301 million in HomeSaver loans being carried at $7 million fair market value).

[26] Kate Berry, *Refi-Program Previewers Raise Issues*, AM. BANKER, Aug. 19, 2008.

[27] Kate Berry, *HUD Mulling How to Widen FHA Refi Net*, AM. BANKER, Feb. 19, 2008.

[28] FHA, Hope for Homeowners, *at* http://portal.hud.gov/portal/page?_pageid=73,7601299&_dad=portal&_schema=PORTAL (last viewed Nov. 17, 2008).

[29] Interview with Jereon Brown, Deputy Assistant Secretary for Public Affairs, Department of Housing and Urban Development, November 14, 2008.

[30] State Foreclosure Prevention Working Group, *supra* note 21, at 2.

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voluntary efforts at mortgage modification will inevitably fail and why bankruptcy modification presents the only sure method of preventing preventable foreclosures.

Securitization transactions are technical, complex deals, but the core of the transaction is fairly simple. A financial institution owns a pool of mortgage loans, which it either made itself or purchased. Rather than hold these mortgage loans (and the credit risk) on its own books, it sells them to a specially created entity, typically a trust (SPV). The trust pays for the mortgage loans by issuing bonds. The bonds are collateralized (backed) by the loans now owned by the trust. These bonds are so-called mortgage-backed securities (MBS).

Because the trust is just a shell to hold the loans and put them beyond the reach of the financial institution's creditors, a third-party must be brought in to manage the loans. This third-party is called a servicer. The servicer is supposed to manage the loans for the benefit of the MBS holders. The servicer performs the day-to-day tasks related to the mortgages owned by the SPV, such as collecting payments, handling paperwork, foreclosing, and selling foreclosed properties. These servicers are the entities that actually consider loan modification requests. Confusingly, the servicer is often, but not always, a corporate affiliate of originator; most of the major servicers are subsidiaries of bank holding companies: Countrywide Home Loans (Bank of America); CitiMortgage and CitiFinancial (Citigroup); Select Portfolio Servicing (Credit Suisse); Litton Loan Servicing LP (Goldman Sachs); Chase Home Finance and EMC Mortgage (JPMorgan Chase); Wilshire Credit (Merrill Lynch); Wells Fargo Home Mortgage and Homeq Servicing (Wells Fargo).

Securitization creates numerous obstacles to voluntary loan modifications, but they may be reduced to three broad categories: contractual, practical, and economic.[31]

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[31] A fourth category—legal obstacles—in the form of REMIC tax provisions and Financial Accounting Board standards, are no longer a significant obstacle to modifying securitized loans. There are potentially adverse tax and accounting consequences if servicers engaging in too many voluntary modifications. Residential MBS are structured to enjoy pass-thru REMIC (Real Estate Mortgage Investment Conduit) status under the Internal Revenue Code, 26 U.S.C. §§ 1860A *et seq.*, which enables the MBS to avoid double taxation of income. REMIC rules generally preclude wide-scale modification of securitized loans or their sale out of securitized pools, and these REMIC rules are further reflected in the contract with the servicer. The IRS has relaxing application of REMIC rules to mortgage loan modification programs. *See* Rev. Proc. 2008-28, 2008-23 I.R.B. 1054.

Likewise, accounting standards under SFAS 140 indicate that too many modifications would result in the servicer/originator having to take the securitized loans back onto its balance sheet. SEC Staff, however, have indicated that they do not believe that modifications of imminently defaulting loans would require on-balance sheet accounting. Letter from Christopher Cox, SEC Chairman to Rep. Barney Frank, Chairman of Committee on Financial Services, United States House of Representatives, dated July 24, 2008, *at* http://www.house.gov apps/list/press/financialsvcs_dem/sec_response072507.pdf; Letter from Conrad Hewitt, Chief Accounting, SEC to Mr. Arnold Hanish, Chairman of the Committee on Corporate Reporting, Financial Executives International and Mr. Sam Ranzilla, Chairman of the Professional Practice Executive Committee, The Center for Audit Quality, American Institute of Certified Public Accountants, dated Jan.8, 2008, *at* http://www.sec.gov/info/accountants/staffletters/hanish010808.pdf.

A. Securitization Creates Contractual Limitations on Private Mortgage Modification

Securitization creates contractual limitations on private mortgage modification. These limitations *cannot* be bypassed except through bankruptcy modification or a taking of MBS holders' property rights.

Servicers carry out their duties according to what is specified in their contract with the SPV. This contract is known as a "pooling and servicing agreement" or PSA. Although the decision to modify mortgages held by an SPV rests with the servicer, and servicers are instructed to manage loans as if for their own account, PSAs often place restrictions on servicers' ability to modify mortgages. Almost all PSAs restrict modifications to loans that are in default or where default is imminent or reasonably foreseeable in order to protect the SPV's pass-thru REMIC tax and off-balance sheet accounting status.[32]

PSAs often further restrict modifications: sometimes the modification is forbidden outright, sometimes only certain types of modifications are permitted, and sometimes the total number of loans that can be modified is capped (typically at 5% of the pool). Additionally, servicers are frequently required to purchase any loans they modify at the face value outstanding (or even with a premium). This functions as an anti-modification provision.

No one has a firm sense of the frequency of contractual limitations to modification for residential MBS (RMBS). A small and unrepresentative sampling by Credit Suisse indicates that almost 40% of RMBS PSAs have limitations on loan modification beyond a near universal requirement that the a loan be in default or imminently defaulting before it may be modified.[33] The Credit Suisse study, however, did not track all types of modification restrictions, such as face-value repurchase provisions, so the true number of restrictive PSAs is likely higher. Nonetheless, there are still a large number of homeowners whose mortgages are held by securitization trusts with restrictive PSAs. This includes both private-label securitizations and GSE securitizations; some Fannie Mae securitizations, for example, prohibit any reductions in either principal or interest rates.[34]

It is virtually impossible to change the terms of a restrictive PSA in order to allow the servicer greater freedom to engage in modifications. The PSA is part of the indenture

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[32] *See* 26 U.S.C. § 1860A *et seq.* (REMIC treatment); SFAS No. 140 (off-balance sheet accounting treatment).

[33] Credit Suisse, *The Day After Tomorrow: Payment Shock and Loan Modifications*, Fixed Income Research, April 5, 2007, at 5.

[34] *See, e.g.*, Federal National Mortgage Association, Single-Family Master Trust Agreement for Guaranteed Mortgage Pass-Through Certificates evidencing undivided beneficial interests in Pools of Residential Mortgage Loans, June 1, 2007, § 5.3(4), *at* http://www.fanniemae.com/mbs/pdf/singlefamilytrustagreement_June2007.pdf ("For so long as a Mortgage Loan remains in a Pool, the Mortgage Loan may not be modified if the modification has the effect of changing the principal balance (other than as a result of a payment actually received from or on behalf of the Borrower), changing the Mortgage Interest Rate (other than in accordance with any adjustable rate provisions stated in the Mortgage Documents), or delaying the time of payment beyond the last scheduled payment date of that Mortgage Loan.").

under which the MBS are issued. Under the Trust Indenture Act of 1939,[35] the consent of 100% of the MBS holders is needed in order to alter the PSA in a manner that would affects the MBS' cashflow, as any change to the PSA's modification rules would.

Practically speaking, it is impossible to gather up 100% of any MBS issue. There can be thousands of MBS certificates from a single pool and these certificate holders might be dispersed world-wide. The problem is exacerbated by collateralized mortgage obligations (CMOs), second mortgages, and mortgage insurance. MBS issued by an SPV are typically tranched—divided into different payment priority tiers, each of which will have a different dividend rate and a different credit rating. Because the riskier tranches are not investment grade, they cannot be sold to entities like pension plans and mutual funds. Therefore, they are often resecuritized into what are known as CMOs. A CMO is a securitization in which the assets backing the securities are themselves mortgage-backed securities rather than the underlying mortgages. CMOs are themselves then tranched, and the senior tranches can receive investment grade ratings, making it possible to sell them to major institutional investors. The non-investment grade components of CMOs can themselves be resecuritized once again into what are known as CMO^2s. This process can be repeated, of course, an endless number of times.

