HELPING FAMILIES SAVE THEIR HOMES IN BANKRUPTCY ACT OF 2009, AND THE EMERGENCY HOMEOWNERSHIP AND EQUITY PROTECTION ACT

HEARING

BEFORE THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

ON

H.R. 200 and H.R. 225

JANUARY 22, 2009

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HELPING FAMILIES SAVE THEIR HOMES IN BANKRUPTCY ACT OF 2009, AND THE EMERGENCY HOMEOWNERSHIP AND EQUITY PROTECTION ACT

THURSDAY, JANUARY 22, 2009

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Committee met, pursuant to notice, at 2:23 p.m., in room 2141, Rayburn House Office Building, the Honorable John Conyers, Jr. (Chairman of the Committee) presiding.

Present: Representatives Conyers, Scott, Watt, Lofgren, Jackson Lee, Waters, Delahunt, Cohen, Johnson, Pierluisi, Sherman, Wasserman Schultz, Maffei, Smith, Goodlatte, Sensenbrenner, Coble, Lungren, Issa, King, Franks, Gohmert, Jordan, Poe, Chaffetz, Rooney, and Harper.

Staff present: Perry Apelbaum, Staff Director and Chief Counsel; Susan Jensen-Lachmann, Majority Counsel; George Slover, Majority Counsel; Daniel Flores, Minority Counsel; and Zachary Somers, Minority Counsel.

Mr. CONYERS. The hearing will come to order. Thank you, ladies and gentlemen. We are delighted to have our colleagues in front of us again who work so diligently on the subject matter.

At 1 o'clock this afternoon, we had a vote after extensive debate on House Joint Resolution 3, a bill entitled, "Relating on the Disapproval of Obligations Under the Emergency Economic Stabilization Act of 2008."

The vote was 270 in support of the resolution of disapproval and 155 against the resolution of disapproval. And I think that reflects accurately the mood of the American people. It so happens that we are in the process of catching up with them.

Now, the genesis of this hearing goes back to the evening that the then secretary of the treasury, Henry Paulson, met with the leaders of the first branch of Government, the legislature, and he had three sheets of paper. And here is what were on them.

The first thing was the fact that he needed new and extensive authority never before granted a treasury secretary in the history of this country.

The second thing that was on the second sheet of paper was that he needed $700 billion.

And on the third sheet of paper were two other provisos, one which said we need this money right away and the other proviso on the third sheet of paper said, and we want this authority that we are asking you to legislate not to be reviewable by any court nor even the legislative process itself.

And this was the beginning of some of the, to me, foreseeable problems that bring us here today.

Now, we inquire under the jurisdiction of the Judiciary Committee on a very limited set of circumstances. What we are here this afternoon to determine are some very simple questions. They have been outlined by my staff and actually they have been recaptured by one of our witnesses on the second panel, Professor Levitin.

And they boil down to these questions with regard to what we do about the basic problem that caused the subprime mortgage meltdown and, further, what can we do to assist the victims of this meltdown who happen to be homeowners?

And so I offer you these suggestions: that, first, the voluntary efforts to relieve the foreclosure crisis have been unsuccessful. And, second, the bankruptcy provisions in our bills are the modification of them to allow cram-down reopening, examination, can only be accomplished through revising the bankruptcy law; longer terms, less interest, making sure that the mortgage itself does not exceed the value of the property.

And then a couple of other considerations that nothing harmful will come through this bankruptcy modification because there will be no further interest rates that will go higher, nor will these modifications create any unjust benefits or somehow make this some kind of an easy-escape method for undeserving mortgagors.

And so I am happy to begin this discussion with two of the leaders in the Congress about how we came to this point. I am so glad that you are with us, Congressman Miller and Congressman Marshall.

I turn now to the Ranking Member from Texas, Mr. Lamar Smith.

[The bills, H.R. 200 and H.R. 225, follow:]

I

111TH CONGRESS
1ST SESSION

H. R. 200

To amend title 11 of the United States Code with respect to modification of certain mortgages on principal residences, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

JANUARY 6, 2009

Mr. CONYERS (for himself, Ms. LINDA T. SÁNCHEZ of California, Mr. NADLER of New York, Mr. DELAHUNT, Mr. SCOTT of Virginia, and Ms. WATERS) introduced the following bill; which was referred to the Committee on the Judiciary

---

A BILL

To amend title 11 of the United States Code with respect to modification of certain mortgages on principal residences, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Helping Families Save Their Homes in Bankruptcy Act of 2009".

SEC. 2. ELIGIBILITY FOR RELIEF.

Section 109 of title 11, United States Code, is amended—

(1) by adding at the end of subsection (e) the following: "For purposes of this subsection, the computation of debts shall not include the secured or unsecured portions of—

"(1) debts secured by the debtor's principal residence if the current value of that residence is less than the secured debt limit; or

"(2) debts secured or formerly secured by real property that was the debtor's principal residence that was sold in foreclosure or that the debtor surrendered to the creditor if the current value of such real property is less than the secured debt limit."; and

(2) by adding at the end of subsection (h) the following:

"(5) The requirements of paragraph (1) shall not apply in a case under chapter 13 with respect to a debtor who submits to the court a certification that the debtor has received notice that the holder of a claim secured by the debtor's principal residence may commence a foreclosure on the debtor's principal residence.".

SEC. 3. PROHIBITING CLAIMS ARISING FROM VIOLATIONS OF CONSUMER PROTECTION LAWS.

Section 502(b) of title 11, United States Code, is amended—

(1) in paragraph (8) by striking "or" at the end,

(2) in paragraph (9) by striking the period at the end and inserting "; or", and

(3) by adding at the end the following:

"(10) the claim is subject to any remedy for damages or rescission due to failure to comply with any applicable requirement under the Truth in Lending Act, or any other provision of applicable State or Federal consumer protection law that was in force when the noncompliance took place, notwithstanding the prior entry of a foreclosure judgment.".

SEC. 4. AUTHORITY TO MODIFY CERTAIN MORTGAGES.

Section 1322(b) of title 11, United States Code, is amended—

(1) by redesignating paragraph (11) as paragraph (12),

(2) in paragraph (10) by striking "and" at the end, and

(3) by inserting after paragraph (10) the following:

"(11) notwithstanding paragraph (2) and otherwise applicable nonbankruptcy law, with respect to a claim for a loan secured by a security interest in the debtor's principal residence that is the subject of a notice that a foreclosure may be commenced, modify the rights of the holder of such claim—

"(A) by providing for payment of the amount of the allowed secured claim as determined under section 506(a)(1);

"(B) if any applicable rate of interest is adjustable under the terms of such security interest by prohibiting, reducing, or delaying adjustments to such rate of interest applicable on and after the date of filing of the plan;

"(C) by modifying the terms and conditions of such loan—

"(i) to extend the repayment period for a period that is no longer than the longer of 40 years (reduced by the period for which such loan has been outstanding) or the remaining term of such loan, beginning on the date of the order for relief under this chapter; and

"(ii) to provide for the payment of interest accruing after the date of the order for relief under this chapter at an annual percentage rate calculated at a fixed annual percentage rate, in an amount equal to the then most recently published annual yield on conventional mortgages published by the Board of Governors of the Federal Reserve System, as of the applicable time set forth in the rules of the Board, plus a reasonable premium for risk; and

"(D) by providing for payments of such modified loan directly to the holder of the claim; and".

SEC. 5. COMBATING EXCESSIVE FEES.

Section 1322(c) of title 11, the United States Code, is amended—

(1) in paragraph (1) by striking "and" at the end,

(2) in paragraph (2) by striking the period at the end and inserting a semicolon, and

(3) by adding at the end the following:

"(3) the debtor, the debtor's property, and property of the estate are not liable for a fee, cost, or charge that is incurred while the case is pending and arises from a debt that is secured by the debtor's principal residence except to the extent that—

"(A) the holder of the claim for such debt files with the court (annually or, in order to permit filing consistent with clause (ii), at such more frequent periodicity as the court determines necessary) notice of such fee, cost, or charge before the earlier of—

"(i) 1 year after such fee, cost, or charge is incurred; or

"(ii) 60 days before the closing of the case; and

"(B) such fee, cost, or charge—

"(i) is lawful under applicable non-bankruptcy law, reasonable, and provided for in the applicable security agreement; and

"(ii) is secured by property the value of which is greater than the amount of such claim, including such fee, cost, or charge;

"(4) the failure of a party to give notice described in paragraph (3) shall be deemed a waiver of any claim for fees, costs, or charges described in paragraph (3) for all purposes, and any attempt to collect such fees, costs, or charges shall constitute a violation of section 524(a)(2) or, if the violation occurs before the date of discharge, of section 362(a); and

"(5) a plan may provide for the waiver of any prepayment penalty on a claim secured by the debtor's principal residence.".

SEC. 6. CONFIRMATION OF PLAN.

Section 1325(a) of title 11, the United States Code, is amended—

(1) in paragraph (8) by striking "and" at the end,

(2) in paragraph (9) by striking the period at the end and inserting a semicolon, and

(3) by inserting after paragraph (9) the following:

"(10) notwithstanding subclause (I) of paragraph (5)(B)(i), the plan provides that the holder of a claim whose rights are modified pursuant to section 1322(b)(11) retain the lien until the later of—

"(A) the payment of such holder's allowed secured claim; or

"(B) discharge under section 1328; and

"(11) the plan modifies a claim in accordance with section 1322(b)(11), and the court finds that such modification is in good faith.".

SEC. 7. DISCHARGE.

Section 1328 of title 11, the United States Code, is amended—

(1) in subsection (a)—

(A) by inserting "(other than payments to holders of claims whose rights are modified under section 1322(b)(11)" after "paid" the first place it appears, and

(B) in paragraph (1) by inserting "or, to the extent of the unpaid portion of an allowed secured claim, provided for in section 1322(b)(11)" after "1322(b)(5)", and

(2) in subsection (c)(1) by inserting "or, to the extent of the unpaid portion of an allowed secured claim, provided for in section 1322(b)(11)" after "1322(b)(5)".

SEC. 8. EFFECTIVE DATE; APPLICATION OF AMENDMENTS.

(a) EFFECTIVE DATE.—Except as provided in subsection (b), this Act and the amendments made by this Act shall take effect on the date of the enactment of this Act.

(b) APPLICATION OF AMENDMENTS.—The amendments made by this Act shall apply with respect to cases commenced under title 11 of the United States Code before, on, or after the date of the enactment of this Act.

○

I

111TH CONGRESS
1ST SESSION

H. R. 225

To amend title 11 of the United States Code with respect to modification of certain mortgages on principal residences, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

JANUARY 7, 2009

Mr. MILLER of North Carolina (for himself, Ms. LINDA T. SÁNCHEZ of California, Mr. FRANK of Massachusetts, Mr. WATT, Mr. ELLISON, Ms. LEE of California, Mr. COURTNEY, Mr. BLUMENAUER, Mrs. CHRISTENSEN, Ms. EDDIE BERNICE JOHNSON of Texas, Mr. BUTTERFIELD, Mr. GRIJALVA, Ms. JACKSON-LEE of Texas, Mr. SIRES, Mr. CAPUANO, Mr. HINCHEY, Mr. GEORGE MILLER of California, Mr. STARK, Mr. JOHNSON of Georgia, Mr. DAVIS of Alabama, Mr. VAN HOLLEN, Ms. WASSERMAN SCHULTZ, Mr. COHEN, Ms. EDWARDS of Maryland, and Mr. LEWIS of Georgia) introduced the following bill; which was referred to the Committee on the Judiciary

---

A BILL

To amend title 11 of the United States Code with respect to modification of certain mortgages on principal residences, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Emergency Homeownership and Equity Protection Act".

SEC. 2. ELIGIBILITY FOR RELIEF.

Section 109 of title 11, United States Code, is amended—

(1) by adding at the end of subsection (e) the following: "For purposes of this subsection, the computation of debts shall not include the secured or unsecured portions of—

"(1) debts secured by the debtor's principal residence if the current value of that residence is less than the secured debt limit; or

"(2) debts secured or formerly secured by real property that was the debtor's principal residence that was sold in foreclosure or that the debtor surrendered to the creditor if the current value of such real property is less than the secured debt limit."; and

(2) by adding at the end of subsection (h) the following:

"(5) The requirements of paragraph (1) shall not apply in a case under chapter 13 with respect to a debtor who submits to the court a certification that the debtor has received notice that the holder of a claim secured by the debtor's principal residence may commence a foreclosure on the debtor's principal residence.".

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Section 1322(b) of title 11, United States Code, is amended—

(1) by redesignating paragraph (11) as paragraph (12),

(2) in paragraph (10) by striking "and" at the end, and

(3) by inserting after paragraph (10) the following:

"(11) notwithstanding paragraph (2) and otherwise applicable nonbankruptcy law, with respect to a claim for a loan made before the date of the enactment of the Emergency Homeownership and Equity Protection Act secured by a security interest in the debtor's principal residence that is the subject of a notice that a foreclosure may be commenced, modify the rights of the holder of such claim—

"(A) by providing for payment of the amount of the allowed secured claim as determined under section 506(a)(1);

"(B) if any applicable rate of interest is adjustable under the terms of such security interest by prohibiting, reducing, or delaying adjustments to such rate of interest applicable on and after the date of filing of the plan;

"(C) by modifying the terms and conditions of such loan—

"(i) to extend the repayment period for a period that is no longer than the longer of 40 years (reduced by the period for which such loan has been outstanding) or the remaining term of such loan, beginning on the date of the order for relief under this chapter; and

"(ii) to provide for the payment of interest accruing after the date of the order for relief under this chapter at an annual percentage rate calculated at a fixed annual percentage rate, in an amount equal to the then most recently published annual yield on conventional mortgages published by the Board of Governors of the Federal Reserve System, as of the applicable time set forth in the rules of the Board, plus a reasonable premium for risk; and

"(D) by providing for payments of such modified loan directly to the holder of the claim; and".