The upshot of this financial alchemy is that to control 100% of an MBS issuance in order to alter a PSA, one would also have to own 100% of multiple CMOs to alter the CMOs' PSAs and of multiple CMO^2s to alter the CMO^2s' PSAs.

The impossibility of modifying PSAs to permit modification on a wide scale is further complicated because many homeowners have more than one mortgage. Even if the mortgages are from the same lender, they are often securitized separately. If a homeowner is in default on two or three mortgages it is not enough to reassemble the MBS pieces to permit a modification of one of the mortgages. Modification of the senior mortgage alone only helps the junior mortgage holders, not the homeowner. In order for a loan modification to be effective for the first mortgage, it is necessary to also modify the junior mortgages, which means going through the same process. This process is complicated because senior lenders frequently do not know about the existence of the junior lien on the property.

A further complication comes from insurance. An SPV's income can exceed the coupons it must pay certificate holders. The residual value of the SPV after the certificate holders are paid is called the Net Interest Margin (NIM). The NIM is typically resecuritized separately into an NIM security (NIMS), and the NIMS is insured by a financial institution. This NIMS insurer holds a position similar to an equity holder for the SPV. The NIMS insurer's consent is thus typically required both for modifications to PSAs and modifications to the underlying mortgages beyond limited thresholds. NIMS insurers' financial positions are very similar to out-of-the-money junior mortgagees—they are unlikely to cooperate absent a payout because they have nothing to lose.

Thus, the contractual structure of securitization creates insurmountable obstacles to voluntary, private modifications of distressed and defaulted mortgages, even if that would be the most efficient outcome.

[35] 15 U.S.C. § 77ppp(b).

B. Practical Obstacles to Voluntary Modification

There are a range of practical difficulties that impede voluntary modification programs. Servicers lack sufficient personnel to handle a large volume of customer contacts. Servicers lack the trained loan officers necessary to handle the volume of requested modifications, which are essentially the underwriting of a new loan. Servicers often have trouble contacting financially distressed borrowers. And the computer software that servicers use to do their net present value calculations to compare returns from foreclosure or successful modifications may use obsolete inputs, such as assuming that housing prices are rising, which will lead servicers to wrongly believe that foreclosure is the best loss mitigation outcome.

C. Economic Disincentives for Servicers to Engage in Voluntary Modifications

Securitization also creates serious incentive misalignment problems that can lead to inefficient foreclosures. Mortgage servicer compensation structures create a situation in which foreclosure is often more profitable to servicers than loan modification. Therefore servicers are incentivized to foreclose rather than modify loans, even if modification is in the best interest of the MBS holders and the homeowners.[36]

Servicers receive three main types of compensation: a servicing fee, which is a percentage of the outstanding balance of the securitized mortgage pool; float income from investing homeowners mortgage payments in the period between when the payments are received and when the are remitted to the trust; and ancillary fees. When a loan performs, the servicer has largely fixed-rate compensation. This is true also when a loan performs following a modification.

Thus, if a servicer modifies a loan in a way that reduces monthly payments, the servicer will have a reduced income stream itself. This reduced income stream will only last as long as the loan is in the servicing portfolio. If the loan is refinanced or redefaults, it will leave the portfolio. Generally servicers do not expect loans to remain in their portfolios for very long. For example, a 2/28 ARM is likely to be refinanced by year three, when the teaser rate expires, and move to another servicer's portfolio. Moreover, for non-GSE RMBS, servicers are not compensated for the sizeable costs of loan modification. Thus, when a servicer modifies a loan, the servicer loses servicing and float income (which it will not have long into the future anyhow) and incurs expenses.

When a servicer forecloses, servicer compensation shifts to a cost-plus basis. The servicer does not receive any additional servicing fee or float revenue from the loan, but does receive all expenses of the foreclosure, including any fees it tacks on, such as collateral inspection fees, and process serving fees, etc. These fees are paid off the top from foreclosure recoveries, so it is the MBS holders, not the servicer, that incur the loss in foreclosure.[37] The fees servicers can lard on in foreclosure can be considerable, and

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[36] Adam J. Levitin & Tara Twomey, *Not Everyone Loses in Foreclosure: Principal-Agent Conflict in Mortgage Backed* Securities, working paper, Nov. 17, 2008 (on file with author).

[37] Servicer income in foreclosure is offset in part by the time-value of advancing payments owed on defaulted loans to the trust until foreclosure. These payments are recoverable by the servicer, but without interest.

there is effectively no oversight of their reasonableness or even authorization.[38] MBS holders lack the ability to monitor servicer decisions, and securitization trustees do not have the responsibility to do so. Servicers are essentially able to receive cost-plus-percentage-of-cost compensation when foreclosing. The incentive misalignments from this form of compensation are so severe that it is flatly prohibited for federal government contracts.[39]

The choice between modification and foreclosure is a choice between limited fixed-price income and a cost-plus contract arrangement with no oversight of either the costs or the plus components. For mortgage servicers, this creates a very strong incentive to foreclose on defaulted loans rather than modify them, even if modification is in the best interest of the MBS holders.[40] The principal-agent conflict between RMBS holders and mortgage servicers is a major factor inhibiting voluntary loan modifications.

III. Permitting Modification of All Mortgages in Bankruptcy Will Not Result in Higher Mortgage Rates or Less Credit Availability

Traditionally, bankruptcy is one of the major mechanisms for resolving financing distress. Bankruptcy creates a legal process through which the market can work out the problems created when parties end up with unmanageable debt burdens. Although the process can be a painful one for all parties involved, bankruptcy allows an orderly forum for creditors to sort out their share of losses and return the deleveraged debtor to productivity; a debtor hopelessly mired in debt has little incentive to be economically productive because all of the gain will go to creditors. Moreover, the existence of the bankruptcy system provides a baseline against which consensual debt restructurings can occur. Thus, for over a century bankruptcy has been the social safety net for the middle class, joined later by Social Security and unemployment benefits.

The bankruptcy system, however, is incapable of handling the current home foreclosure crisis because of the special protection it gives to most residential mortgage claims. Debtors may generally modify all types of debts in bankruptcy—reducing interest rates, stretching out loan tenors, changing amortization schedules, and limiting secured claims to the value of collateral ("strip down" or "cram down"). Under current law, debtors can modify mortgages on vacation homes, investor properties, and multifamily residences in which the owner occupies a unit.[41] Debtors can also currently

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[38] Katherine M. Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims*, 87 TEX. L. REV. (2008).

[39] *See* 41 U.S.C. § 254(b); 10 U.S.C. § 2306(a).

[40] Alternatively, if a servicer modifies a loan in a way that guarantees a quick redefault, it might be even more profitable. This might explain why so many modifications have resulted in *higher* monthly payments and why a large percentage of foreclosures have been after failed modification plans. *See* Jay Brinkmann, Mortgage Bankers Association, *An Examination of Mortgage Foreclosures, Modifications, Repayment Plans, and Other Loss Mitigation Activities in the Third Quarter of 2007*, at 10, *at* http://www.mortgagebankers.org/files/News/InternalResource/59454_LoanModificationsSurvey.pdf (nearly 30% of foreclosure sales in the third quarter of 2007 involved failed repayment plans).

[41] *E.g.*, *In re* Scarborough, 461 F.3d 406, 413 (3d Cir. 2006) (permitting strip-down on two unit property in which the debtor resided); Chase Manhattan Mortg. Corp. v. Thompson (*In re* Thompson), 77 Fed. Appx. 57, 58 (2d Cir. 2003) (permitting strip-down on three unit property in which the debtor resided);

modify wholly unsecured second mortgages on their principal residences,[42] as well as loans secured by yachts, jewelry, household appliances, furniture, vehicles, or any other type of personalty.[43]

The Bankruptcy Code, however, forbids the modification of mortgage loans secured solely by the debtor's principal residence.[44] Single-family owner-occupied property mortgage loans must be cured and then paid off according to their original terms, including all fees that have been levied since default, or else the bankruptcy automatic stay will be lifted, permitting the mortgagee to foreclose on the property. As a result, if a debtor's financial distress stems from an unaffordable home mortgage, bankruptcy is unable to help the debtor retain her home, and foreclosure will occur.

The Bankruptcy Code's special protection for home mortgage lenders reflects an economic assumption that preventing modification of home mortgage loans in bankruptcy limits lenders' losses and thereby encourages greater mortgage credit availability and lower mortgage credit costs, which in turn encourage homeownership.[45] Underlying the economic assumption embedded in the Bankruptcy Code's anti-modification provision is another assumption—that mortgage markets are sensitive to bankruptcy modification risk. All existing empirical evidence, however, indicates that these assumptions are incorrect. Mortgage markets are indifferent to bankruptcy modification risk.[46]

A. All Empirical Evidence Indicates that Mortgage Markets Are Indifferent to Bankruptcy Modification Except at Margins

There is a simple way to test for market sensitivity to bankruptcy modification: compare mortgage interest and insurance rates on property types for which the mortgages may currently be modified in bankruptcy with the rates on properties on which the

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Lomas Mortg., Inc. v. Louis, 82 F.3d 1 (1st Cir. 1996) (permitting strip-down on three unit property in which the debtor resided).

[42] Every federal circuit court of appeals to address the issue has held that modification, including strip-down, of wholly unsecured second mortgages on principal residences is permitted. *See, e.g.* Zimmer v. PSB Lending Corp. (*In re* Zimmer), 313 F.3d 1220, 1227 (9th Cir. 2002); Lane v. W. Interstate Bancorp (*In re* Lane), 280 F.3d 663, 669 (6th Cir. 2002); Pond v. Farm Specialist Realty (*In re* Pond), 252 F.3d 122, 126 (2d Cir. 2001); Tanner v. FirstPlus Fin., Inc. (*In re* Tanner), 217 F.3d 1357, 1360 (11th Cir. 2000); Bartee v. Tara Colony Homeowners Ass'n (*In re* Bartee), 212 F.3d 277, 288 (5th Cir. 2000); McDonald v. Master Fin., Inc. (*In re* McDonald), 205 F.3d 606, 608 (3d Cir. 2000); *In re* Lam, 211 B.R. 36 (9th Cir. BAP), *appeal dismissed*, 192 F.3d 1309 (9th Cir. 1999).

[43] Until 2005, loans secured by all vehicles could be stripped-down. Since October 17, 2005, purchase money loans secured by motor vehicle may not be stripped-down in their first two-and-a-half years, and other purchase money secured loans may not be stripped-down in their first year. 11 U.S.C. § 1325(a)(9) (hanging paragraph).

[44] 11 U.S.C. § 1322(b)(2). *Cf.* 11 U.S.C. § 1123(b)(5) (parallel residential mortgage anti-modification provision for Chapter 11). Section 1322(b)(2) provides that a plan of reorganization 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..." Since 2005, section 101(13A) of the Bankruptcy Code has defined "debtor's principal residence" as "a residential structure, including incidental property, without regard to whether that structure is attached to real property and...includes an individual condominium or cooperative unit, a mobile or manufactured home or trailer." 11 U.S.C. § 101(13A). State law, however, still determines what is "real property."

[45] Nobelman v. Am. Sav. Bank, 508 U.S. 324 (1993) (Stevens, J., concurring).

[46] Mortgage servicers, however, may not be, as discussed above in section II.C.

mortgages may not be modified in bankruptcy. Courts have interpreted the Bankruptcy Code's mortgage anti-modification provision to apply only to single-family principal residence mortgages.[47] Thus, single-family principal residence mortgages may not be modified in bankruptcy; all other mortgages may be modified in bankruptcy. One would expect that if the market were sensitive to bankruptcy modification, there would be a risk premium for mortgages on the types of property that can currently be modified in bankruptcy—mortgages on vacation homes, multifamily homes, and investment properties—and that this premium would not exist for single-family owner-occupied principal residence mortgages, which cannot be modified.

In an article forthcoming in the *Wisconsin Law Review*,[48] I tested this hypothesis using three different pricing measures in mortgage markets: effective mortgage interest rates (annual percentage rates or APRs), private mortgage insurance rates, and secondary mortgage market pricing from Fannie Mae and Freddie Mac. In each market I examined rate variation by property type in order to isolate the expected risk premium for bankruptcy modification risk on non-single-family owner-occupied properties. All three measures indicate that mortgage markets are indifferent to bankruptcy modification risk, at least in terms of pricing;[49] the variation in rates in each market does not track with bankruptcy modification risk.

In a companion article-in-progress, coauthored with Joshua Goodman of Columbia University, I test the impact of permitting cramdown historically in the period before 1993, when it was permitted in many judicial districts. This historical evidence shows scant evidence of market sensitivity. Historically, in a very different mortgage market, we only detect a 12 basis point average impact on interest rates from cramdown, and no impact on credit availability. Current market data, however, suggest no impact whatsoever from any ability to modify mortgages in bankruptcy. Taken together, the evidence in these articles suggests that permitting modification of mortgages in bankruptcy would have no overall impact on mortgage costs or availability, except at the margins. Marginal, high-risk borrowers might find credit slightly more expensive, but all available evidence indicates that there will be no impact on creditworthy borrowers.

These empirical finding comport with economic theory. If foreclosure losses are greater than bankruptcy modification losses, the market will not price against bankruptcy modification. Evidence from a variety of historical and contemporary sources indicates that lenders' losses from bankruptcy modification would be less than from foreclosure. Indeed, by definition a lender cannot do worse in bankruptcy than in foreclosure; bankruptcy law provides that a secured lender must receive at least what the lender would receive in foreclosure, namely the value of the collateral.[50]

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[47] *See supra* note 41.

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

[49] It is possible that there is simply less available credit for modifiable properties. We were unable to test this possibility, however.

[50] At worst, then bankruptcy only imposes a *de minimis* time delay on the lender (which may itself be helpful, depending on the housing market), but the adequate protection provisions of the Bankruptcy Code ensure that the mortgagee is protected against declines in the house's value. 11 U.S.C. § 361.

B. The Mortgage Bankers Association's Claim Regarding the Impact of Bankruptcy Modification Is Patently False and Disprovable

The Mortgage Bankers Association (MBA) has claimed that permitting modification of mortgages in bankruptcy will result in an effective 200 basis point increase in interest rates on single-family owner-occupied properties ("principal residences").[51] The MBA figure has varied over the course of the MBA's lobbying effort against bankruptcy reform, shrinking by a quarter to 150 basis points in more recent lobbying materials. The MBA's methodology for calculating the figure has also changed.[52] Regardless of size or calculation, the MBA figure is patently false and is the result of a cherry-picked comparison.

The MBA figure is derived from a comparison of the current interest rate spread between mortgages on single-family principal residences and on investor properties.[53] The MBA reasons that because single-family principal residence mortgages cannot be modified in bankruptcy while investor property mortgages can, then the *entire* difference in mortgage prices for these property types is attributable to bankruptcy modification risk for the investor properties.

The MBA's claim is demonstrably false. First, the MBA engages in questionable calculations of the price spread. It includes not only the current additional interest rate premium for investor properties of 37.5 basis points, but also amortizes the higher down payments and points generally required on investor properties in order to achieve the 200 (or 150) basis point figure.[54]

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

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

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

[53] Kittle, *supra* note 51, at 3.

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

Even accepting the MBA's inflated numbers, however, the idea that the entire spread in mortgage rates between single-family owner-occupied properties and investor properties being due to bankruptcy modification risk is preposterous.[55]

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

There are many non-bankruptcy risk factors that explain the pricing spread on mortgages between investment properties and single-family owner occupied properties. The higher interest rates and points required on investor properties are explained by higher default rates on investor properties, the greater likelihood of investor properties being non-recourse, and the more limited secondary market for investor property mortgages. Investor properties have inherently greater default risk in part because an investor has the additional rent or mortgage expense that an owner-occupier does not. Investor properties also carry a variety of tenant risks—vacancy, nonpayment, and damage. Because investor properties mortgages are often financed through rental payments, tenant risk adds to the default risk. There are myriad risk factors for investor properties that single-family owner-occupied properties do not have. The MBA, of all organizations, should recognize that most, if not all, of the price spread between investor property mortgages and single-family owner-occupied mortgages is due to factors *other* than bankruptcy modification risk. Yet the MBA contends that the entire price-spread is due to differences in bankruptcy modification risk. If the MBA revealed a non-cherry-picked comparison in its lobbying materials, its spurious 150 or 200 basis point claim would fall apart.