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(2) in paragraph (2) by striking the period at the end and inserting a semicolon, and

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"(3) the debtor, the debtor's property, and property of the estate are not liable for a fee, cost, or charge that is incurred while the case is pending and arises from a debt that is secured by the debtor's principal residence except to the extent that—

"(A) the holder of the claim for such debt files with the court (annually or, in order to permit filing consistent with clause (ii), at such more frequent periodicity as the court determines necessary) notice of such fee, cost, or charge before the earlier of—

"(i) 1 year after such fee, cost, or charge is incurred; or

"(ii) 60 days before the closing of the case; and

"(B) such fee, cost, or charge—

"(i) is lawful under applicable nonbankruptcy law, reasonable, and provided for in the applicable security agreement; and

"(ii) is secured by property the value of which is greater than the amount of such claim, including such fee, cost, or charge;

"(4) the failure of a party to give notice described in paragraph (3) shall be deemed a waiver of any claim for fees, costs, or charges described in paragraph (3) for all purposes, and any attempt to collect such fees, costs, or charges shall constitute a violation of section 524(a)(2) or, if the violation occurs before the date of discharge, of section 362(a); and

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(3) by inserting after paragraph (9) the following:

"(10) notwithstanding subclause (I) of paragraph (5)(B)(i), the plan provides that the holder of a claim whose rights are modified pursuant to section 1322(b)(11) retain the lien until the later of—

"(A) the payment of such holder's allowed secured claim; or

"(B) discharge under section 1328; and

"(11) the plan modifies a claim in accordance with section 1322(b)(11), and the court finds that such modification is in good faith.".

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(A) by inserting "(other than payments to holders of claims whose rights are modified under section 1322(b)(11)" after "paid" the 1st place it appears, and

(B) in paragraph (1) by inserting "or, to the extent of the unpaid portion of an allowed secured claim, provided for in section 1322(b)(11)" after "1322(b)(5)", and

(2) in subsection (c)(1) by inserting "or, to the extent of the unpaid portion of an allowed secured claim, provided for in section 1322(b)(11)" after "1322(b)(5)".

SEC. 7. EFFECTIVE DATE; APPLICATION OF AMENDMENTS.

(a) EFFECTIVE DATE.—Except as provided in subsection (b), this Act and the amendments made by this Act shall take effect on the date of the enactment of this Act.

(b) APPLICATION OF AMENDMENTS.—The amendments made by this Act shall apply with respect to cases commenced under title 11 of the United States Code before, on, or after the date of the enactment of this Act.

○

Mr. SMITH. Thank you, Mr. Chairman.

Mr. Chairman, this country is faced with a foreclosure crisis of historic proportions. Many were complicit in the creation of this crisis. It was brought on largely by irresponsible mortgage policies.

These policies were implemented by lenders and encouraged by Government entities like Fannie Mae, who were all too willing to put profits ahead of prudence.

Their irresponsible behavior was encouraged by Congress, and too often borrowers, spurred on by cheap credit and little or nothing as a down payment, borrowed more than they could afford.

We in Congress are now considering solutions to the foreclosure crisis. The legislation before us today represents the so-called bankruptcy solution.

It is tempting to some because allowing bankruptcy courts to rewrite home mortgages does not require up-front taxpayer dollars. In that sense, it may appear costless.

But despite their superficial attractions, the bankruptcy proposals create real problems and will cost future homeowners.

My overriding concern with the bankruptcy proposals is that they undermine personal accountability. Although an unusual number of people took on mortgages they could not afford, the vast majority of Americans simply did not. They took on loans for which they assumed responsibility and continued to pay their mortgages on time.

Americans undoubtedly want solution to the foreclosure crisis, but I do not believe that they want proposals that amount to absolving borrowers of their personal responsibility. I fear that the broad terms of the two bills we are considering today do just that.

Both of these bills are open-ended and place no limits on who is eligible for relief. They also give little, if any, guidance to debtors and bankruptcy judges as to how mortgages may be modified in bankruptcy.

Because this bankruptcy legislation is overly broad, it will send shock waves through the mortgage lending, credit and housing markets. This legislation will increase the risks associated with mortgage lending and discourage investment in the mortgage-backed securities market.

In turn, this will lead to fewer mortgages being written, and those that are written will come with higher interest rates and higher up-front costs. Future homeowners will pay a steep price.

Further, because many borrowers will be eligible for relief, these bills may open the flood gates to an unprecedented wave of bankruptcy filings. Current estimates are that 5 million homeowners are delinquent and another 12 to 15 million owe more than their houses are worth.

If a significant number of these homeowners choose bankruptcy, then bankruptcy filings could double or triple as a result. And this legislation will unnecessarily tempt them by promising the ability to reduce principal and interest rates.

Finally, this legislation will not supplement but compete with the targeted loan modification programs lenders and the Government are now using to help struggling homeowners. As a result, this legislation will undermine many of those prograMs.

Any relief should be targeted at the mortgages that are at the heart of the current crisis. Relief must be short-lived so that we can return quickly to the normal operation of the bankruptcy code.

Debtors and bankruptcy courts must be given concrete guidance as to how loans are to be modified to reduce monthly payments to affordable levels.

Finally, if bankruptcy relief is to be considered, it must be done in a manner that does not undermine personal accountability. It must not unfairly reward those who acted irresponsibly.

And it must not be an affront to those who did act responsibly, borrowed only what they could afford, and have been working hard to make their monthly payments.

Unfortunately, the legislation we consider today, in my opinion, will create more problems than it will solve.

Mr. Chairman, thank you, and I will yield back.

Mr. CONYERS. Thank you so much.

I do not see the gentleman from Arizona, Trent Franks, here.

Mr. SMITH. He is not here.

Mr. CONYERS. He is not here.

We move, then, to the gentlelady from California, Chairwoman of a Financial Services Subcommittee, Maxine Waters of California.

The gentlelady is recognized.

Ms. LOFGREN. Ms. Waters has asked that I precede her.

Mr. CONYERS. Oh, I didn't have your name down. That is——

Ms. LOFGREN. I will be brief, both because I am eager to hear from our two witnesses, and also I am losing my voice.

I would first like to thank Congressman Miller and Congressman Marshall for the tremendous leadership that they have exhibited on this issue. It has been important and very wise. And I think the country is really very much in their debt for that leadership.

I would just like to note that I think this is a time when disagreements over this issue are starting to disappear, and people are coming together in conclusion that something should be done in this arena.

We are mindful that the Constitution itself, in Article 1, Section 8, provides for the bankruptcy laws of the United States, so we are doing nothing that was not in the thinking of the founders when we take a look at our bankruptcy laws.

Let me just say that I was here and worked on the 1978 bankruptcy bill as a young staffer for Congressman Don Edwards, who was the Chairman of the Committee—Subcommittee of jurisdiction. And honestly, I could not recall that we had excluded principal mortgages from the bankruptcy revisions.

And when that became apparent, I actually called Alan Parker—many of you remember him—who was the general counsel for the Subcommittee, and I said, "Why did we do that?" And he said, "Oh, no, we didn't do that."

It turns out that was added in on the Senate side without a lot of discussion. There was no huge policy issue involved. It became part of the law, but it never really became a focus, a public policy focus, until we had this meltdown of the mortgage market.

And that is because mortgages were a very different creature back in the late 1970's. And now, of course, we have subprimes and Alternate-As and actually a collapse of the housing market.

We have been advised by Mark Zandi, who is a very noted economist and, I would note, the principal economic adviser to Senator John McCain during his presidential run, that this change in bankruptcy law is an important element of halting the collapse of the housing market.

Why is that? Well, right now, we are engaged in watching not only the subprime market collapse but the prime market as well.

And I will give you some examples from my own district, where people who bought a $700,000 home a year ago, not with a subprime instrument, with a—you know, equity down, 20 percent down or more, are now faced with a neighbor next door who has a house for sale in bankruptcy that—or a short sale at $250,000 that won't sell.

The value of everybody's property, including those who did nothing wrong, has been depressed. And until the lending institutions are able to put a floor under these losses, we are not going to pull out from this disaster.

I would note that Citigroup has come out in favor of a bankruptcy provision as part of this, so I do know that we can come together if there are issues—you know, I would honestly prefer to simply repeal the provision that I think was misguided.

But I think coming together, we can come up with a provision that perhaps limits it to existing mortgages, to work and reason together to really solve this problem for our country.

So I honor you, Mr. Chairman, for holding this very important hearing and for all the Members who I know will work together in good faith on behalf of the American people.

And I yield back and thank the gentlelady for yielding to me.

Mr. CONYERS. I would like now to recognize the gentlelady from California, Maxine Waters, a longtime Member of the Judiciary Committee, and also a Subcommittee Chair of the Finance Committee as well.

Ms. WATERS. Thank you very much, Mr. Chairman, and I do appreciate that you have made this literally the first order of business for this 111th Congress.

It is so important, and I want to remind everyone that this Committee passed H.R. 3609, the Emergency Home Ownership and Mortgage Family—Mortgage Equity Protection Act, on December 12, 2007, and that the House failed to pass the legislation in the 110th Congress. We are way behind on this issue.

And let me give you an example why what we are doing now will not solve the crisis that we are in. Last evening, "Nightline" showed what they had done in looking at the loan modifications, or lack of, by financial institutions. They stayed in my office literally for 2 days.

I implement or help to facilitate loan modifications for my constituents, against the advice of the Ethics Committee. I am bombarded with people who are losing their homes, whose homes are about to be in foreclosure, who have tried everything that they possibly could try to get a loan modification.

They can't get through to the servicers. The servicers and the offices—many of them owned by some of our big banks, like Wells Fargo, Bank of America, Countrywide or the former Countrywide, what have you.

And so you are on the telephone waiting for hours. They play music for you. You get cut off. "Nightline" followed through with me on one that I was working on for a couple of hours. I sat on the telephone for an hour with the Wells Fargo servicing company, on and on and on.

You cannot get these modifications done one by one. All of those counselors that are certified by HUD who work with the volunteer program, Hope Now, are not trained in loan modifications. These people are trained to do counseling for first-time home buyers. They can't get through to the servicers. The servicers don't pay any attention to them.

The closest we have come to doing credible loan modifications has been with Sheila Bair of IndyMac, where she took the IndyMac portfolio and was able to do almost 6,000 because she developed a more systematic way of doing these modifications.

Even now, for some of the servicers who do modifications—they don't do what I would consider a real modification. They will sometimes extend the time of payment and load it up on the back end, but they are not marking down interest rates.

They are not taking adjustable-rate mortgages and converting them to 30-and 40-year loans that would reduce the amount of the mortgage payment. And so you have this glut of foreclosed houses just building up throughout the United States of America, much of it now in disrepair.

And even the money that I helped to orchestrate to stabilize communities is not enough. We put $4 billion out there for a stabilization program, but still, as Zoe Lofgren just said, these houses are in disrepair. The value is being lost. They are under water.

And so you have whole communities that are devastated, and the homes are losing value. So we have got to do something real. We have got to modify or change the bankruptcy law.

And I want to commend you for taking leadership, both of you—Mr. Marshall, Mr. Miller—because I think, despite the fact we are—because the banking industry is just so powerful. They are so powerful they have owned this Congress for far too long. And we have got to break this up.

Judges must have the ability to put these into the bankruptcy proceeding and do the modifications themselves. And so I think we are on our way. And you know, when Citigroup—and they say that yes, it makes good sense, everybody ought to be on board to do it.

So, I am hopeful, Mr. Chairman, that we can move forward with this. We would like to see it—Zoe and I would to see it in the stimulus package. That is where we want it. We want it done quickly, and we want it done now. So let us see how far we can get.

I thank you for being here today, my colleagues.

I thank you again, Mr. Chairman. I will continue to try and implement loan modifications, but it is like dropping a little rock into a huge ocean, and it won't get the job done. But bankruptcy will get it done. Thank you very much.

I yield back the balance of my time.

Mr. CONYERS. Well, that is very informative, because the Speaker of the House has just come out in acceptance of the proposal that is being made here today.

I might put it in the record without objection. The question was—this is dated January 22, 2009——

[The information referred to follows:]

Q Madam Speaker, there is a hearing in Judiciary today on the bill that would let bankruptcy judges alter mortgages. Where does that fit into your priority scheme and would you plan to move that any time soon?

Speaker Pelosi. Very high. Enacting bankruptcy legislation is a very high priority, and we will have it either free standing or in some piece of legislation that will become law soon.

Q Any timetable?

Speaker Pelosi. Well, in my view as soon as possible, because I never supported the original bankruptcy bill. But in terms of building the consensus to win the vote to have a bill signed into law, as I say, we will either put it forthfree standing or as part of another engine leaving the station.

Q This year?

Speaker Pelosi. Yes, this year, in answer to your question. The gentleman was asking does that mean this year? Yes, this year. Because, again, the more time that goes by, more people lose the opportunity to stay in their homes. It is urgent.

Q Do you support putting it in the stimulus?

Speaker Pelosi. I would be very open to that. I would like to get it passed as soon as possible. But there are several other options. But I support getting it done and getting it done in a timely fashion.

Q Are you worried it could cause problems for the stimulus, either here or in the Senate?

Speaker Pelosi. No. No, I am not. But we have a lot of work to do, and, as has been indicated, we have a deadline and a sense of urgency that we need to get the job creation part of this done. We will have a housing bill. We will have other legislation, or a free standing bill, but we will get it done.

Mr. CONYERS. And I now turn to a former Subcommittee Chairman of the Judiciary, Melvin Watt of North Carolina, who is now a Subcommittee Chairman on the Finance Committee.

Mr. WATT. Thank you, Mr. Chairman. And I see both of the witnesses at the table looking at their watches and wondering when they are going to get to testify, so I am very much aware——

Mr. MILLER. I have no where to go that is more important than being here.

Mr. WATT [continuing]. That you want to move this on. I do want to pick up where my colleague on financial services, Maxine Waters, left off because we do have the unique blessing or curse of serving on both the Judiciary Committee and the Financial Services Committee. And not only do I want to commend these two gentlemen, who have taken the lead on this bankruptcy bill, but I want to commend her for the tremendous amount of work that she has done on this whole foreclosure issue to try to effect some solutions short of bankruptcy, in addition to supporting the bankruptcy provision.

She is absolutely right. We are regularly, because of our position, in either friendly or sometimes not so friendly conversation with financial institutions. And about a year and a half ago or more, I said to the folks in the financial services, the lenders, some of them that they needed to line up and support this for several reasons.

First of all, when you have a foreclosure in a lot of states, and there is a public sale, that is all they—the lender can get. There is a provision under North Carolina law, for example, that you can't go and get anything beyond that foreclosure amount. And it is not at all to be above 40 percent when you sold a foreclosure.

Now it is down to about 20 percent or 10 percent, Mr. Marshall probably has more information on that. And they ain't getting much in a foreclosure sale. They would actually get more, I think, if these loans were restructured and rewritten in the bankruptcy courts, and I just think they would—the lenders would be better off. So their position was short sighted.