Based on my empirical analysis of a wide variety of mortgage market data,[56] there is statistically a zero percent chance that the MBA's 150 or 200 basis point claim is

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

correct. All empirical and market observational data indicates that that MBA's claim of an effective 150-200 basis point increase from allowing strip-down is simply groundless. At best the MBA's figure is a wild and irresponsible guess; at worse it is a deliberately concocted falsehood.

Contrary to the MBA's spurious claims, all empirical evidence indicates that there is unlikely to be anything more than a *de minimis* effect on interest rates as a result of permitting bankruptcy modification.

IV. BANKRUPTCY MODIFICATION DOES NOT CREATE A MORAL HAZARD

One of the major objections voiced against permitting modification of mortgages in Chapter 13 bankruptcy is that it will create a moral hazard and that consumers will be tempted to go out and gamble on unaffordable loans because they can always discharge their debt in bankruptcy. This view reflects a fundamental misunderstanding of the bankruptcy process and of the problem created by foreclosures.

A. Bankruptcy Imposes Significant Costs on Debtors

Permitting modification of mortgages in Chapter 13 bankruptcies will not create a moral hazard problem. Chapter 13 is not a "drive-by" process. In order to receive a discharge in Chapter 13, a debtor must live on a court-supervised means-tested budget for 3 or 5 years.[57] Having to get the court and the United States Trustee to sign off on the reasonableness of daily expenses creates a powerful disincentive against filing for bankruptcy unless the filing is absolutely necessary. Moreover, Chapter 13 insists on full repayment of certain debts, including allowed secured claims, domestic support obligations, and tax liabilities.[58] A below-median-income debtor who does not repay creditors in full can only receive a Chapter 13 discharge once every six years; an above-median-income debtor who does not repay creditors in full can only receive a Chapter 13 discharge once every ten years.[59] This means that the minimum time between repeat Chapter 13 filings is longer than the time a foreclosure stays on a credit report.

Debtors are also unlikely to receive a windfall from Chapter 13 modification. Cramdown would only result in the debtor having zero equity in the property, not positive equity. Given the large transaction costs to a sale, debtors are unlikely to sell their properties for anything beyond a *de minimis* profit absent a remarkable recovery of the housing market.

B. Wealthy Debtors Are Ineligible for Chapter 13 Bankruptcy

It is also important to recognize that permitting modification of mortgages in Chapter 13 bankruptcy will not result in wealthy or spendthrift debtors receiving unmerited relief. For starters, Chapter 13 bankruptcy is not available to debtors with

[56] *See* Levitin, *supra* note 48.

[57] 11 U.S.C. § 1325(b).

[58] 11 U.S.C. §§ 1322(a); 1325(a)(5).

[59] 11 U.S.C. § 1328(f)(2) prohibits a Chapter 13 discharge if a Chapter 13 discharge was granted within two preceding years, but for debtors who do not repay creditors in full, a Chapter 13 plan must last at least three of five years, depending on whether the debtor is below or above the applicable state's median income. 11 U.S.C. §§ 1325(b)(1), (4). Thus, it is the length of plan, not the time between discharges, that controls for debtors who have repay less than 100% of their debts.

huge debt burdens. To file for Chapter 13, an individual must have less than $250,000 in noncontingent, liquidated, unsecured debts and less than $750,000 in noncontingent, liquidated secured debts.[60] This means that a homeowner with a million dollar mortgage cannot avail himself of Chapter 13. Instead, if that homeowner wishes to keep his mansion, he must file for Chapter 11 bankruptcy. While there is a parallel antimodification provision in Chapter 11,[61] adopted after the Supreme Court's 1993 *Nobelman* (banning cramdown of principal residence mortgages in Chapter 13) in the 1994 amendments to the Bankruptcy Code, there has been no legislation proposed to remove it.[62]

C. Permitting Bankruptcy Modification Would Not Benefit Speculators or Vacation Home Purchasers

Bankruptcy modification would not yield a windfall to housing speculators ("flippers") or second home purchasers. A mortgage loan modification in bankruptcy can occur only as part of a plan.[63] The automatic stay would likely be lifted on an investment property (or second home) before a plan could be confirmed.[64] Accordingly, speculators and homeowners intent on keeping their second homes are unlikely to file for bankruptcy to seek mortgage modification in the first place. Permitting bankruptcy modification of primary home mortgages thus steers a true course between extending the right sort of relief and not extending it too broadly.

D. Foreclosure Falls Within the Moral Hazard Exception for "Contagion Fires"

Permitting bankruptcy modification of mortgages in order to prevent inefficient foreclosures also fits into a well-recognized exception to moral hazard, that for "contagion fires." It would create a moral hazard for the fire department to rescue people from fires caused by smoking in bed, yet we rescue in-bed smokers without hesitation, in part because fires can spread and harm third-parties, like neighbors. Foreclosures function like fires, and a rash of foreclosures can destroy property values throughout a neighborhood.

Moral hazard concerns are inapplicable given the immense third-party costs of foreclosures, and the Bankruptcy Code already has powerful antidotes to moral hazard risk. Concerns about more than isolated serial and strategic filings are greatly overstated and unsupported by empirical evidence.

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[60] 11 U.S.C. § 109(e).

[61] 11 U.S.C. § 1123(b)(5).

[62] Arguably, 1123(b)(5) is largely unnecessary in light of 1111(b), and its presence deprives creditors of their ability to make an 1111(b) election.

[63] 11 U.S.C. § 1322(b) ("A *plan* may...") (emphasis added).

[64] The Bankruptcy Code provides that the automatic stay shall be lifted for cause, including either lack of adequate protection of a secured creditor's interest in the property—that is payments to compensate the secured creditor for depreciation in its collateral during the bankruptcy—or if the debtor does not have equity in the property and the property is not necessary for an effective reorganization. 11 U.S.C. § 362(d). Thus, debtors with positive equity who could not handle mortgage payments prepetition would be unlikely to be able to make the adequate protection payments necessary to prevent the lifting of the stay, 11 U.S.C. § 362(d)(1), and debtors with negative equity would find the stay lifted because investment properties and second homes are not essential to their reorganizations. 11 U.S.C. § 362(d)(2).

V. POTENTIAL IMPROVEMENTS TO THE BILL

A. Equalize Treatment of Bankruptcies and Foreclosures on Credit Reports

The legislation could be improved by changing section 605(a)(1) of the Fair Credit Reporting Act,[65] to provide that Title 11 case may not remain on a credit report for more than seven years. Currently Title 11 cases may remain on credit reports for up to ten years, while all other adverse reports, including foreclosures, may remain on credit reports for only up to seven years. The unequal weighting of bankruptcy filings and other defaults on credit reports creates a disincentive for bankruptcy filings and should be changed.

The unequal weighting of foreclosures and bankruptcies on credit reports bears no correlation with lenders' ultimate recovery on their loans. Nor does it provide much protection to potential creditors, as there is only a two-year window under which two Chapter 7 discharges could appear on a credit report,[66] and serial bankruptcy filers will have sufficient other adverse entries on their credit reports to alert potential creditors of risk. Equalizing the treatment of bankruptcies and other defaults on credit reports would simply lead to bankruptcy being treated as a default on all reported debts, which is exactly what it is.