Second, it just seemed to me that their concern about this was overstated, and I did share one concern, which I have expressed publicly, and I think we need to address, and I am sure Mr. Marshall will address it, one of the concerns they have had is that it will encourage people to go into bankruptcy.

And I have that concern because I don't want to rush anybody into bankruptcy solely for the purpose of restructuring, but the threat of going to bankruptcy, I think, is important. Bankruptcy has some negative impacts that go well beyond—so we don't want to be in a position of encouraging people into bankruptcy. But I think that can be dealt with in the legislation.

And finally, over the last month or so, those same people that I talked to a year and a half or two, are coming back to me and saying, "Yes, you did suggest to us that this was a good idea and maybe it is not such a terrible idea." So maybe we are coming full circle. I think we are going to get there pretty soon. We just need to keep pushing, and I applaud the Chair for having the hearing today and for that purpose. Because it is part of that push to keep the pressure on to do this. And with that, I yield back, Mr. Chairman.

Mr. CONYERS. Thank you. Did Bill Delahunt have his hand up or not?

Mr. DELAHUNT. I will be very brief, Mr. Chairman.

Mr. CONYERS. All right.

Mr. DELAHUNT. I would just echo the sentiments expressed by my colleagues. I think the speaker responded to those questions with a clear sense of urgency. And I would just say, if we don't move quickly that we are going to be accused of fiddling while Rome is burning.

This financial crisis that we are in at this point in time was precipitated by the mortgage crisis. I think what is clear is that no voluntary program has worked to date. And will not work because the order of magnitude is such that it is going to take time. We don't have any time left. And if you don't believe that, watch the Dow Jones today and yesterday and the day before. If we really want to precipitate a free fall in terms of a financial crisis, then let us just sit here and debate and not move expeditiously on the bills that are put forth by our two esteemed colleagues.

And by the way, Mr. Chairman, their proposals will not cost the taxpayers a single dime. I think that is very important to discuss or to mention. And that the public should be aware of that.

This is not authorizing the expenditure of $700 billion or $350 billion. This is an effort to resolve the mortgage crisis, the housing crisis, if you will. And until that happens, because that crisis has infected all of our economy, we are not going to solve the problems of an economic meltdown that we are currently facing.

And with that, I yield back.

Mr. CONYERS. Okay. Thank you very much.

Steve Cohen, have you given up any opportunity to make a comment?

Mr. COHEN. Many times in the past, but not today, Mr. Speaker.

Mr. CONYERS. The gentleman is recognized.

Mr. COHEN. Thank you, Mr. Chairman. And I apologize for being late. As I explained as I was coming in, I was speaking on the floor on H.R. 104, something dear to this Committee, the bill that the Chairman put in to study the possible abuses of the Bush-Cheney administration, a commission to look at that, which I think is important.

I appreciate the gentleman who came forward with this bill and the others who have come forward with similar bills. And I was very proud to be a member of our democratic caucus when caucus members from throughout the range of the caucus spoke up in favor of this type of law and putting it in the stimulus package.

Mr. Chairman, I most appreciate Speaker Pelosi and appreciate her response. But Speaker Pelosi always speaks of what Dr. Martin Luther King spoke about, and that is the fierce urgency of now.

And I believe the fierce urgency of now not only requires us to pass these bills out, but to see to it that they are part of the stimulus package. Because that is the bill that we know is going to pass. That is going to pass.

If we have this as a free standing bill, we don't know when it will pass or if it will pass because senators will have more reason to vote simply against this bill. In the stimulus package, there will be things in there for their constituents and they know, as Mr. Delahunt well said, that we are in an economic crisis and we need to act. And there are enough republicans in that senate, in addition to the democrats, to pass this because they know the financial structure of our country is in the balance. They may not pass the bankruptcy bills as stand-alone measures. So I would urge us to do all we can, and I know the Chairman will, to include it.

What we have seen so far in the TARP is helping out folks that are in essence the officers who sent people into battle. But the casualties, which are the homeowners, have not been treated. The casualties are still laying out there in the field of combat and not having any regard, any treatment whatsoever, or anybody apparently interested in their condition. And every day that we go, we miss people.

Memphis, my home, has one of the highest levels of subprime mortgage lending in the country and Tennessee has the highest per capita bankruptcy filings in the country. There are 7.6 bankruptcies per 1,000 people in Tennessee, and that is the highest. I don't know exactly the number of foreclosures, but each day we go by, there are people losing their homes. And how can you expect people to get jobs or to feel comfortable spending money if they and their families are put out of their homes?

The Congressional budget office estimated a similar bill would be a net $17 million gain to our budget in savings and increased revenues if we pass such a bill. So I appreciate the Chairman giving me some time. I appreciate the sponsors. And I join with them in whatever efforts we can make to see to it that homes are put on the same level as yachts, as secondary vacation homes, as airplanes and commercial real estate and can be modified in bankruptcy. That is because they are even more important and should be put at least on that level where they can be saved for people and not lost.

Thank you, Mr. Chairman.

Mr. CONYERS. Hank Johnson is exercising his prerogatives as new Subcommittee Chairman from Georgia, and he will be the last Member to make a comment before our distinguished witnesses begin.

Mr. JOHNSON. Thank you, Mr. Chairman. And I will say that my first term of Congress, I did a lot of listening and I plan on continuing to do that during this second term. But I would be remiss not to speak out in favor of both of these pieces of legislation, both of which I am a co-sponsor of.

The need in my state and in my district for this kind of assistance is almost overwhelming. In the fourth district of Georgia, which is the second most affluent African-American majority district in the Nation, we have been targeted for many years by predatory lenders who, despite the fact that residents are eligible for prime loans, they have been targeted aggressively with these high cost predatory loans, with exorbitant interest rate swings and of course our real estate market has been good. We have put a lot of people into homes. In fact, the home building market has been a great economic stimulus for the economy of the State of Georgia.

Now, with the foreclosures having ravaged our area and the home building market being decimated, the State of Georgia is now looking at a $2 billion deficit. And so things are quite tight.

The genesis of the financial meltdown crisis that we are in now arose from the mortgage-backed securities that had been sold throughout the world to investors and that became worthless.

And it became worthless due to the fact that so many properties had been foreclosed upon. And this trend of foreclosures, ladies and gentlemen, 2008, 2.3 million houses went into foreclosure. Eight hundred sixty thousand of those were actually repossessed, and those numbers are expected to climb this year. And so it continues, this problem of foreclosures contributing or being the cause of this economic meltdown. We must stop the meltdown, and we must do so quickly and effectively. And instead of—this is what we call instead of trickle-down economics, which has not worked, this is rebuilding the economy from the ground up.

And so, you know, I believe that both pieces of legislation will deal with this fundamental issue that impacts the world economy. And I think that it is a shame that if you are a millionaire, and you had, say, seven properties, you may have more properties than you even know of, more homes. And you get into trouble and you file bankruptcy and you can modify the terms of the mortgages on all of your other properties. You can select that suppose where your principle residence would be. That might be the one that has the lowest balance on the principal owed. And then you can get adjustments on all of your other properties.

Why is it that just a regular common man or woman is not able to have in bankruptcy their adjustment for their primary residence, their only home? Why is it that a millionaire, who made choices and should be personally responsible and accountable for overspending be able to get relief under the Bankruptcy Act when regular people who only own one residence are barred? It just doesn't make sense, so the time is now for so many reasons for us to deal with both pieces of legislation.

I was privileged to hear an eloquent and persuasive statement from my Georgia colleague Professor Marshall and Attorney Marshall, by the way, on this issue in a Democratic caucus meeting where he strongly advocated for inclusion of this legislation or idea, this legislative idea, in the economic stimulus package. And I support that also, but if we need to do in a stand-alone, let us go ahead and do it right away.

I commend the speaker of this Committee for showing that this a priority, and I look forward to supporting this legislation.

Mr. CONYERS. Brad Miller is the distinguished representative from North Carolina, who sponsored in the last Congress legislation to protect homeowners from predatory mortgage lending. He has earned a Master's degree at the London School of Economics and a law degree from Columbia University, and we welcome him at this time.

STATEMENT OF THE HONORABLE BRAD MILLER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH CAROLINA

Mr. MILLER. Thank you, Chairman Conyers.

Chairman Conyers, Ranking Member Smith, Members of the Committee, thank you for this opportunity to address pending legislation to empower bankruptcy courts to modify home mortgages just as bankruptcy courts already can modify every other kind of secured debt.

The mortgage industry treats that peculiarity in the law as if it were brought down from Mount Sinai on stone tablets, but Ms. Lofgren remembers correctly. It was just a sloppy political compromise in the Senate in 1978, and that nonsensical quirk in the law is now responsible for much of the paralysis in our Nation's response to the foreclosure crisis, and we are just beginning to see the effects of the foreclosure crisis.

The Census Bureau estimated that 69.2 percent of American families owned their own homes in the second quarter of 2004, and 67.9 percent owned their own homes in the third quarter of 2008. That is a fairly slight drop to this point, but the number will go much, much lower.

Credit Suisse now estimates that 8.1 million families will lose their homes to foreclosure in the next 4 years, and the number will rise to 10.2 or as many as 10.2 million families if the recession becomes more severe, a frighteningly real possibility.

In 2006, about 2.5 million families were under water or owed more on their mortgages than their homes were worth. Moody's now estimates that 12 million homeowners are under water & and the number will rise to 14.6 million by the fall if the climb in home values reaches 10 percent, an additional 10 percent, as Moody's expects.

Homeowners who owe more on their homes than their home is worth are stuck. They can't sell their house to pay off their mortgage. They can't refinance, and they almost certainly can't qualify for any other kind of credit. Even if homeowners can make their current monthly payments, they have no wiggle room if anything goes wrong, if anyone in the family gets seriously ill, or if anyone loses their job, or if they go through a divorce.

Foreclosures are contributing to the decline in home values. The decline in home values is contributing to the foreclosure crisis, and both are contributing to the decline in the economy. Vacant foreclosed homes are stigmatizing neighborhoods and pushing down homevalues, and priced-to-sell foreclosed homes are flooding real estate markets around the country. Half the homes on the market in the bay area of California are foreclosures.

Families that lose their homes to foreclosure lose their membership in the middle class, probably forever, and almost all middle class homeowners are seeing their life savings evaporate with the collapse in their home's value.

A homeowner who has seen his home decline in value by 20 or 30 percent is going to be in no hurry to buy a new car. If 10 million families lose their homes to foreclosure in the next 4 years, nothing else we do to revive the economy is going to work.

Ms. Waters was correct. Voluntary modifications are not even touching the problem. Three quarters of the voluntary modifications that the industry claims are just payment schedules with no reduction in principal or interest. Half the modifications in November were forbearance agreements that allowed the homeowner to catch up back payments and actually resulted in a higher monthly payment than the original mortgage.

If a homeowner defaulted on a lower monthly payment, what are the chances that homeowner can make a higher monthly payment? Industry has one explanation after another for why there are so few real voluntary modifications, but after a while it all just sounds like "the dog ate my homework."

One explanation that critics of the financial industry offer is that the industry is facing millions of mortgages in default, but they are paralyzed, consumed by the fear that they are not getting as much as possible out of each homeowner in default. One witness to that on the second panel criticizes the legislation, both Mr. Conyers' bill and mine, as one-size-fits-all.

Mr. Chairman, Members of the Committee, with 10 million families facing foreclosure, we can't afford a lot of elaborate, individualized tailoring. We know exactly what will happen in foreclosure—in bankruptcy rather. It may not be in this bill, but there is a wealth of case law. We know exactly what the court will do.

It will result in predictable, orderly, sensible modifications. The court will limit the amount of debt secured by the home to the value of the home. Any indebtedness that exceeds the value of the collateral is not really secured by the collateral anyway, and the court would treat that portion of the debt as unsecured, which it really is.

Now, the court would then set a term for the mortgage and set an interest of prime plus maybe 1 percent. Those terms make perfect sense. It is what industry should be doing voluntarily already.

The legislation does not help homeowner who bought too much house. It does not help homeowners who live beyond their means. It only helps homeowners who can afford their house but not their mortgage. It does not help speculators. Mortgages on investment property can already be modified in bankruptcy.

A year ago, I spent hours—I spent time and energy refuting each argument by the financial industry against this legislation. Many of you remember those arguments. They said that their lawyers told them the legislation was unconstitutional and would never survive a court challenge. If their lawyers told them that, they need to get some new lawyers.

A year ago, union members were reluctant to question the financial services industry. They believed what the financial industry said. After all, the financial industry made 40 percent of all corporate profits in America in 2007, so those guys must be really smart.

If you think that still, go home this weekend and ask the people you represent how much credibility they think the financial should still have with Congress. I think Mr. Conyers is right. The vote we had just a short while ago on TARP tells us a great deal, speaks volumes of what Americans now think about the financial industry and the conduct that got us in the mess we are in.

We spent a year and a half, a precious year and a half, a year and a half we could not afford to waste, on failed efforts to encourage voluntary modifications. We have offered industry carrot after carrot. It is time for a stick.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Miller follows:]

PREPARED STATEMENT OF THE HONORABLE BRAD MILLER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH CAROLINA

Chairman Conyers, Ranking Member Smith, members of the Committee, thank you for this opportunity to address pending legislation to empower bankruptcy courts to modify home mortgages, just as bankruptcy courts already can modify every other kind of secured debt. The mortgage industry treats that peculiarity in the law as if it were brought down from Mount Sinai on stone tablets. In fact, it appears to have been just a sloppy compromise in the Senate in 1978, and that nonsensical quirk in the law is now responsible for much of the paralysis in our nation's response to the foreclosure crisis.

We are just beginning to see the effects of the foreclosure crisis.

The Census Bureau estimates that 69.2 percent of American families owned their own homes in the second quarter of 2004, and 67.9 percent owned their own homes in the third quarter of 2008. The number will go much, much lower.

Credit Suisse now estimates that 8.1 million families will lose their homes to foreclosure in the next four years, and the number will rise to 10.2 million families if the recession becomes more severe, a frighteningly real possibility.

In 2006, about 2.5 million families were "underwater," or owed more on their mortgages than their homes were worth. Moody's now estimates that 12 million homeowners are underwater, and the number will rise to 14.6 million by the fall if home values decline another ten percent, as Moody's expects.