The Bankruptcy Code already has provisions to address the potential problem of serial bankruptcy filers;[67] credit reporting is not the place to do so. Bankruptcy is sometimes both the responsible, efficient, and fair course of action, and it should not be disincentivized relative to a non-bankruptcy default. Moreover, leaving bankruptcies on credit reports longer than other types of defaults interferes with the core bankruptcy policy of the fresh start for honest but unfortunate debtors. Bankruptcy filings should be treated like any other default for the purposes of credit reporting.[68]

Notably, when the FCRA was enacted in 1970, it provided that bankruptcy filings could remain on credit reports for fourteen years, while all other types of adverse entries could only remain on reports for seven years. When Congress passed the Bankruptcy Reform Act of 1978 that created the current Bankruptcy Code, the House bill included an amendment by Representative McKinney of Connecticut that would have reduced the time bankruptcy remains on a credit report from fourteen to seven years. Representative McKinney noted that "an exhaustive search of the legislative history of [the fourteen year] provision has disclosed no compelling reason for the statute's unforgivingly lengthy memory."[69] While Representative Butler noted that "The purpose of the provision was to keep the record open long enough so that creditors could determine whether the individual had filed more than one bankruptcy,"[70] this reason is simply inapplicable in the world of modern, instantaneous, computerized credit scoring. Indeed, even at the

[65] 15 U.S.C. § 1681c(a)(1).

[66] 11 U.S.C. § 727(a)(8) (requiring eight years between Chapter 7 discharges).

[67] *See,* 11 U.S.C. §§727(a)(8)-(9); 1328(f).

[68] I do not express an opinion on the length of time a bankruptcy or other default should be on a credit report, only that they should not receive disparate treatment.

[69] 124 CONG. REC. H1799, Feb. 1, 1978 (statement of Rep. Stuart Brett McKinney (R-Conn.))

[70] *Id.* (statement of Rep. Manley Caldwell Butler, R.-Va.)

time, Representative Butler did not think it was reason enough and supported the amendment. Yet the enrolled version of the Bankruptcy Reform Act only reduced the time that bankruptcy remains on credit report from fourteen to ten years,[71] in a compromise between the Senate and House.[72]

Unfortunately, this compromise creates an imbalance in credit reporting treatment that favors foreclosure to bankruptcy filing. Given that bankruptcy modification of mortgages presents an important potential tool for helping homeowners keep their homes and benefiting all parties at interest—homeowners, lenders, and communities—it is important to amend the FCRA to provide for equal treatment of bankruptcy and foreclosure.

B. Permit Mortgage Modification in Chapter 11 Bankruptcies

Any changes made to section 1322(b)(2) of the Bankruptcy Code should also be made to its parallel Chapter 11 provision, 11 U.S.C. § 1123(b)(5).[73] Debtors who have too much debt to qualify for Chapter 13 are not particularly sympathetic characters. But for inflated real estate markets like California, there are far from wealthy debtors who have mortgage and auto loan debt that exceeds $750,000, making them ineligible for Chapter 13. Making a parallel change in Chapter 11 would have even less impact on creditors, not just because of the relative rarity of individual Chapter 11 filers, but also because in Chapter 11 creditors have the protection of a plan vote and, for undersecured creditors, an 1111(b) election, which allows them to avoid cramdown.

VI. CONCLUSION

Bankruptcy modification presents the best and most powerful solution to the foreclosure crisis. It presents an impressive list of features:

- Immediate solution
- No cost to taxpayers
- Addresses both negative equity and payment reset shock
- Addresses the contractual and incentive problems created by securitization; cuts servicers out of the modification decision
- Addresses the problem of second lien mortgages
- No moral hazard problem
- No costs for future borrowers
- Screens out speculators
- Forces losses to be shared by lender and borrowers

[71] Bankruptcy Reform Act of 1978, P.L. 95-598, § 312(b), 92 Stat. 2676 (Nov. 6, 1978).

[72] 124 CONG. REC. H32411, Sept. 28, 1978; S34011 Oct. 5, 1978.

[73] Mortgage modification is already possible in Chapter 12 family farm or fisherman bankruptcies. 11 U.S.C. § 1222(b)(2).

- Encourages voluntary modifications

In a perfectly functioning market without agency and transaction costs, lenders would be engaged in large-scale modification of defaulted or distressed mortgage loans, as the lenders would prefer a smaller loss from modification than a larger loss from foreclosure. Voluntarily modification, however, has not been happening on a large scale[74] for a variety of reasons,[75] most notably contractual impediments, agency costs, practical impediments, and other transaction costs.

If all distressed mortgages could be modified in bankruptcy, it would provide a method for bypassing the various contractual, agency, and other transactional inefficiencies. Permitting bankruptcy modification would give homeowners the option to force a workout of the mortgage, subject to the limitations provided by the Bankruptcy Code. Moreover, the possibility of a bankruptcy modification would encourage voluntary modifications, as mortgage lenders would prefer to exercise more control over the shape of the modification. An involuntary public system of mortgage modification would actually help foster voluntary, private solutions to the mortgage crisis.

Unlike possible programs for government refinancing or guarantee of distressed mortgages, the bankruptcy system is immediately available to resolve the mortgage crisis. Government refinancing or guarantee plans would take months to implement, during which time foreclosures would continue. In contrast, bankruptcy courts are experienced, up-and-running, and currently overstaffed relative to historic caseloads. Moreover, the bankruptcy automatic stay would immediately halt any foreclosure action in process upon a homeowner's filing of a bankruptcy petition.[76] And, unlike government guarantees or refinancing, bankruptcy modification of all mortgages would not involve taxpayer dollars.

Bankruptcy modification would not impose costs on future borrowers except at the very margins. A wide range of empirical data show that permitting bankruptcy modification of all mortgages would have little or no impact on mortgage credit cost or availability. Because lenders face smaller losses from bankruptcy modification than from foreclosure, the market will not price against bankruptcy modification.

Bankruptcy modification would also avoid the moral hazard for lenders and borrowers of a bailout. Lenders would incur costs for having made poor lending decisions thru limited recoveries. Borrowers would face the requirement of living for three or five years on a court-supervised budget in which all disposable income goes to creditors, a damaged credit rating, and the inability to file for bankruptcy for a number of years.

Bankruptcy modification also provides an excellent device for sorting out types of mortgage debtors. It can correct the two distinct mortgage problems in the current crisis--payment reset shock from resetting adjustable rate mortgages and negative equity from

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[74] *See, e.g.*, Office of the Comptroller of the Currency, OCC Mortgage Metrics Report: Analysis and Disclosure of National Bank Mortgage Loan Data, October 2007-March, 2008, *at* http://www.occ.treas.gov/ftp/release/2008-65b.pdf.

[75] *See* Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 HOUSING POL'Y DEBATE (2007).

[76] 11 U.S.C. § 362(a).

rapidly depreciating home prices—while preventing speculators and vacation home purchasers from enjoying the benefits of modification. And, by providing an efficient and fair system for restructuring debts and allocating losses, bankruptcy will help stabilize the housing market.

Allowing bankruptcy to serve as a forum for distressed homeowners to restructure their mortgage debts is both the most moderate and the best method for resolving the foreclosure crisis and stabilizing mortgage markets. Unlike any other proposed response, bankruptcy modification offers immediate relief, solves the market problems created by securitization, addresses both problems of payment reset shock and negative equity, screens out speculators, spreads burdens between borrowers and lenders, and avoids both the costs and moral hazard of a government bailout.

Permitting modification of all mortgages in bankruptcy would thus create a low-cost, effective, fair, and immediately available method for resolving much of the current foreclosure crisis without imposing costs taxpayers, creating a moral hazard for borrowers or lenders, or increasing mortgage credit costs or decreasing mortgage credit availability. As the foreclosure crisis deepens, bankruptcy modification presents the best and least invasive method of stabilizing the housing market and is a crucial step in stabilizing financial markets.

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TESTIMONY OF CHRISTOPHER J. MAYER
BEFORE THE COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE
HEARING: HELPING FAMILIES SAVE THEIR HOMES: THE ROLE OF BANKRUPTCY LAW
NOVEMBER 19, 2008

Good morning Chairman Leahy, Ranking Member Specter, Ac and Members of the Committee. Thank you for inviting me to speak today. My name is Christopher J. Mayer. I am the Paul Milstein Professor of Real Estate and Senior Vice Dean at Columbia Business School. I have spent the last 16 years studying housing markets and credit while working at the Federal Reserve Bank of Boston and serving on the faculties of Columbia Business School, the University of Michigan Business School, and the Wharton School of the University of Pennsylvania.

Preventing foreclosures is an important goal because of the human suffering from homeowners losing their homes and the spillover effect on local communities and governments. However, it is crucial to consider the broader context of the housing and foreclosure crisis. Reducing foreclosures through allowing judicial "strip-downs" comes with many risks, including likely increases in the future cost of borrowing (or reductions in the amount available to borrow) as well as the possibilities of many millions of additional bankruptcy filings and of substantially slowing down the recovery of the housing and mortgage markets. These negative consequences would impact nearly all Americans. In addition, in my view, there are quicker and more substantial policies available that could substantially reduce foreclosures by reducing the rate of house price declines as well as benefitting tens of millions of homeowners and potential homeowners. These policies would focus on reinvigorating the mortgage market and helping bridge the gap between house prices and mortgage values. My comments on judicial strip downs as well as suggestions for alternative policies are summarized below.

1) Risks and Problems with Judicial "Strip Downs" and existing legislation

a. <u>While few studies exist, evidence suggests "strip-downs" or delays in foreclosures reduce the amount of available mortgage borrowing and may also increase mortgage rates.</u>

Economists often point out that there is no such thing as a free lunch. Two recent papers on mortgage lending provide consistent evidence that strip-downs or slower foreclosures reduce the amount of borrowing available. Karen Pence shows that loans sizes are 3 to 7 percent smaller in defaulter-friendly states.[1] Research by Adam Levitin and Joshua Goodman shows that loan-to-value ratios are almost 2.8 percent lower for the borrowers at the 80th percentile of the loan-to-value distribution in their preferred specification within 6 months of allowing strip-downs (Table 4a).[2] As well, the authors find increased mortgage rates at or below the median borrowing rate of between 0.15 and 0.27 percent within 6 months after allowing strip-downs (Table 2a). In addition, the Levitin and Goodman evidence might well underestimate the effect of allowing strip-downs on credit availability. Uncertainty across judicial districts at the time of those changes in federal judicial rulings suggests that lenders must have factored in some risk that the courts or legislators might eventually clarify the law to allow strip-downs in all states. The Pence results are based on more stable differences in state laws and find larger impacts of reduced creditor rights on mortgage credit availability.

Even beyond existing studies, common sense suggests lenders would be wary of lending in an environment in which rules change after the fact and creditor rights to collect on their collateral are reduced.

b. The current legislation provides disincentives to borrowers to negotiate under most existing private and FDIC-sponsored loan modification programs, likely delaying resolution of the housing crisis.[3]

The recently announced FDIC program to modify Indy Mac mortgages provides a possible benchmark for other private lenders and servicers to roll-out large-scale programs to quickly modify millions of troubled loans. The FDIC/Indy Mac program provides for reductions in both interest rates and forbearance on principal payments.[4] While there are some problems with the incentives in the FDIC/Indy Mac program that encourage borrowers to miss payments in order to qualify for a loan modification, this program can be rolled-out in a large enough scale to make a significant dent in foreclosures over a short period of time and

[1] Pence, Karen M. 2006. "Foreclosing on Opportunity: State Laws and Mortgage Credit." *Review of Economics and Statistics*, 88:1, 177-82.
[2] Levitin, Adam J and Joshua Goodman. 2008. "The Effect of Bankruptcy Strip-Down on Mortgage Markets," Georgetown University Law Center, Business, Economics and Regulatory Policy Working Paper Series Research Paper No. 1087816.
[3] See "Loan Modification Review" issued by RBS/Greenwich Capital on 11/14/2008 for a summary of the various loan modification programs.

[4] Forbearance reduces the amount of principal that a lender applies interest to when computing monthly mortgage payments.

thus has significant benefits. The recently announced private effort by JP Morgan/Chase uses a similar strategy of loan forbearance. Many of the Bank of America and Citigroup modifications to subprime loans involve interest rate reductions rather than principal reductions. Fannie Mae and Freddie Mac have rolled out their own programs.

Borrowers have little incentive to accept an offer from a lender of interest rate reductions or forbearance, when they can go to court and have a judge strip-down their principal balance, leading to an eventual permanent reduction in the amount of money they owe on their mortgage. When house prices rise, as they eventually will, strip-downs eliminate the possibility that a lender will ever recover its losses on borrowing. Thus borrowers have incentives to hold out for a better deal than they are likely to be currently offered, potentially delaying the resolution of housing problems for years. It will require time for the courts to examine all the issues with various types of complex mortgages and to develop precedents and operating procedures for handling millions of bankruptcies. Evidence from the Japanese recession of the 1990s shows that delays in resolution are a poor way of dealing with credit problems.

Private lenders do not face legal restrictions with resolving their own loans, as servicers do, so they could choose write downs if they thought that write-downs were a more profitable way of resolving credit problems relative to forbearance. Thus a program of forcing strip-downs must surely lower these lenders' recoveries, leading them to raise rates on future loans given the likelihood that judicial strip-downs might become the law for future loans as well.

Private lenders are now moving ahead with much more aggressive workout programs. These programs should be given time to work. To the extent that legal liabilities for servicers are delaying workouts for some pools, legislators might consider more explicit protections for servicers who attempt to maximize recoveries through applying the same loan modification program to their pools with third-party servicing as with their own pools. However, as described below, I believe that a program to share losses and move as many mortgages as possible out of troubled securitizations is the best policy.

c. <u>The existing legislation is written quite broadly relative to the number of borrowers who might have been misled by lenders.</u>

One of the largest tragedies of the current subprime crisis is the fact that some borrowers were misled into getting mortgages that they did not understand and would eventually not be able to afford. Research by economists Brian Bucks and Karen Pence of the Federal Reserve Board shows that the most difficult to understand provisions of mortgages included the margin on adjustable rate mortgages and the possibility of future rate increases.[5]

The existing legislation includes all subprime loans, both fixed- and adjustable-rate loans. Borrowers with fixed-rate mortgages would have surely received loans that they understood. While the payment-to-income ratios were high on some of these subprime loans, borrowers likely understood the benefits of making regular payments in order to allow them to build up their credit and refinance into a lower rate mortgage. As I discuss below, the most appropriate fix for these borrowers is to repair the mortgage market so responsible subprime borrowers who have made all their payments can refinance into a lower rate, conforming mortgage. Allowing fixed-rate borrowers with simple mortgages to strip-down their balance is unfair to the many other borrowers who took on mortgages and bought houses they could better afford.

As well, many adjustable-rate borrowers may now be in default even before they have faced an appreciable rate increase. If the major problem is the excesses associated with subprime lending, I would recommend that the legislation much more narrowly focus on two particular products that encompass the most toxic loans: i) subprime 2/28 or 3/27 mortgages—loans that are fixed for 2 or 3 years, and then adjust to a higher rate beyond the teaser rate; and ii) so-called "option ARMs" that allow mortgage balances to negatively amortize. To further limit a possible spurt of bankruptcy filings and to encourage quicker workouts, lenders should be able to obtain a "safe harbor" from bankruptcy filing by modifying the loan to ensure that rates on subprime 2/28 or 3/27 mortgages will not rise above the initial rate. The option-ARMs are more difficult to resolve, but lenders should be able to obtain a safe harbor by limiting the extent of negative amortization by writing down mortgage balances. It was for the group of option ARM borrowers that Bank of America agreed to forgive some negative amortization in the Countrywide settlement.

Limiting the legislation to a very specific group of likely misled borrowers allows for a much quicker resolution of existing cases, as well as sends a message to lenders that the legislated strip-downs are quite limited and thus might mitigate

[5] Bucks, Brian and Karen Pence. 2008. "Do borrowers know their mortgage terms?" *Journal of Urban Economics*, 64(2): 218–33.

future mortgage rate increases from the legislation. After all, it is quite unlikely that lenders will again issue such toxic mortgage products in any scale. By contrast, applying strip-downs to fixed-rate mortgages sold to riskier borrowers sends a strong message to future lenders that they should be careful about lending to risky borrowers. This would likely appreciably reduce lending for exactly the type of mortgage loans for the riskiest borrowers that we would like to encourage in the future and set back much of the recent progress in providing funding to disadvantaged borrowers.