Homeowners who owe more on their home than their home is worth are stuck. They can't sell their house and pay off their mortgage, they can't refinance, and they almost certainly can't qualify for any other kind of credit. Even homeowners who can make their current monthly payments have no wiggle room if anything goes wrong, if anyone in the family gets seriously ill, or if anyone loses their job, or if they go through a divorce.

Foreclosures are contributing to the decline in home values, the decline in home values is contributing to the foreclosure crisis, and both are contributing to the decline in the economy. Vacant foreclosed homes are stigmatizing neighborhoods and pushing down home values, and priced-to-sell foreclosed homes are flooding real estate markets around the country. Half of the homes on the market in the Bay Area of California are foreclosures.

Families that lose their homes to foreclosure lose their membership in the middle class, probably forever. Almost all middle-class homeowners are seeing their life's savings evaporate with the collapse in the value of their home. And a homeowner who has seen his home decline in value by 20 or 30 percent is in no hurry to buy a new car.

If ten million families lose their homes to foreclosure in the next four years, nothing else we do to revive the economy is going to work.

Voluntary modifications are not even touching the problem. Three quarters of the voluntary modifications that industry claims are just payment schedules with no reduction in the principal or interest. Half of the modifications in November were forbearance agreements that allowed the homeowner to catch up back payments, and actually resulted in a higher monthly payment than the original mortgage. If a homeowner defaulted on a lower monthly payment, what are the chances the homeowner can make a higher monthly payment?

Industry has one explanation after another for why there are so few real voluntary modifications, but after a while it all just sounds like "the dog ate my homework."

One explanation that critics of the financial industry offer is that the industry is facing millions of mortgages in default, but they are paralyzed, consumed by the fear that they are not getting as much as possible out of each borrower in default. One witness today criticizes the legislation before this committee as "one size fits all." Mr. Chairman, with ten million families facing foreclosure, we can't afford a lot of elaborate, individualized tailoring.

We know exactly what will happen in bankruptcy. It will result in predictable, orderly, sensible modifications. The court will limit the amount of debt secured by the home to the value of the home. Any indebtedness that exceeds the value of the collateral is not really secured anyway, and the court would treat that portion of the debt as unsecured. The court would then set a term and an interest rate of prime plus maybe one percent.

Those terms make perfect sense. It is what industry should already be doing voluntarily.

The legislation does not help homeowners who bought too much house. It only helps homeowners who can afford their house but not their mortgage. It does not help speculators. Mortgages on investment properties can already be modified in bankruptcy.

I spent a lot of time and energy a year ago refuting each argument by the financial industry against this legislation. Many of you remember those arguments. They said their lawyers told them the legislation was unconstitutional and would never survive a court challenge. If their lawyers told them that, they need to get some new lawyers.

But a year ago, many members were reluctant to question what the financial industry said. After all, the financial industry made 40 percent of all corporate profits in 2007, so those guys must be really smart.

If you still think that, go home this weekend and ask the people you represent how much credibility they think the financial industry should have with Congress now.

We've spent a year and a half on failed efforts to encourage voluntary modifications. We've offered industry carrot after carrot. It is time for a stick. This legislation is the stick.

Mr. CONYERS. Thank you, Mr. Miller, for your excellent work.

Now, Jim Marshall of Georgia is known as a military man. He interrupted his education at Princeton to join the infantry combat mission in Vietnam. He came back, thank goodness, and subsequently obtained his law degree from Boston University, and we welcome him here this afternoon.

TESTIMONY OF THE HONORABLE JIM MARSHALL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF GEORGIA

Mr. MARSHALL. Thank you, Mr. Chairman, Members of the Committee.

I guess I ought to start by adding to what the Chairman described as my background, the fact that I have spent years as a bankruptcy lawyer, bankruptcy law professor, taught creditor's rights courses, advised banks, had written extensively in this area and have been married for many, many years to a Chapter 13 trustee, who handles one of the largest volumes of Chapter 13 cases in the country. So I am extremely—oh, and I have done a lot of Chapter 11s. My expertise is in business bankruptcy, typically representing lenders, sometimes representing debtors.

When Dan Miller came to me as the subprime crisis was unwinding a couple of years ago and suggested that we permit modification of mortgages and Chapter 13, I said I wouldn't support it.

Largely, Mr. Smith, I wouldn't support it for the reasons that you described, and I have got 30 years of background in this subject matter. It took me about 2 months of thinking about it before I realized that probably a modified version of what Mr. Miller is suggesting is absolutely necessary under our circumstances, national circumstances, and it can be enacted in a way that doesn't hold out all the problems that you, I think, correctly have identified as the things to be worried about with regard to legislation like this.

It should only apply to preexisting loans. It shouldn't apply prospectively.

That eliminates, probably altogether, but certainly diminishes substantially the worry that the consequence of this will be to increase costs for everybody who wants to get a mortgage in the future because it doesn't really threaten future mortgages.

When I made my proposal and not in the form of written legislation but sort of an outline to different folks a couple of years ago, I not only suggested retroactivity. I suggested that it be limited to certain types of loans, that they be subprime, Alt-A, maybe constrained to a certain period of time.

The reason I was absolutely convinced that we need today move and move quickly is because there really is no other mechanism available to us to address this crisis. Whether you are interested in helping out the homeowners, or you are interested in helping out the rest of us, the folks who didn't drag us into this mess, the people who were not irresponsible borrowers, the people who were not irresponsible lenders but who are caught up in all of this, seeing our home values plummet, jobs disappear, the economy in tatters, if you are interested in helping and you are interested in focusing on what dragged us into all of this mess, let us get the parties that dragged us into this to resolve their problem between themselves without having a whole bunch of houses on the market, foreclosed on, vacant, dragging down the portfolio of values for all of the lenders that I used to represent, causing them to have all kinds of problems meeting capital requirements, having FDIC come in and close banks.

It is a tidal wave that is slowly sweeping the country causing misery and tragedy to a whole bunch of folks when it wasn't necessary and, certainly, could have been slowed down if we had just been a little bit more open minded to the only mechanism that is really available to slow it down; and that is modification of these notes in a Chapter 13 setting.

Now, why won't it work out in Chapter 13? It is pretty simple. Most of these folks who get to the point where they have got to modify their mortgage, they have got credit card issues, alimony issues, child support issues, hospital bill issues. They have got many, many other creditors. The amounts, relatively, are fairly small. There is effectively no such thing as custom modification and workouts in consumer cases because the amounts are too small to put the effort into it for the industry.

So it is a—apparently, somebody is going to be dismissive of Brad's proposal. I would modify Brad's proposal. But it is the individual who is dismissive on the notion that this is a one-size-fits-all problem. Yes, it is a one-size-fits-all problem from the perspective of the industry because these are consumer cases.

And so you cannot expect to take taxpayer dollars, put them into homeowner relief or mortgage relief or what have you and expect it is going to have much effect because these folks have other debt problems that aren't going to get resolved even if their home mortgage debt problem does get resolved. A small percentage, yes. But the vast majority, no.

The efforts that we have made so far to try and help folks whose properties are going to go into foreclosure, who are going wind up homeless, who are going to wind up out of the middle class and, perhaps, as Brad suggests, never to return to the middle class. The program we have come up with so far, they are just not going work for the reasons I just described. It is too big a problem.

Now, Chapter 13 is a very fair process for all parties concerned. It is one that has safely and effectively modified loans in all kinds of other circumstances except primary residences. And the bankruptcy process generally deals with this modification problem time and time again.

Mr. Smith, I found myself agreeing with the items that you listed as reasons to be concerned. And I would like to quickly just address those different items.

First, you identified one reason to be fairly comforted by the prospect of making this change in our law. And that is, in effect, it says to the parties who are dragging us into this, the lenders, call it the debtors and the creditors, you deal with this among yourself. Don't let it play out in our neighborhoods across the country. You are going to settle this thing, and we are going try and keep more people in—you are not going to drag down the portfolio values of all these banks that are innocent. You are not going drag down the value of my house. I am innocent.

So it is attractive that no taxpayer dollars need to be used in order to accomplish that. And what taxpayer dollars are used can be blended into the realities that would then exist under the circumstances of modification. There is no reason to suggest that somehow a program permitting loan modification in Chapter 13 would undermine our other efforts, just supplement them and actually diminish the necessity for them, which is very attractive to me.

There should be no long-term increase in mortgage rates if it is only retroactive and, in fact, there is scholarship out there that suggests that there wouldn't be an increase in mortgage rates anyway; that the impact is too small; that there are others that differ.

Yes, there will be a lot of bankruptcy filings. I think there is a very legitimate concern. And it is a concern that the bankruptcy system could get overwhelmed. And that is something that this Committee needs to be thinking about.

How do you simplify the process? How do you make valuation easy and more reliable? Is this going to be full relief for appraisers, you know, many of whom are responsible for dragging us into this by giving high valuations to start out with? Because they will all be testifying in bankruptcy courts and running the clock at the time—full relief for lawyers, full relief for trustees.

Some attention must be given to trustee fees here. If payments are made outside of the bankruptcy plans and there is a huge increase in volume, there may not be enough money in the system to handle that. So there are issues that need to be focused on in light of the fact that this would increase dramatically the amount of filing. There is no doubt about that.

But this system is set up to handle exactly this problem. We don't have any other system that is set up to handle it, and there is no other system that can handle it. You can't do it voluntarily. And the industry itself is not going to be able to deal with this.

And the final thing, I wholeheartedly agree on personal responsibility. There is all kinds of scholarship out there that clearly indicates that people don't take out loans thinking, as a fallback, I am going file bankruptcy if I can't pay this thing. There is lots of scholarship to that effect.

But what worries me more than the concern about personal responsibility and somehow undermining personal responsibility is that bankruptcy judges are human. Humans err. They are not perfect. They are going to make mistakes where valuation is concerned. And I don't think it is fair for a debtor to get a windfall just because a judge made a mistake on valuation or for unsecured creditors who then might get some payments that they wouldn't otherwise have gotten to get a windfall.

And so I have thought and I proposed a couple of years ago that inaddition to this being retroactive, that what we ought to have is what is referred to sometimes as a claw-back position. Basically, the idea is that, at least initially, when the judge makes a valuation determination, that is fine; it is final. We move on. There is an appeal right? But most creditors are not going to appeal. There is just not enough money in it.

We move on. But the creditor, actually, for a certain period of time gets 100 percent of the upside if that property is sold. And gradually rights transfer, equity transfers to the debtor. It seems to me that that is one way to reduce the number of filings that are just sort of—well, I am going take a shot at maybe getting a reduced price on my house. And it is a way to reduce any likelihood at all that somehow personal responsibility is going to be undermined and people are going to be filing in order to take advantage of the bankruptcy process instead of just being up front and straight in their relationships with their creditors.

There are a number of other issues here, Mr. Chairman. You are going to have to worry about eligibility for Chapter 13. Right now, as eligibility is currently defined, there are going to be some folks who are not eligible that you would probably want to be eligible if you are going to offer this areas a solution to our national problem or one of the—part of the solutions there.

There ought to be restraints on the judge's ability to modify loans. There should be a cap on the number of years. There should be some limitation on what the judge can do as far as interest rate, et cetera, is concerned. Most judges aren't going to get carried away, but it would be good if the legislation covered those things.

Trustee compensation, I have already mentioned that. The valuation process somehow injecting speed, simplicity, and diminishing costs—those are important, also. And the final thing I would say is that I have never been one to appreciate the ways in which, in bankruptcy law, people like me can sort of get you. Find a technical problem and, as a result of having found that technical problem with your paperwork or your filing or you didn't throw three rocks over your left shoulder at the right time in order to truly establish your rights, all of a sudden, you are not properly secured.

And it seems to me we ought to ask the industry to identify ways in which the mortgage-backed security process and securitization of debt generally has caused problems with enforcement. And we ought to invite the industry to suggest language that could be included in this bill that would assist the creditor in getting to an equitable solution here so that both sides are fairly treated.

Bankruptcy courts are courts of equity. We should long ago—a year and a half ago—have permitted bankruptcy courts to have the authority to modify, with certain limitations that take care of some of the problems that Mr. Smith has correctly identified. And we ought to do it as quickly as we can.

Thank you, Mr. Chairman.

Mr. CONYERS. Thank you very much, both of you.

I successfully restrained the Members of the Committee who have dozens of questions that they would like to put to you now. But as you know, our custom is that we do not enter into the question process with our distinguished colleagues who come before us.

Mr. MARSHALL. Mr. Chairman, if I could offer all Members who would like to at all further with me about this in an informal setting or in a formal setting—it doesn't matter to me. I am happy to do it. As I said, I was originally a no. It took me a couple of months of thinking about our circumstances and how we could work this out to conclude that we really ought to do it. And I would be happy to share my—respond to questions in another setting at any time.

Mr. MILLER. And, Mr. Chairman, I would, too. I have had many, many conversations. Ms. Lofgren has also played an important role in trying to work compromises on this. My caution is that that process not slow things down. We need to act quickly.

Mr. Chairman, thank you. I think we would be both willing to take questions. Thank you for relieving us of that.

Whatever else I may accomplish as a Member of Congress, I think I can now claim fairly to be the only Member of Congress who has succeeded in persuading Jim Marshal to change his mind about anything.

Mr. CONYERS. Your message is very well received. Thank you, both.

Ms. JACKSON LEE. Mr. Chairman?

Mr. CONYERS. I am sorry.

The next witness is Professor Adam Levitin from George Washington University, who will be followed by David Certner of the

AARP. And the final witness is Matt Mason, associate director of the United Automobile Workers GM Legal Services.

Professor Levitin is really from Georgetown University Law School. My error. He has presented us with one of the longest statements for the record that I have encountered because it was in very small print and it still went to 27 pages, which will be duly entered into the record.

He specializes in bankruptcy and commercial law. He has practiced business and finance and restructuring in the department of Weil, Gotshal, and Manges in New York, and is an adviser to the Congressional oversight panel supervising the Troubled Asset Relief Program.

All of your statements will be entered into the record. And I want to invite you, Professor Levitin, to begin our discussion.

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

Mr. LEVITIN. Mr. Chairman Conyers, Ranking Member Smith, and Members of the Committee, good afternoon. My name is Adam Levitin, and I am an associate professor of law at Georgetown University Law Center.

I am here this morning to testify in support of H.R. 200 and H.R. 225. I think it is interesting to look back at where we were, where we were standing a year ago. A year ago, the idea of modifying mortgages in bankruptcy looked radical to many people.

But then 6 months ago, who would have thought that this Congress would have approved the single largest expenditure in U.S. government history? The $700 billion Troubled Asset Relief Program, the TARP.