I should be clear: I believe it would be quite problematic to allow the judicial strip-downs proposed in this legislation as they inherently change the terms of existing lending contracts and inhibit the possibility of quicker large-scale resolutions of problem loans. However, limiting the classes of covered borrowers would mitigate the damage and there are some compelling arguments in favor of adjusting the terms of the most misleading and toxic contracts.

2) **"Fix the Mortgage Market": The Hubbard-Mayer proposal for putting a floor on house price declines, cleaning up household balance sheets and preventing foreclosures by refinancing millions of homeowners into stable 30-year fixed rate mortgages**[6]

   a. The Problem: Higher mortgage rates lead to lower house prices

   Even as the federal government has taken conservatorship of Fannie Mae and Freddie Mac, the spread between the interest rate on the average 30-year conforming mortgage and the 10-year Treasury bond has widened enormously. In fact, while the yield on the 10-year Treasury bond has fallen by nearly 1.5 percent in the past 2 years, the average rate on a conforming mortgage has fallen by about 0.5 percent. The increase in mortgage spreads has had catastrophic consequences for housing affordability and will surely drive house prices down well below what their fundamental value would be with a normally functioning mortgage market.

   The impact of this additional increase in the mortgage spread is quite large. Our calculations suggest that malfunctioning mortgage markets have reduced housing affordability by between 10 to 17 percent. These computations suggest

[6] More detail on the proposal is described in the paper "House Prices, Interest Rates, and the Mortgage Market Meltdown" by Christopher Mayer and R. Glenn Hubbard. The paper and an FAQ are available on the web at http://www4.gsb.columbia.edu/realestate/research/mortgagemarket.

an appreciable drop in demand associated with higher mortgage rates that could push house prices down far beyond where they should fall based on fundamentals. The combination of a deteriorating economy and malfunctioning mortgage market are leading house prices to spiral downward.

b. Higher mortgage rates and lower house prices lead to more foreclosures

Research at the Federal Reserve Bank of Boston and the Federal Reserve Board of Governors confirms that falling house prices are a major factor contributing to the rise in mortgage default rates.[7] In my mind, the single most effective policy to reduce foreclosures would be to help put a floor on declining house prices and improve the mortgage market.

Some have argued that we are in a new downward spiral in which declining house prices cause greater foreclosures, which then lead to even further house price declines. Research has not clearly demonstrated that foreclosures really cause house prices to fall. Certainly neighborhoods that have a cluster of foreclosures are likely to see house prices fall in the short-run, but the best policy might be to help local communities fight crime and other negative externalities if it is not possible or efficient to prevent all foreclosures.

Finally, in addition to falling house prices, the mortgage market meltdown itself has likely led to additional foreclosures. Subprime borrowers who could otherwise afford a refinanced mortgage at 5.25 percent might not be able to afford a mortgage on the same home at the current 6.25 percent rate.

c. Solution: Lower mortgage rates and work out negative equity

We believe the appropriate course for policy is to re-establish "normal" lending terms for housing finance, while offering tools to resolve the millions of mortgages with negative homeowners' equity, preventing unnecessary foreclosures.[8] The appropriate mortgage rate would be about 1.6 percent above the 10-year Treasury, which would lead current mortgage rates to be about 5.25 percent.

[7] See Foote, Chris, Kristopher Gerardi, and Paul S. Willen. 2008. "Negative Equity and Foreclosure: Theory and Evidence," *Journal of Urban Economics*, 64(2):234-245; Sherlund, Shane. 2008. "The Past, Present, and Future of Subprime Mortgages." Federal Reserve Board, November; Mayer, Christopher, Karen Pence, and Shane Sherlund. 2009. "The Rise in Mortgage Defaults," *Journal of Economic Perspectives*, forthcoming.

[8] This argument was initially laid out in the opinion piece by R. Glenn Hubbard and Christopher Mayer entitled "First, Let's Stabilize House Prices," *Wall Street Journal*, October 2, 2008.

A second part of our plan is to create a modern equivalent of the Home Owners Loan Corporation. The modern HOLC would initially offer to help homeowners with negative equity refinance into a stable 30-year fixed rate mortgage with a 95 percent loan-to-value ratio by helping to absorb negative equity that is currently freezing credit and housing markets. It could offer to owners and servicers the opportunity to split the losses evenly on refinancing a mortgage with the new agency. Servicers or lenders would have to agree to accept these refinancings on all mortgages or on none at all to avoid cherry-picking. In return for the government portion of the write-down, which would be paid in cash, the HOLC would take an equity position in the house so that the taxpayer-funded agency profits when the housing market turns around. The cash cost of this program would be $121 billion per year, but this would be partially offset by home equity gains as house prices stabilize and eventually start to rise.

We see two immediate beneficiaries of lower rates for 30-year fixed rate mortgages: existing borrowers currently in adjustable rate mortgages with higher rates and complicated step-up provisions and new first-time home buyers. Getting more homeowners into easily understandable mortgages would surely provide large benefits by eliminating more complicated mortgage products that many consumers do not understand and that put these consumers at risk of large payment shocks. In addition, lower mortgage rates make housing more affordable. Moreover, a substantial intervention that benefits homeowners and the housing market will surely raise the confidence of buyers that an end to the downward spiral of house prices may be in sight.

d. <u>Lower mortgage rates provide a stimulus of $118 billion *per year*</u>

Allowing mortgage refinancing as we have described above would reduce mortgage payments for almost 20 million homeowners whose mortgage rates are currently 5.75 percent or higher and meet our other criteria.[9] The typical borrower would reduce his or her principal and interest payments by about $350 dollars, a total reduction in mortgage interest payments of nearly $55 billion *per year*.

At the low end of our estimates, improved mortgage market operations would reduce house price declines by 10 percent. If we assume a relatively low marginal propensity to consume out of housing wealth of 3.5 percent, U.S.

[9] See Appendix 3 for detailed calculations and what the costs and benefits might be for other caps.

consumption would rise by $63 billion relative to what would otherwise have occurred.

The current mortgage meltdown and housing crisis has led to serious repercussions to the economy and to our financial system. Reducing foreclosures is an essential part of the recovery process. Rather than using the bankruptcy courts, which might take years and lead to higher lending costs in the future, policymakers should consider focusing on the mortgage market. Helping consumers to refinance into new mortgages with lower rates and helping to address the negative equity problem will reduce foreclosures, help clean up consumer balance sheets, and provide an annual $118 billion stimulus. Economists believe that consumers are much more likely to spend permanent reductions in expenses than one-time stimulus funds. In addition, a well-publicized program to reduce mortgage rates helps instill confidence and improve affordability for potential new home buyers, who must eventually occupy the more than 2 million vacant houses. Finally, taxpayers have strong incentives to protect their nearly $6 trillion in mortgages and mortgage guarantees that now sit on the federal balance sheet. Without appropriate and prompt policy action, the problems in the housing market will just get worse with appreciable consequences for all Americans.

AARP[SM]

November 18, 2008

Senator Patrick Leahy	Senator Arlen Specter
Chairman	Ranking Member
Senate Judiciary Committee	Senate Judiciary Committee
Washington, DC 20510	Washington, DC 20510

Dear Chairman Leahy and Ranking Member Specter:

In anticipation of tomorrow's Judiciary Committee hearing on mortgage modifications in bankruptcy, AARP is writing to reiterate our strong support for Senator Durbin's legislation allowing for court-supervised mortgage modifications. Bankruptcy judges already have the authority to modify primary mortgage debt for second homes, vacation properties, and real estate investments; this legislation would extend this authority to primary residences.

This bill is particularly important for older homeowners, many of whom were targeted by subprime lenders in the height of the subprime boom. Older homeowners, cash-poor but equity-rich, received subprime refinance loans with low teaser rates that were not properly underwritten. Now, as those rates expire and escalate upwards, some older homeowners on fixed incomes simply cannot afford to stay in their homes. A recent AARP Public Policy Institute report found that in the last six months of 2007, nearly 700,000 older homeowners were in default or foreclosure. Since that time, mortgage conditions have only worsened. The mortgage modification legislation could help hundreds of thousands of older Americans at risk of foreclosure to stay in their homes – at no cost to the taxpayer – while they pay off their mortgage debts.

In addition to being a matter of fairness, the legislation is also necessary to help get the economy back on track. Foreclosures were the initial cause of the economic meltdown, which has since spread to other industries; the economy as a whole will not recover until foreclosures decrease. Unfortunately, foreclosure numbers continue to hit record levels, highlighting that the many modification programs that are voluntary on the part of servicers are not working. Indeed, the mortgage crisis has worsened: According to RealtyTrac, the nearly 300,000 foreclosure filings in October 2008 (approximately one per every 450 households) represent a five percent increase from the September 2008 and a 25 percent increase from October 2007.

Thank you for your consideration. If you have any questions, please contact me or have your staff contact Susanna Montezemolo in AARP's Government Relations and Advocacy department at (202) 434-3800 or smontezemolo@aarp.org.

Sincerely,

David P. Sloane

David P. Sloane
Senior Vice President
Government Relations and Advocacy

TESTIMONY OF SCOTT A. STENGEL
BEFORE THE
SENATE JUDICIARY COMMITTEE

Hearing on
"Helping Families Save Their Homes: The Role of Bankruptcy Law"

November 19, 2008

Mr. Chairman, Ranking Member Specter, and Members of the Committee, I am grateful for your invitation to testify today on the role that bankruptcy laws should play in the current housing crisis.

I am a partner in the Washington, DC, office of Orrick, Herrington & Sutcliffe LLP, and a significant part of my practice is devoted to advising participants in the capital markets on the application of bankruptcy and other insolvency laws. I appreciate the opportunity to share with you this morning some observations from that perspective and to assist the Committee in understanding the impact that proposed legislation might have on the mortgage-finance market.

At the outset, I want to express my gratitude to the Members of this Committee and to the other officials at federal, State, and local levels who have worked so tirelessly to address the economic challenges facing our nation. Speaking just as a citizen, I am heartened by the leadership that has been exhibited and am confident that, when honest policy debates are coupled with a collaborative spirit, constructive solutions can emerge.

In the last seven months, however, a dizzying array of legislative and regulatory initiatives has been adopted that represents a staggering level of federal intervention in our economy and a dramatic shift in many longstanding government policies. From my perspective as a lawyer advising market participants, I can say that much in these programs is still being digested and, in some cases, deciphered. Yet, what has become clear is that each one is rippling through the financial markets and the broader economy and is influencing the behavior of both businesses and consumers in ways that no doubt were intended and in other ways that may have been unforeseen. This butterfly effect, in my view, should not be overlooked or underestimated as changes in the bankruptcy laws are considered and, in the current environment, counsels in favor of especially careful deliberation.

Among the most pressing issues that I continue to perceive in the capital markets is uncertainty in pricing risk. Before the present credit and liquidity crises, this process was facilitated by credit rating agencies independently assessing the probability of default on a security and assigning a corresponding rating. In the last year, however, questions have been raised about the degree of comfort that can be taken from such a rating, and the resulting uncertainty has sparked a flight of capital especially among investors who relied heavily on credit ratings to make judgments on pricing. This has resulted in liquidity becoming increasingly scarce and market volatility skyrocketing, which in turn have fueled a vicious cycle in which the overall tolerance for uncertainty has declined sharply.

From the standpoint of the capital markets, therefore, the time would seem ripe for policies that are designed to provide greater clarity and stability on issues that factor into investment decisions and associated risk assessments. A prominent example is the impact of bankruptcy and other insolvency laws on the rights of creditors. An inordinate degree of uncertainty attends the application of these laws generally, not only because they have a more debtor-friendly orientation than their counterparts in other countries but also because they are administered by courts that continue to claim broad powers in equity. This lack of predictability can generate material risk premiums for liquidity from the capital markets, which ultimately must be passed through to borrowers in the form of higher interest rates or other charges if credit can be extended at all.

In the same vein, this would seem an inopportune time to propose initiatives that could increase uncertainty among investors in pricing the risks associated with capital-markets transactions. This includes, I fear, any legislation authorizing bankruptcy courts to "strip down" or otherwise modify the principal and interest that is due on a loan secured by a debtor's principal residence. The prohibition against such forced modifications in bankruptcy is three decades old and, contrary to arguments that have been advanced by some scholars, has little to do with the kinds of mortgage-loan products that were offered when the Bankruptcy Code of 1978 was originally enacted. Rather, its purpose has always been to foster a liquid and efficient mortgage-finance market, which is needed now more than ever.

I wholeheartedly agree that the rising tide of foreclosures must be stemmed in order to stabilize the housing market and, even more, to alleviate the increasingly unsustainable burdens on families across the country. But I am equally convinced that a change to the bankruptcy laws is not the answer. Instead – with Fannie Mae and Freddie Mac in conservatorship and with promising financial products like covered bonds on the horizon – I respectfully recommend that the Congress consider a more holistic approach to reinvigorating our system of mortgage finance and that, as part of this framework, a comprehensive protocol for voluntary loan modifications be established that includes meaningful incentives.

I would be pleased to answer any questions that Members of the Committee may have.

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STATEMENT OF GREGG W. ZIVE
U.S. Bankruptcy Judge, District of Nevada
President of the National Conference of Bankruptcy Judges

U.S. Senate Judiciary Committee

Hearing on "Helping Families Save Their Homes: The Role of Bankruptcy Law"

November 19, 2009

Chairman Sen. Leahy, Ranking Member Sen. Specter, Presiding Sen. Durbin and members of the committee:

I am Gregg Zive, the U.S. Bankruptcy Judge in Reno, Nevada and president of the National Conference of Bankruptcy Judges. Thank you for the opportunity to submit this statement regarding the role of the bankruptcy courts and bankruptcy judges in addressing the home mortgage dilemma.

The Conference appreciates the opportunity to serve Congress as a resource on questions affecting bankruptcy practice. Obviously the NCBJ cannot and should not take a position on the merits of legislation but we can, based on our experience and expertise, provide you with the impact of proposed legislation on the operation of the bankruptcy courts. We will leave the commentary on the political and economic issues raised by allowing the modification of home mortgages to the experts (including potential impacts on home values and the cost and availability of home loans). We have an excellent vantage point from which to assess the likely impact of proposed legislation on bankruptcy courts and to respond to questions regarding implementation. Needless to say, our organization would be delighted to provide any testimony that would assist you in your review, analysis and enactment of any bankruptcy legislation.

In my personal opinion, which I am confident is shared by nearly all of my 338 colleagues, if Congress determines to allow modification of home mortgages, the bankruptcy courts would be able to implement that policy efficiently, and, in contrast to other proposals for dealing with this issue, without imposing new costs, without requiring a new structure and without incurring any delay in implementation. Under current law, bankruptcy judges have been applying procedures for modifying debts secured by collateral other than first mortgages on the debtor's principal residence, including second homes, family farms, commercial real estate, accounts receivable, plants and equipment, and other real and personal property of individual debtors. In essence, Congress has already created a mechanism and process in the bankruptcy courts for dealing with mortgage modification issues so that a new bureaucracy is not needed. Existing bankruptcy law has established limits regarding the extent to which secured debt can be modified, such as requiring collateral valuation at a market price and an interest rate that provides protection against risk of nonpayment. The present statutory provisions, rules and case law provide for due process and fairness.

Finally, we would not anticipate an unworkable volume of new activity in our courts as a result of the mortgage modification provisions. These provisions cover a relatively small class of home mortgages and the experience of the bankruptcy courts is that once standards for modification of secured debt are established in a few test cases, parties work out agreements based on those standards without judicial intervention. It was predicted the courts would be greatly burdened with the passage of the Chapter 12 , the family farmer provisions, but that did not occur for the reasons mentioned. The bankruptcy courts would neither be overwhelmed nor suffer an undue burden as the result of the mortgage modification proposal.

In sum, the bankruptcy system offers the American public an experienced, tested, effective and economical process and forum to implement the mortgage modification provisions.

Thank you for the opportunity to comment on these matters. The Conference would be happy to provide such further assistance as may be helpful.

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