Today, bankruptcy modification not only looks like the only free meal in town, but it is also, by far, the most moderate response that can possibly deal with the foreclosure crisis. And it is truly the only serious option on the table.

Our choices today are bankruptcy modification or nothing. And it is important to realize doing nothing is a choice, and it is a very bad choice.

I wish to make two points in my oral testimony. First, permitting bankruptcy modification of mortgage will have only a minimal impact on mortgage credit. And second, bankruptcy modification is the only guaranteed method for dealing with obstacles to loan modification created by securitization.

Bankruptcy modification will only have a de minimus impact on mortgage credit. Mortgage costs will not go up for prospective borrowers, and mortgage credit availability will not be reduced except at the very margins.

For the average borrower, there will likely be almost no impact. This is because lenders would typically lose less in bankruptcy modification than in foreclosure.

Indeed, by definition, the bankruptcy code guarantees a secured creditor, like a mortgage creditor, at least as much of a recovery as in foreclosure—namely, the value of the property.

Now, basic economic theory posits that lenders will charge more when faced with larger potential losses. And I think you will hear more from Professor Mayer about this.

Professor Mayer and I are on the same page about this, but Professor Mayer focuses on what I believe is the wrong question. The question is not the trade off between bankruptcy losses and no losses.

Instead, the relevant question when trying to gauge the economic impact of bankruptcy modification on future mortgage credit is whether loan modification would result in larger losses for a lender than foreclosure. It won't.

There is no evidence that bankruptcy modification losses would be larger in foreclosure. I have conducted the only research to date that examines the foreclosure modification trade off.

Currently, foreclosure losses for lenders are running at around 55 percent of loan value. Bankruptcy modification, even in lenders' worst-case scenarios, like Riverside and San Bernardino, California, would only result in an average 23 percent loss of loan value.

As foreclosure losses are greater than bankruptcy modification losses would be, lenders will not price against bankruptcy modification.

Unfortunately, parts of the lending industry, including the Mortgage Bankers Association, have been touting some bogus claims to Congress and to the public. They have been arguing that bankruptcy modification would result in a 150-point across-the-board increase in mortgage interest rates.

Let me be very clear about this: The Mortgage Bankers Association's 150-basis-point number is false. It is grossly irresponsible. And it is dis-provable.

It is a number that they, the Mortgage Bankers Association, has continually changed its calculation of this number, so it is a bit of amoving target, and I am not quite sure which calculation I should be taking aim at today.

And I see that my time is running down. I refer you to my written testimony for a detailed refutation of this number.

So here is the key question. If modification is really a better outcome for foreclosure—than foreclosure for lenders, why aren't we seeing lots of meaningful, voluntary loan modifications?

The answer lies with securitization and the contractual and incentive problems it creates. Securitization separates beneficial ownership of mortgage loans from the servicing of the loans. This creates several problems for modifications. I will mention two of them briefly.

First, mortgage servicers' contracts frequently limit their ability to perform modifications. Servicers are often banned from writing down principal, reducing interest rates, so forth. This is true for Fannie Mae and Freddie Mac loans as well as for private securitizations.

These contractual obstacles can only be reduced with the unanimous consent of the mortgage-backed security holders. That would be impossible to get in most cases. The only way to cut through these contracts is bankruptcy modification.

Likewise, securitization also creates economic incentives for foreclosure. If you want to understand why we are seeing such dismal voluntary efforts at loan modification in the private market, you need to follow the money, and that trail leads to mortgage servicers.

Many mortgage servicers are able to make more money in foreclosure than they do with a loan modification, even if the modification is in the interest of the investors.

I want to conclude by emphasizing that bankruptcy modification is the only guaranteed method for dealing with the contractual and incentive problems for loan modification created by securitization. It costs taxpayers nothing, and it will not create moral hazard.

Unless the problems created by securitization are addressed, we will not be able to abate the flood of foreclosures, and we will not be able to stabilize financial markets.

I strongly urge Congress to pass legislation permitting all mortgages to be modified in bankruptcy. Thank you, and I look forward to your questions.

[The prepared statement of Mr. Levitin follows:]

PREPARED STATEMENT OF ADAM J. LEVITIN

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 House of Representatives
Committee on the Judiciary

Hearing: on
H.R. 200, the "Helping Families Save Their Homes in Bankruptcy Act of 2009,"
and
H.R. 225, the "Emergency Homeownership and Equity Protection Act"

January 22, 2008

Mr. Chairman, Ranking Member, Members of the Committee:

I am pleased to testify in support of both H.R. 200, the Helping Families Save Their Homes in Bankruptcy Act of 2009, and H.R. 225, the Emergency Homeownership and Equity Protection Act, legislation proposed by Representatives Conyers and Miller that would significantly help ease the nationwide foreclosure crisis and stabilize financial markets.

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 or unjust windfalls.

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 1.7 million in the first three quarters of 2008.[2] Over half of a million homes were actually sold in foreclosure or otherwise surrendered to lenders in 2007, and over seven hundred thousand were sold in foreclosure in the first three quarters of 2008 alone.[3] At the end of the third quarter of 2008, one in ten homeowners was either past due or in foreclosure, the highest levels on record.[4] Already nearly 20% of homeowners have negative equity

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[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.

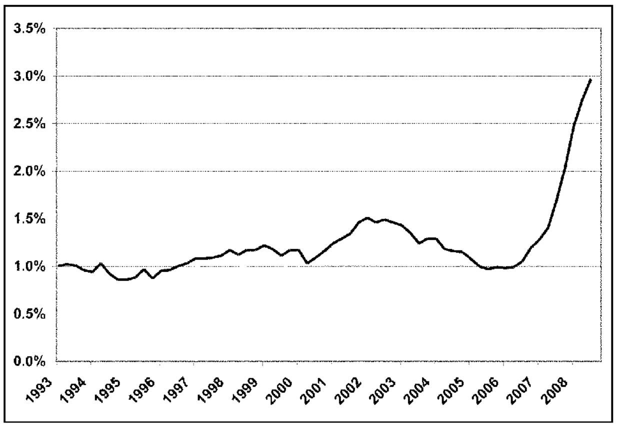
[2] HOPE Now, *Workout Plans (Repayment Plans – Modifications) and Foreclosure Sales, July 2007 - November 2008*, *at* http://www.hopenow.com/upload/data/files/HOPE%20NOW%20Loss%20Mitigation%20National%20Data%20July%2007%20to%20November%2008.pdf. *See also* Chris Mayer et al., *The Rise in Mortgage Defaults*, 23 J. ECON. PERSPECTIVES – (2009) (forthcoming) (1.2 million foreclosure starts in first half of 2008).

[3] E-mail from Daren Blomquist, RealtyTrac, Inc. to author, March 7, 2008 (on file with author).

[4] Mortgage Bankers Association, Press Release, Delinquencies Increase, Foreclosure Starts Flat in Latest MBA National Delinquency Survey, Dec. 5, 2008, *at*http://www.mbaa.org/NewsandMedia/PressCenter/66626.htm. 2.97% of all one-to-four family residential mortgages outstanding were in the foreclosure process in the first quarter of 2008, and 6.99% were delinquent. *Id.* *See also* Vikas Bajaj & Michael Grynbaum, *About 1 in 11 Mortgageholders Face*

in their homes,[5] and by the time the housing market stabilizes, 40% of homeowners will have negative equity positions.[6] By 2012, Credit Suisse predicts, around 8.1 million homes, or 16% of all residential borrowers could go through foreclosure.[7] In other words one in every nine homeowners—and one in six households who have a mortgage—will lose their home to foreclosure.

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.

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 mortgage means that an even greater percentage of Americans are directly affected by higher delinquency and foreclosure rates.

[5] 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.

[6] Ruth Simon, *Rescue Includes Steps to Help Borrowers Keep Homes*, WALL ST. J., Sept. 20, 2008.

[7] Credit Suisse, *Foreclosure Update: over 8 million foreclosures expected*, Fixed Income Research, Dec. 4, 2008. Even Credit Suisse's best-case scenario still involves 6.3 million foreclosures. *Id.*

[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.

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.

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]

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[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).

[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

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 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.

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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.

[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.

Chart 2: Workouts to Foreclosures by Type, HOPE Now Alliance Members,[21]

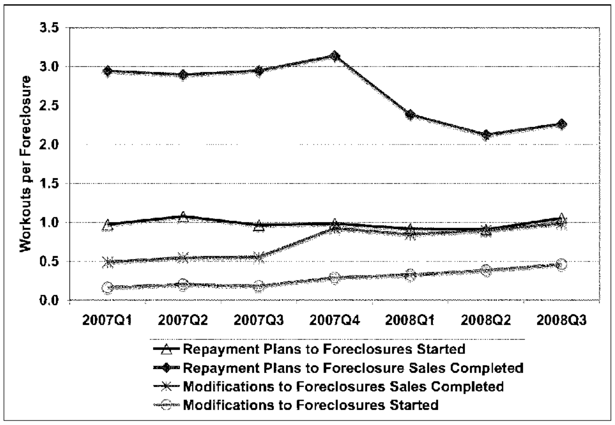
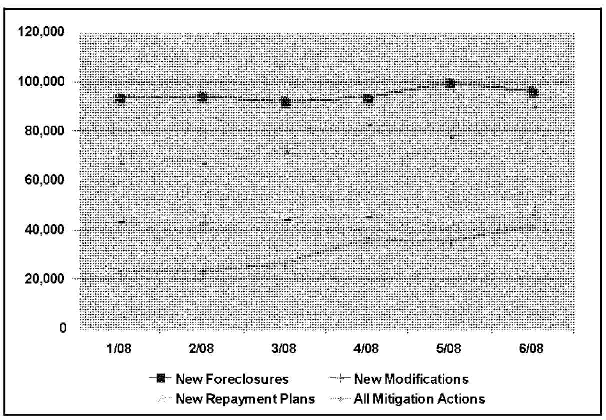


Chart 3: Loan Modifications, Repayment Plans, and Foreclosures in National Banks' and Federal Thrifts' Servicing Portfolios, 2008[22]



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 a select group of national banks and federal thrifts that comprise around 60% of the total

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[21] HOPE Now, HOPE NOW Loss Mitigation National Data July 07 to November 08, *at* http://www.hopenow.com/upload/data/files/HOPE%20NOW%20Loss%20Mitigation%20National%20Data%20July%2007%20to%20November%2008.pdf; Author's Calculations.

[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.

servicing portfolios nationwide. 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 fail 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 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]

The failure of existing loan modification programs is not surprising—most loan modifications do not change monthly payments or even *increase* monthly payments. Less than 20% of voluntary loss mitigation efforts rarely reduce monthly mortgage payments according to a study by Professor Alan White of Valparaiso University Law School.[25] Likewise, the Center for Responsible lending estimates that under 20% of HOPE Now loan modifications result in lower monthly payments.[26]

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

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[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)

[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] Alan M. White, *Deleveraging American Homeowners: December 18,2008 Update to August 2008 Report*, Valparaiso University School of Law (December 18, 2008) *available at* http://www.hastingsgroup.com/Whiteupdate.pdf; Alan M. White, *Rewriting Contracts, Wholesale: Data on Voluntary Mortgage Modifications from 2007 and 2008 Remittance Reports*, FORDHAM URBAN L.J. (2009) available at http://ssrn.com/abstract=1259538.

[26] Sonia Garrison *et al.*, Continued Decay and Shaky Repairs: The State of Subprime Loans Today, Center for Responsible Lending, Jan. 2009, *at* http://www.responsiblelending.org/pdfs/continued_decay_and_shaky_repairs.pdf.

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,[27] 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 has only helped a few thousand delinquent homeowners,[28] not the 240,000 predicted.[29] Likewise, the HOPE for Homeowners program, established by Congress in July 2008 to permit FHA insurance of refinanced distressed mortgages, and predicted to help 400,000 homeowners, had as of mid-December 2008 attracted only 312 applications,[30] and not actually refinanced any mortgages,[31] in part because of its reliance on private market cooperation to do voluntary principal write-downs.[32]

Similarly, the Streamlined Loan Modification Program (SMP) adopted by the GSEs (in conservatorship) is set up to fail.[33] The SMP does not require any modifications, but instead merely sets a target for modified loan payments (principal, interest, taxes, insurance) to be no more than 38% of gross monthly income (front-end DTI). Putting aside whether it makes sense to do modifications based only on front-end DTI, ignoring back-end DTI (total monthly debt payments to gross monthly income), the SMP's front-end DTI target is grossly inadequate and has already been rejected as resulting in unsustainable loan modifications by leading elements of the mortgage servicing industry have already abandoned as resulting in unsustainable modifications. Litton Loan Servicing, a Goldman Sachs affiliate, uses 31% front-end DTI as its initial target,[34] FDIC has proposed a general modification program using a 31% front-end DTI

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[27] 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).

[28] Michael Corkery, *Mortgage 'Cram-Downs' Loom as Foreclosures Mount*, WALL ST. J., Dec. 31, 2008.

[29] *See, e.g.*, Press Release, US Dep't of Housing and Urban Development, Bush Administration to Help Nearly One-Quarter of a Million Homeowners Refinance, Keep Their Homes; FHA to implement new "FHASecure" refinancing product (Aug. 31, 2007), *available at* http://www.hud.gov/news/release.cfm?content=pr07-123.cfm; Press Release, US Dep't of Housing and Urban Development, FHA Helps 400,000 Families Find Mortgage Relief; Refinancing on pace to help half-million homeowners by year's end (Oct. 24, 2008), *available at* http://www.hud.gov/news/release.cfm?content=pr08-167.cfm.

[30] Dina ElBoghdady, *HUD Chief Calls Aid on Mortgages a Failure*, WASH. POST. Dec. 17, 2008, at A1, *at* http://www.washingtonpost.com/wp-dyn/content/article/2008/12/16/AR2008121603177.html.

[31] Tamara Keith, *Despite Program, No Hope for Homeowners*, National Public Radio, Dec. 17, 2008, *at* http://www.npr.org/templates/story/story.php?storyId=98409330.

[32] Adam J. Levitin, *Flaws in the FHA Housing Bill*, WALL ST. J., July 11, 2008.

[33] The SMP standard has also been adopted voluntarily by the HOPE Now alliance of servicers is an entirely voluntary program.

[34] Oversight of the Emergency Economic Stabilization Act: Examining Financial Institution Use of Funding Under the Capital Purchase Program: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs, 110th Cong. (Nov. 13 2008) (testimony of Gregory Palm), *available*

target,[35] and Bank of America/Countrywide's settlement with the state Attorneys General requires use of a 25%-34% front-end DTI standard.[36] The GSEs' own initial underwriting guidelines suggest a maximum 25%-28% front-end DTI.[37] If the GSEs do not believe that 38% DTI is prudent underwriting for a loan to begin with, it is not clear why they would use 38% DTI as a modification target, especially as most loans *already* have a front-end DTI of less than 38%.[38] Only around 10-15% of prime loans and alt-A and 25-30% of subprime loans are already above this threshold.[39] SMP consists largely of suggesting a standard so low that most troubled loans already comply with it.

All voluntary foreclosure mitigation efforts to date have failed, as have federally-sponsored efforts, which have been reliant on private market cooperation. 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.[40]

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, 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

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at: http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.LiveStream&Hearing_id=1d38de7d-67db-4614-965b-edf5749f1fa3, at minutes 143-144.

[35] FDIC, FDIC Loss Sharing Proposal to Promote Affordable Loan Modifications, *at* http://www.fdic.gov/consumers/loans/loanmod/index.html (proposed Nov. 14, 2008).

[36] Stipulated Judgment & Injunction, California v. Countrywide Fin. Corp., No. LC083076, Cal. Sup. Ct., L.A. County, NW District, Oct. 20, 2008, *at* 14, *available at* http://ag.ca.gov/cms_attachments/press/pdfs/n1618_cw_judgment.pdf.

[37] Freddie Mac Single-Family Seller/Servicer Guide Section Section 37.15.

[38] Admittedly, DTI reporting is of questionable accuracy.

[39] Merrill Lynch, MBS / ABS Special Report, *Loan Modifications: What Investors Need to Know*, Nov. 21, 2008, at 7. Reliance on DTI is itself questionable; loan performance seems to correlate better to loan-to-value ratio than front-end DTI. *Id.*

[40] State Foreclosure Prevention Working Group, *supra* note 24, at 2.

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.[41]

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.[42]

[41] 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.

[42] *See* 26 U.S.C. § 1860A *et seq.* (REMIC treatment); SFAS No. 140 (off-balance sheet accounting treatment).

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.[43] 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.[44]

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 under which the MBS are issued. Under the Trust Indenture Act of 1939,[45] 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

[43] Credit Suisse, *The Day After Tomorrow: Payment Shock and Loan Modifications*, Fixed Income Research, April 5, 2007, at 5.

[44] *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.").

[45] 15 U.S.C. § 77ppp(b).

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 in any way that would affect cash flows, 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. Given that there were 6,815 private-label securitizations from 2001 thru 2007, not counting many more agency securitizations, and then numerous resecuritizations and re-resecuritizations, the scope of the obstacle to voluntary modification of PSAs to permit greater servicer discretion is considerable.[46]

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.

B. Practical Obstacles to Voluntary Modification

There are a range of practical difficulties that impede voluntary modification programs. Mortgage servicing is largely a highly scalable, automated transaction processing business of collecting payments and remitting them to investors. Loan workouts, however, involve consider manpower and discretion. Servicers have built their businesses around transaction processing and 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 when they do, their loan workout overtures are viewed with suspicion because they follow months of dunning calls and dunning letters. And the computer software that servicers

[46] Inside Mortgage Finance MBS Database.

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.[47]

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.[48] The fees servicers can lard on in foreclosure can be considerable, and there is effectively no oversight of their reasonableness or even authorization.[49] 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

[47] 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).

[48] 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.

[49] Katherine M. Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims* , 87 TEX. L. REV. (2008).

this form of compensation are so severe that it is flatly prohibited for federal government contracts.[50]

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.[51] 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.[52] Debtors can also currently modify wholly unsecured second mortgages on their principal residences,[53] as well as

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[50] *See* 41 U.S.C. § 254(b); 10 U.S.C. § 2306(a).

[51] 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).

[52] *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); Lomas Mortg., Inc. v. Louis, 82 F.3d 1 (1st Cir. 1996) (permitting strip-down on three unit property in which the debtor resided).

[53] 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.

loans secured by yachts, jet-skis, snowmobiles, jewelry, household appliances, furniture, cars, trucks, or any other type of personalty.[54]

The Bankruptcy Code, however, forbids the modification of mortgage loans secured solely by the debtor's principal residence.[55] 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.[56] 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.[57]

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 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.[58] 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

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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).

[54] 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).

[55] 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."

[56] Nobelman v. Am. Sav. Bank, 508 U.S. 324 (1993) (Stevens, J., concurring).

[57] Mortgage servicers, however, may not be, as discussed above in section II.C.

[58] *See supra* note 52.

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*,[59] 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; 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.

B. The Relevant Comparison: Bankruptcy Losses Versus Foreclosure Losses

The comparison between loss severities in bankruptcy modification and loss severities in foreclosure is a crucial one that many economists miss.[60] Most economists who have examined bankruptcy modification are inexpert in bankruptcy, mortgage foreclosure or both. As a result they inappropriately view bankruptcy modification as an alternative to no lender loss whatsoever, and therefore conclude that because lenders would incur losses from modification of mortgages in bankruptcy, they will react by increasing cost of mortgages for other borrowers.

[59] Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WISC. L. REV. (forthcoming).

[60] *See e.g.*, *Helping Families Save Their Homes: The Role of Bankruptcy Law: Hearing Before the S. Comm. on the Judiciary*, 110th Cong. 1 (2008) (testimony of Dr. Christopher J. Mayer), *available at* http://judiciary.senate.gov/hearings/testimony.cfm?id=3598&wit_id=7543 ("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.[61]

So which loss will be smaller? Bankruptcy modification losses will generally be less than foreclosure sale losses. By definition a lender cannot do worse in bankruptcy than in foreclosure. The adequate protection provisions of the Bankruptcy Code protect lenders from pre-plan confirmation losses due to depreciation,[62] and the Bankruptcy Code requires that a secured creditor must receive at least what the creditor would receive in foreclosure, namely the value of the collateral.[63]

There is, of course, the possibility that bankruptcy judges' valuations of property will be lower than foreclosure sale returns. But there is absolutely no evidence to support this belief. My own empirical research indicates that losses due to cramdown would generally be in the 20%-25% range,[64] 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 than foreclosure sale prices, 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. At worst, then, bankruptcy imposes a time delay on the lender. If this delay is only pre-plan, it is *de minimis*, and potentially helpful, depending on the housing market. And if a plan fails and results in a delayed foreclosure, the losses from the delay would be offset by the additional monthly payments under the plan. Bankruptcy modification will generally result in a lender receiving at least as much as in foreclosure, and often more.

The relevant economic question is one of bankruptcy losses versus foreclosure losses, not the straw man comparison between bankruptcy losses and no losses. There is *no* empirical evidence supporting 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 have a *de minimis* impact on the

[61] This conclusion is consistent with Karen M. Pence, *Foreclosing on Opportunity: State Laws and Mortgage Credit*, 88 REV. OF ECON. & STAT. 177 (2006). Dr. Pence's article does not address the question of bankruptcy modification loss versus foreclosure loss. Instead, it deals with the impact of judicial versus non-judicial foreclosure on mortgage credit availability. Dr. Pence finds that there is lower credit availability in states that require judicial foreclosure, which is more cumbersome and therefore more expensive than non-judicial foreclosure. The key to understanding Dr. Pence's findings is that it is loss severity due to delay, not delay per se, that affects credit availability. Thus, while bankruptcy is a longer process than foreclosure, as long as it results in smaller loss severities than foreclosure, it will not reduce credit availability.

[62] 11 U.S.C. §§ 361, 362(d).

[63] 11 U.S.C. § 1325(a)(5).

[64] Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WISC. L. REV. (forthcoming).

cost and availability of credit and ensure more prudent and sustainable underwriting standards.[65]

C. 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").[66] 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.[67] 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.[68] 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.[69]

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[65] Adam J. Levitin, *Helping Homeowners: Modification of Mortgages in Bankruptcy*, 3 Harv. L & Pol'y Rev. (online) (Jan. 19, 2009), *at* http://www.hlpronline.com/Levitin_HLPR_011909.pdf, at 9.

[66] 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.

[67] *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.

[68] Kittle, *supra* note 66, at 3.

[69] *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

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.[70]

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.

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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.

[70] 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.

Based on my empirical analysis of a wide variety of mortgage market data,[71] there is statistically a zero percent chance that the MBA's 150 or 200 basis point claim is 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. Debtors' finances become a matter of public record. Debtors' credit reports are damaged by the bankruptcy filing for up to ten years, raising their future costs of credit. 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.[72] 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.[73] 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.[74] 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.

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[71] *See* Levitin, *supra* note 59.

[72] 11 U.S.C. § 1325(b).

[73] 11 U.S.C. §§ 1322(a); 1325(a)(5).

[74] 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.

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. Traditionally, wealthy debtors rarely file for bankruptcy. The mean income of Chapter 13 bankruptcy filers in 2007 was $35,688,[75] and less than 10% of all debtors earn over $60,000.[76]

Part of the reason for this is that Chapter 13 bankruptcy is not available to debtors with huge debt burdens. To file for Chapter 13, an individual must have less than $336,900 in noncontingent, liquidated, unsecured debts and less than $1,010,650 in noncontingent, liquidated secured debts.[77] 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,[78] adopted after the Supreme Court's 1993 *Nobelman* decision (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.[79]

C. Permitting Bankruptcy Modification Would Not Benefit Speculators

Bankruptcy modification would not yield a windfall to housing speculators ("flippers").[80] Many speculators are ineligible for 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,[81] 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.

Even if the speculator is eligible for Chapter 13, he is unlikely to be able to retain his investment properties, much less modify the mortgages thereon. A mortgage loan modification in bankruptcy can occur only as part of a plan.[82] The automatic stay would likely be lifted on an investment property (or second home) before a plan could be confirmed.[83] Accordingly, speculators and homeowners intent on keeping their second

[75] Robert M. Lawless *et al.*, *Did Bankruptcy Reform Fail? An Empirical Study of Consumer Debtors*, AM. BANKR. L.J. 349, 361 (2008).

[76] *Id.* at 360.

[77] 11 U.S.C. § 109(e) (2006, 2008 supp.).

[78] 11 U.S.C. § 1123(b)(5).

[79] 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.

[80] This section also holds true for vacation home purchasers.

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

[82] 11 U.S.C. § 1322(b) ("A *plan* may…") (emphasis added).

[83] 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

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.

Even if the speculator is eligible for Chapter 13, he is unlikely to be able to retain his investment properties, much less modify the mortgages thereon. 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.

If the speculator were able to avoid the lifting of the automatic stay, the loan could only be modified as part of a repayment plan proposed by the debtor, which would have to be confirmed by the court[84] 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. The Bankruptcy Code is replete with provisions to protect against abuse by small time real estate speculators and it is extremely unlikely that a speculator would be able to take advantage of bankruptcy modification.

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.

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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).

[84] 11 U.S.C. §§ 1321; 1322(b)(2) ("A *plan* may…") (emphasis added); 1325.

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.

The concern over moral hazard in bankruptcy is more an economists' fantasy than an empirically grounded reflection of real Americans' behavior. Americans do not behave as strategically with bankruptcy as economists like to believe people act. While there are undoubtedly some debtors who abuse bankruptcy, there are numerous safeguards built into the system to discourage strategic use of the bankruptcy system, and there is no evidence suggesting that abusive debtors are anything other than a small minority. Most debtors are confused, ashamed, and unhappy. They don't want to be in bankruptcy; it is a last choice option for them, not a cold calculated decision. Simply put, economists are far more likely to file for bankruptcy than actual consumers.

E. Bankruptcy Modification Would Not Produce a Windfall to Debtors If Property Values Later Appreciate

It is also important to note that bankruptcy modification that reduces loan principal does not produce a windfall for a debtor, even if the property later appreciates. The debtor cannot benefit from the appreciation during the course of the plan. If the mortgage appreciates in the three to five years of a plan, the debtor can only benefit upon a sale or disposition of the house. If the debtor sells the house at an appreciated value during the term of the plan, the debtor's income from the sale will be available to satisfy unsecured claims, including any unsecured mortgage claim that results from bifurcation under section 506(a).[85] Thus, there is no windfall possible for the debtor in the short term.

If the property appreciates in the long term (5-40 years potentially under H.R. 200 or H.R. 225), that appreciation would belong to the debtor, but the debtor has a better claim to it than the mortgagee.

Seen from a perspective of the original loan, letting the debtor keep future appreciation looks like a windfall. But this is the wrong perspective. The original loan was unable to perform, and insisting on its terms would have resulted in foreclosure. When a property is sold in foreclosure, the foreclosing creditor does not receive the future appreciation on the property; that belongs to the foreclosure sale purchaser. Giving the creditor more in bankruptcy than the creditor would have received in a foreclosure is a windfall to the creditor, not the debtor. The creditor has already been rewarded in bankruptcy by getting a loan modification that will provide at least the value the creditor would have received in foreclosure. If the creditor were able to claw back future appreciation, the bankruptcy modification would be equivalent to a temporary loan modification, and temporary modifications are less likely to succeed than life-of-the-loan modifications.

In the case of securitized loans, permitting an appreciation claw back would also reward precisely the parties whose irresponsible behavior created the foreclosure crisis.

[85] 11 U.S.C. § 1325(b)(2) (requiring debtors to commit all disposable income to unsecured creditors), 11 U.S.C. § 1329 (permitting modification of a plan to account for increases in debtor's income).

Securitization trusts are often short-lived entities. When the outstanding principal balance reaches a certain threshold, often 10%, the servicer will exercise a "clean-up call" and purchase out the remaining balance from the trust; it is not economical for the servicer to service small balances. Most trusts reach this "clean up call" threshold in their first seven years, as loans are refinanced out of the trust or default. Thus, the trust that owned the mortgage at the time of bankruptcy may well not exist to receive the shared appreciation. Instead, the clawed back appreciation would accrue to the party who held the residual rights in the mortgages—often the servicer/originator.

This is particularly troubling because in many cases principal reductions are necessary because the original lender condoned or even encouraged inflated property appraisals in order to make larger loans that it could then securitize for more money. Thus, rather than being a windfall to debtors, an appreciation claw back would reward the very entities that fueled the mortgage bubble through irresponsible lending.

Finally, it is important to emphasize that appreciation clawbacks do not exist for any other sort of lien stripping in bankruptcy. Likewise, unsecured creditors do not get to claim future income or assets after the debtor is discharged. Even if the debtor wins the lottery the next day, the core bankruptcy policy of the fresh start emphasizes that pre-petition creditors have no claim on post-discharge assets.

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,[86] 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,[87] 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;[88] 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

[86] 15 U.S.C. § 1681c(a)(1).
[87] 11 U.S.C. § 727(a)(8) (requiring eight years between Chapter 7 discharges).
[88] *See*, 11 U.S.C. §§727(a)(8)-(9); 1328(f).

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.[89]

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."[90] 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,"[91] this reason is simply inapplicable in the world of modern, instantaneous, computerized credit scoring. Indeed, even at the 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,[92] in a compromise between the Senate and House.[93]

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).[94] 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.

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[89] 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.

[90] 124 CONG. REC. H1799, Feb. 1, 1978 (statement of Rep. Stuart Brett McKinney (R-Conn.)).

[91] *Id.* (statement of Rep. Manley Caldwell Butler, R.-Va.).

[92] Bankruptcy Reform Act of 1978, P.L. 95-598, § 312(b), 92 Stat. 2676 (Nov. 6, 1978).

[93] 124 CONG. REC. H32411, Sept. 28, 1978; S34011 Oct. 5, 1978.

[94] Mortgage modification is already possible in Chapter 12 family farm or fisherman bankruptcies. 11 U.S.C. § 1222(b)(2).

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
- 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[95] for a variety of reasons,[96] 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

[95] *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.

[96] *See* Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 HOUSING POL'Y DEBATE (2007).

a homeowner's filing of a bankruptcy petition.[97] 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 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.

[97] 11 U.S.C. § 362(a).

Mr. CONYERS. Thank you very much.

Before I bring on Mr. Certner, I want to add that Professor Mayer, Christopher Mayer, who is the Paul Milstein professor of real estate and senior vice dean at Columbia Business School, has joined us, and I welcome him.

He spent his 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. He has received his degrees from University of Rochester and from MIT.

I now turn to Mr. Certner to introduce him at this moment and note, of course, that he is the legal counsel and legislative policy director at AARP, a nonprofit, nonpartisan membership organization for people at the young age of 50 and over.

With 40 million members, AARP is the Nation's largest organization dedicated to enhancing quality of life for senior citizens by advocating for positive social change. Mr. Certner has been with AARP since 1982, serves as counsel for the association's legislative, regulatory, and policy efforts at the Federal and state levels.

His degrees come from the National Law Center at George Washington University, and I am delighted to invite him to give his testimony at this moment.

TESTIMONY OF DAVID M. CERTNER, LEGAL COUNSEL AND LEGISLATIVE POLICY DIRECTOR, AARP, WASHINGTON, DC

Mr. CERTNER. Thank you, Mr. Chairman.

Chairman Conyers and Members of the Committee, thank you for the opportunity to appear before the Committee this afternoon on behalf of AARP.

As Congress begins work this week on broad economic recovery legislation, it is critical to remember that the underlying cause of our Nation's economic crisis is the huge number of mortgage loans currently delinquent or in foreclosure.

Home foreclosures today are at an all-time high, and another 2 million households with subprime mortgages are currently delinquent and in danger of losing their homes in the near future.

The prospect of widespread foreclosures is particularly serious for older Americans, who depend on their homes not only for shelter but as their primary asset for retirement.

For Americans age 50 and over, losing a house represents a significant financial loss in which there is limited time to recover. And for many, recovery may be impossible.

AARP analyzed mortgage data covering a 6-month period ending in December of 2007.

And, Mr. Chairman, I ask that a copy of our report be included in the record.

Mr. CONYERS. Without objection, so ordered.

[The information referred to follows:]

AARP Public Policy Institute

INSIGHT on the Issues

A First Look at Older Americans and the Mortgage Crisis*

This first-ever analysis of data on the mortgage crisis by age shows a surprisingly significant impact on older Americans. The data shows more than 684,000 homeowners aged 50 and over were either delinquent in mortgage payments or actually in foreclosure at the end of 2007. The analysis also finds older African Americans and Hispanics have higher foreclosure rates than whites of any age. Older Americans have less time and ability to recover from financial losses associated with a foreclosure, and losing a home jeopardizes their long-term financial security.

SUMMARY

Conventional wisdom is that most older Americans have built significant equity in their homes or have paid off their mortgages. The reality is that while many are secure in their homes, hundreds of thousands of others are not.

For Americans age 50 and over, losing a house represents a loss from which there is limited time to recover, and for some a recovery may be impossible given their age and limited incomes.

To date there have been no studies on how Americans age 50 and over have fared during the housing and mortgage market crises. Traditional sources of information on subprime lending, such as the Home Mortgage Disclosure Act (HMDA) database, or mortgage delinquencies, such as the National Delinquency Survey conducted by the Mortgage Bankers Association (MBA), do not have information on borrowers' age.

To quantify and understand the impact of the mortgage crisis on older Americans, AARP purchased data from Experian, one of the three large U.S. credit bureaus. The data is a 2.5 million person random sample pulled from the credit bureau's larger database on December 31, 2007. Foreclosure data in the sample covers the six-month period from July through December, 2007. Of the 2.5 million mortgage holders in the random sample purchased by AARP, about 1 million are age 50 or over.

Key findings from the study:

- Americans age 50 and over represent about 28 percent of all delinquencies (30 to 180 days late) and foreclosures in the current crisis.

* The author would like to thank the AARP Foundation for funding this research. The author is also grateful to Chris Herbert of Abt Associates and to Bill Apgar of the Harvard Joint Center for Housing Research for crucial suggestions and comments, although they are not responsible for any errors. Finally, thank you to Carlos Figueirdo for technical help.

AARP

- Over 684,000 older Americans (age 50 and over) were either delinquent or in foreclosure at the end of 2007. Of these, nearly 50,000 were in foreclosure or had already lost their homes.
- African Americans age 50 and over hold 6.8 percent of all first mortgages held by this age group, but represent 14.4 percent of all foreclosures in this age group. Hispanics age 50 and over hold 7.5 percent of all first mortgages held by this age group, but represent 15.9 percent of all foreclosures in this age group. Older African Americans and Hispanics have higher foreclosure rates than whites of all ages.
- Older Americans with subprime first mortgage loans are nearly 17 times more likely to be in foreclosure than Americans of the same age with prime loans. They are over 8 times more likely to be delinquent than Americans age 50 and over with prime loans.
- For Americans over the age of 50, a loan-to-value ratio that exceeds 100% is associated with foreclosure rates that are roughly double the national rate for consumers in this age group.
- States where overall foreclosure rates are the highest are the same states where older owners have high foreclosure rates: California, Colorado, Florida, Nevada and Michigan.
- Americans age 50 and over hold about 41 percent of all first mortgages.

This first report explores questions related to how the current mortgage crisis is affecting Americans age 50 and over. Later reports will look more closely at what factors make this group of older Americans vulnerable to delinquency and foreclosure.

DATA SOURCES

Data on the impact of the mortgage crisis on different age groups is not available from the usual housing databases. For example, HMDA and MBA data do not have an age variable. While the American Housing Survey (AHS) does have homeowner age and detailed information on outstanding mortgages, it does not have any information on mortgage delinquency or foreclosure. To find appropriate age information AARP purchased data from Experian, one of the three large credit bureaus.

AARP purchased a 2.5 million person random sample from Experian's much larger database. Of the sample of 2.5 million mortgage holders, about 1 million are age 50 or older. Attributes such as delinquency status are a snapshot taken on the date of December 31, 2007, while foreclosures occurred at any time during the six-month period ending on December 31, 2007. This particular sample does not include historical data, nor does it shed light on what has happened in mortgage markets since December, 2007.

Experian's data examine how different classes of consumers by age, race/ethnicity and credit score are impacted by mortgage delinquencies and foreclosures. These data are different in many ways from widely publicized MBA data which assess the performance of individual loans.

In order to validate AARP's dataset we ran some comparisons with MBA results for end-December, 2007. The Experian foreclosure rates are lower than those reported by the MBA for the end-December timeframe: 0.39% nationwide in the Experian dataset, versus 0.83% reported by the MBA. Differences between the two datasets are to be expected, however. First, the Experian dataset covers consumers compared to the MBA dataset which covers loans. Second, the Experian foreclosure data cover a period that saw rates rise from July to December, 2007, while the MBA dataset covers the later period from September to December, 2007. Other differences may arise from different reporting and collection procedures.

The MBA and Experian state-level data are highly correlated for 30-day and 60-day delinquencies (0.93 and 0.92, respectively), and somewhat lower but still well correlated for foreclosure starts (0.81). In short, the Experian dataset tracks MBA foreclosure rates closely, although at lower levels.

The Experian dataset includes variables on age, VantageScore (credit score), loan-to-value, ethnicity, income, marital status, and other credit and demographic variables. The dataset also includes some information on prime versus subprime loans.

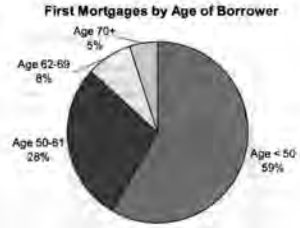
In particular, using reports from HUD and Inside Mortgage Finance we were able to identify lenders specializing in either prime or subprime loans. With this information we were able to link consumers to these prime or subprime specialists, and create subgroups of consumers with either prime and subprime loans. We couldn't, however, distinguish loan type for lenders that offer both types of loans (e.g. Citigroup).

Therefore we do not have a complete universe of subprime loans and cannot answer questions such as "what percent of subprime loans are extended to Americans age 50 and over?" We can, however, look at the differential impact of prime versus subprime loans on borrowers within the identified lending company subgroups.

FINDINGS

Americans age 50 and over hold about 41 percent of all first mortgages. As defined in the database purchased by AARP, first mortgages may include loans on residential, vacation and investment properties, depending somewhat on conventions followed by reporting institutions.

First Mortgages by Age of Borrower



Foreclosure Rates. The foreclosure rate among American first mortgage holders age 50 and over in the sample is 0.24%. This compares to a rate of about 0.50% among Americans under the age of 50, and to a nation-wide average of 0.39%. (See table 1.)

Table 1
Foreclosure Rates, end-2007

Age	Foreclosure Rate
Age < 50	0.50%
Age 50-61	0.26%
Age 62-69	0.21%
Age 70+	0.20%
Total Age 50+	0.24%
Total Age 62+	0.20%
United States Average	0.39%

Foreclosure Totals. About 634,000 Americans age 50 and older are between 30 and 180 days late on a first mortgage. About 50,000 in this age group are in foreclosure or real-estate-owned. In all, about 684,000 Americans are either delinquent on a mortgage, in foreclosure or lost their homes during the period. (These figures have been adjusted for sample share, which is confidential, and by several other technical factors to arrive at total population figures.) Older Americans constituted about 28 percent of all delinquencies and foreclosures, and about one quarter of all foreclosures, during the six-month period ending in December, 2007. (See table 2.)

Race/Ethnicity. The dataset also includes foreclosure rates (although not delinquencies rates) for various demographic groups. African Americans age 50 and over hold 6.8 percent of all first mortgages in this age group but represent 14.4 percent of all foreclosures in this age group. Hispanics age 50 and over hold 7.5 percent of all first mortgages in this age group but represent 15.9 percent of all foreclosures in this age group.

Foreclosure rates are higher for African-American and Hispanic homeowners than for Caucasian homeowners, in all age brackets. Among mortgage holders age 50 and over, African American and Hispanic borrowers both have foreclosure rates of 0.51 percent, compared to a rate of 0.19 percent for Caucasians.

One telling comparison is that the foreclosure rates for older African American and Hispanic age groups are generally higher than the foreclosure rate for Caucasians under the age of 50. Thus while the elderly generally have lower foreclosure rates than younger

Table 2
First Mortgages, July to December, 2007

	Number of Consumers Delinquent (30, 60, 90, 180 days late)	Number of Consumers in Foreclosure	Total Consumers Delinquent or in Foreclosure	Age Group in Foreclosure as Percent of All Foreclosures	Age Group Delinquent or in Foreclosure as Percent of All Delinquencies/ Foreclosures
Age < 50	1,604,719	145,300	1,750,019	74.4%	71.9%
Age 50-61	470,519	36,500	507,019	18.7%	20.8%
Age 62-69	99,275	8,560	107,835	4.4%	4.4%
Age 70+	64,282	4,920	69,202	2.5%	2.8%
Total Age 50+	634,075	49,980	684,055	25.6%	28.1%
Total Age 62+	163,557	13,480	177,037	6.9%	7.3%
Total All Ages	2,238,794	195,280	2,434,074	100.0%	100.0%

Table 3

Foreclosure Rates by Age and Race/Ethnicity (First Mortgages)

Age	Caucasian	African American	Hispanic	Other
<50	0.36%	1.07%	1.11%	0.48%
50-61	0.20%	0.53%	0.57%	0.30%
62-69	0.17%	0.52%	0.38%	0.21%
70 and up	0.15%	0.42%	0.36%	0.30%
50+	0.19%	0.51%	0.51%	0.28%
United States	0.29%	0.80%	0.93%	0.41%

households, rates among elderly minorities are quite high. (See table 3.)

Impact of Subprime Loans. Having a subprime loan is associated with higher delinquency and foreclosure rates for all age groups, but the impact of subprime lending appears to fall disproportionately heavily on older (age 50 and over) Americans. Older holders of subprime first mortgages are 17 times more likely to be in foreclosure than older holders of prime loans. For consumers under age fifty, the comparable multiple is about 13. (See table 4.)

The database allows us to analyze how outcomes differ among consumers who took loans from either prime or subprime specialists. This was done by identifying groups of lenders that specialize in prime and subprime loans. We assume that all loans made by companies that specialize in prime loans are prime loans, and that all loans made by companies that specialize in subprime loans are subprime loans. The database does not, however, allow the separate identification of loans as either prime or subprime. Therefore it is not possible to determine the rates at which older Americans take up either type of loan.

Table 4

Having a Subprime Loan Increases Chances of Delinquency or Foreclosure, Relative to Prime Loans, by a Multiple of...

Age	30 Days Delinquent	60 Days Delinquent	90-180 Days Delinquent	Foreclosure
<50	5.3	6.9	9.4	12.6
50-61	7.5	9.7	12.0	16.2
62-69	9.3	11.5	17.0	15.0
70 and up	9.0	9.2	15.2	21.5
50 and up	8.0	10.3	13.3	16.8
U.S. Average	6.3	8.2	11.0	14.4

Impact of Loan-to-Value Ratio. House prices have fallen dramatically in a number of American housing markets over the past year. For some borrowers this increases the incentive to default, while for others this closes off the ability exit from high mortgage burdens by refinancing or selling the house. For older Americans in particular, it may be that living on a fixed income makes it impossible to sustain high debt levels, while at the same time falling house prices makes it impossible to get out from under the mortgage.

Having a mortgage loan amount greater than the value of one's house (a loan-to-value ratio greater than 100%) is associated with increased foreclosure rates for all age groups, but the impact is larger for older Americans. For Americans over the age of 50, a loan-to-value ratio that exceeds 100% is associated with a foreclosure rate that is roughly double the national rate. (See table 5.)

Table 5

Having a Loan-to-Value Ratio Greater than 100% Increases the Chances of Delinquency or Foreclosure by a Higher Multiple for Older Americans

Age	Foreclosure Rate Among Consumers with LTV > 100%	Foreclosure Rate Among All Consumers	Multiple
<50	0.85%	0.50%	1.7
50-61	0.54%	0.26%	2.1
62-69	0.33%	0.21%	1.6
70 and up	0.45%	0.20%	2.3
50 and up	0.49%	0.24%	2.0
US Average	0.72%	0.39%	1.8

CONCLUSION

Over 684,000 Americans age 50 and over were either delinquent or in foreclosure at the end of 2007. While foreclosure rates on first mortgages are lower for borrowers over 50 than for borrowers under 50, Americans age 50 and over represent about 28 percent of all delinquencies (30 to 180 days late) and foreclosures in the current crisis. Among mortgage holders age 50 and over, African American and Hispanic borrowers both have foreclosure rates of 0.51 percent, compared to a rate of 0.19 percent for Caucasians. Older Americans appear particularly vulnerable to house price declines and to subprime loans.

The impact of a foreclosure is often more significant for older households as they have less time and ability to recover the financial losses associated with a foreclosure. The problem is likely growing, as homeowners increasingly carry mortgage debt into their retirement years. By 2007, 53 percent of all owners with a head of household age 50 or older had a mortgage, up from 34 percent just two decades ago.[1]

In this analysis we have offered some highlights from the new dataset. The Experian dataset offers several opportunities for future research. In particular, it is possible within the dataset to examine home equity and home equity line of credit loans separately. Additional variables, such as VantageScores (credit scores) and income, may help to explain why some older Americans are in foreclosure and others are not. In addition, the dataset breaks out states and certain metropolitan statistical areas (MSAs), although some areas may have small observation counts. We welcome comments and suggestions on this research as it proceeds.

Insight on the Issues 9, September, 2008

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[1] William Apgar, Joint Center for Housing Studies, Harvard University, presentation at AARP forum, September 19, 2008.

Mr. CERTNER. The report produced a number of important findings. Americans age 50 and over hold about 41 percent of all first mortgages, and nearly 700,000 homeowners age 50 and over were either delinquent or in foreclosure at the end of 2007, representing 28 percent of delinquencies and foreclosures.

African American and Hispanic homeowners over age 50 experienced even higher rates of foreclosure. Older African American homeowners held 6.8 percent of all first mortgages, but represented 14.4 percent of all foreclosures, while Hispanic homeowners age 50 and over held 7.5 percent of first mortgages but represented 15.9 percent of all foreclosures.

Also, having a subprime loan was found to be associated with higher foreclosure rates for all age groups, but the impact was greatest for older homeowners. Homeowners age 50 and over with subprime mortgages were nearly 17 times more likely to be in foreclosure than those with prime loans.

And homeowners age 50 and over with loan-to-value ratios of 100 percent or greater experienced foreclosure rates nearly double the national foreclosure rates for all older homeowners.

This last finding is significant when you consider that some additional 2.3 million households age 50 and older have less than 20 percent equity in their homes.

Home prices have been falling dramatically the last 2 years, meaning that even higher percentages of older homeowners face foreclosure and the loss of retirement security in coming years.

To date, it has been noted the only systemic efforts that have been made to help individual borrowers avoid foreclosure have involved voluntary efforts by lenders and servicers, and the available data suggests that these voluntary efforts have been inadequate both in the number of mortgages modified and the level of relief provided to homeowners.

These actions often do little to actually improve the borrower's financial condition and have resulted in loan modifications in which relief for homeowners has been either temporary or unsustainable.

A number of obstacles have tended to limit the willingness of loan lenders and servicers to engage voluntarily in loan modifications. Most mortgages are combined in mortgage securities, making it difficult to obtain investors' consent.

Loan servicers fear investor lawsuits. Holders of second liens can refuse consent. And servicers have little incentive to engage in modifications, as was noted, since service contracts typically pay forforeclosures, but not the more labor-intensive loan modifications.

These obstacles help explain why the spreading foreclosure crisis cannot be resolved through voluntary efforts. A mechanism is needed to enable courts to implement economically rational loan modifications where mortgage lenders or servicers are unwilling to do so.

Court-supervised loan modification through the bankruptcy court offers quick and effective relief for millions of homeowners without the added cost to taxpayers.

AARP supports, and we urge Congress to enact, a broad bankruptcy reform provision as part of the economic recovery legislation.

Currently, judicial modification of loans in bankruptcy is available, as noted, for owners of commercial properties, investment properties, vacation homes, yachts, family farms and other securitized property.

It is denied to struggling homeowners to protect the home they live in. Eliminating this exemption to the bankruptcy code would create a number of immediate and important benefits. First, it would allow bankruptcy judges to cut through the various obstacles that have doomed the voluntary loan modifications.

It would provide a process for loan modification that recognizes all debts a household is facing and provide sensible and affordable loan workouts.

And it provides a process in which the legitimate interests of lenders, servicers and investors are recognized and where all parties can realize greater returns.

And finally, it would create an incentive for servicers and lenders to engage voluntarily in loan modifications rather than have the bankruptcy judges do it for them.

Mr. Chairman, AARP strongly believes that judicial modification of primary mortgages must be part of any solution to the foreclosure crisis. Continued reliance on voluntary approaches to loan modification will not adequately address the problem.

Chapter 13 bankruptcy offers an existing structure and an impartial process that can help hundreds of thousands of families save their homes.

And as a matter of basic fairness, it is time that Congress provided average homeowners with the same rights and opportunities to protect their primary assets in bankruptcy that corporations, investors, farmers and others have relied on for many years.

Thank you.

[The prepared statement of Mr. Certner follows:]

PREPARED STATEMENT OF DAVID M. CERTNER

AARP

TESTIMONY OF

DAVID M. CERTNER

LEGAL COUNSEL AND LEGISLATIVE POLICY DIRECTOR

AARP

BEFORE THE

HOUSE COMMITTEE ON THE JUDICIARY

ON

H.R. 200—"HELPING FAMILIES SAVE THEIR HOMES IN BANKRUPTCY ACT of 2009" and H.R. 225—"EMERGENCY HOMEOWNERSHIP AND EQUITY PROTECTION ACT"

January 22, 2009

RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, D.C.

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Chairman Conyers, Ranking Member Smith, and Members of the Judiciary Committee, I appreciate the opportunity to appear before the Committee this afternoon on behalf of AARP. I am David Certner, Legislative Counsel and Legislative Policy Director for AARP. With 40 million members, AARP is the nation's largest organization representing the interests of Americans age 50 and older and their families.

As Congress begins work this week on broad economic recovery legislation to revive our nation's economy, it is important to remember that the underlying cause of our nation's economic crisis is the huge number of mortgage loans currently delinquent or in foreclosure. The impact of record numbers of foreclosures is felt not only by individual families, but by neighborhoods, entire communities and the economy as a whole. We cannot address the broader economic crisis without first resolving the current foreclosure crisis. Families need help to stay in their homes, and communities need to be stabilized, before the economy can start growing again.

Home foreclosures today are at an all-time high and are projected to go even higher. Various estimates place the number of homes already lost to foreclosure at between 1.2 and 1.5 million. Another two million households with subprime mortgages are currently delinquent and in danger of losing their homes in the near future. A December 2008 Credit Suisse report estimated that foreclosures for all types of mortgages could exceed 8 million by the end of 2012—the equivalent of 1 foreclosure for every 6 U.S. households with mortgages.

The Foreclosure Crisis and Older Americans

The prospect of widespread foreclosures is particular serious for older Americans who depend on their homes not only for shelter, but as their primary asset for retirement. For Americans age 50 and over, losing a house represents a significant financial loss from which there is limited time to recover, and for many recovery may be impossible given their age and limited income.

There is ample evidence to suggest that the foreclosure crisis has included many older homeowners among its victims. Older homeowners, many of whom live on limited incomes while having significant equity in their homes, have been targeted by unscrupulous lenders and brokers since the early stages of the subprime boom with offers of questionable home repair loans, second mortgages and home refinancing. We also know that far greater numbers of older persons are carrying substantial mortgage debt into retirement. According to Harvard's Joint Center for Housing Studies, 53 percent of homeowners age 50 and older are entering retirement with mortgage debt, nearly double the number of just two decades ago.

Until recently, however, no data has existed to document how many older homeowners may be affected. Traditional sources of housing and mortgage information, including Home Mortgage Disclosure Act and Mortgage Bankers Association data, have not included an age variable. To quantify and understand the impact of the mortgage crisis on older Americans, AARP purchased data from Experian, one the three major U.S. credit bureaus. Experian's database contains information on 49.9 million consumers with first mortgages on residential, vacation and investment properties, representing about 80 percent of all first–lien residential mortgages outstanding. This data includes variables on age, credit score, income, loan-to-value, ethnicity, marital statutes and other credit and demographic variables, as well as information on prime and subprime loans.

AARP's Public Policy Institute analyzed a 2.5 million person random sample of Experian's larger database that included information on nearly 1 million homeowners over age 50. The data covered a six-month period ending December 31, 2007, a period in which interest rates were still rising and home values were only beginning to decline. The resulting report, "Older American and the Foreclosure Crisis," includes a number of important findings:

- Americans age 50 and over hold about 41 percent of all first mortgages.
- More than 684,000 homeowners age 50 and over were either delinquent or in foreclosure at the end of 2007, representing 28 percent of delinquencies and foreclosures.
- African-American and Hispanic homeowners over age 50 experienced higher rates of foreclosure than Caucasian homeowners in all age groups, and roughly double their rate of homeownership:
  - Older African-American homeowners held 6.8 percent of all first mortgages, but represented 14.4 percent of all foreclosures;
  - Hispanic homeowners age 50 and older held 7.5 percent of first mortgages, but represented 15.9 percent of all foreclosures.
- Having a subprime loan was found to be associated with higher foreclosure rates for all age groups, but the impact of subprime lending was disproportionately greater for older homeowners:
  - Homeowners age 50 and older with subprime first mortgage loans are nearly 17 times more likely to be in foreclosure than homeowners of the same age with prime loans; homeowners under age 50 were 13 times more likely to be in foreclosure with subprime loans;
  - Older homeowners with subprime loans are 13 times more likely to be seriously delinquent in their mortgage payments than comparable homeowners with prime loans; for homeowners under age 50, a multiple of 9 times are seriously delinquent.
- Homeowners age 50 and older with loan-to-value ratios of 100% or greater experienced foreclosure rates nearly double the national foreclosure rate for all older homeowners.

This last finding is significant when you consider data from the American Housing Survey for 2006 showing some 2.3 million households with a head of household age 50 or older having less than 20 percent equity in their homes. Since 2006, home prices have fallen 20 percent nationwide and are projected to decline by at least another 10 percent during 2009. This means that even higher percentages of older homeowners will be included among the millions of homeowners facing foreclosure and loss of retirement security in coming years.

Current Mortgage Modification Efforts are Iuadequate

Congress has taken two important actions to help address the foreclosure crisis. In August it enacted the HOPE for Homeowners program, as part of the Housing and Economic Recovery Act, to allow homeowners with subprime mortgages facing higher scheduled payments to refinance with lower-rate, FHA-insured fixed rate mortgages. In the Emergency Economic Stabilization Act in October, Congress authorized a Troubled Asset Relief Program (TARP) to help restore confidence and stability in our housing market and expand access to credit. It also directed the Treasury Secretary to "implement a plan" to encourage modification of loans acquired by Treasury and other financial regulators to provide long-term affordability for distressed homeowners.

To date, the Treasury Department has largely ignored Congress' directive to facilitate mortgage modifications and has sought to implement a TARP program that focuses primarily on recapitalizing financial institutions and restoring investor confidence. Whatever systematic efforts have been made to help individual borrowers avoid foreclosure have been largely voluntary by lenders and servicers both under the framework of the HOPE for Homeowners program and financial industry initiatives such as the HOPE NOW Alliance.

Available data suggests that these voluntary efforts have been inadequate, both in the numbers of mortgages modified and the level of relief provided to homeowners. HUD reports that fewer than 1,000 lenders or servicers have filed applications with the FHA on behalf of borrowers seeking relief under the HOPE for Homeowners program. The requirement that lenders reduce loan principal to 90% of the home's current appraised value represents a significant up-front loss that few lenders appear willing to assume voluntarily. Industry efforts at voluntary loan modification have not fared much better. Credit Suisse reported in October that only 2.5 percent of delinquent subprime mortgages received modification during the prior month. The Working Group of Attorneys General and Banking Commissions reported similar data showing that nearly eight out of ten seriously delinquent homeowners were not on track to receive any form of loan modification.

Most of the voluntary modifications that have occurred involve changes in interest rates for adjustable rate loans that include freezing rates at current levels, or not fully resetting rates to the full indexed rate. Most HOPE NOW loans also include repayment plans that typically require homeowners to add previously unpaid debt to their current loan payments. These modifications do little to actually improve the borrower's financial condition. Professor Alan White of the Valparaiso School of Law analyzed a large sample of HOPE NOW loan modifications and found that nearly half (45 percent) the modifications actually increased the homeowner's monthly payments, while another 20 percent left the payments virtually unchanged. The result has been loan modifications in which relief for the homeowner has been temporary or unsustainable. Research conducted by the Office of the Comptroller of the Currency (OCC) found that 58 percent of borrowers who received loan modifications in the first quarter of 2008 had subsequently missed at least one monthly payment, while 51 percent of borrowers receiving loan modifications during the second quarter had already missed payments by December 2008. These findings closely track data reported by Credit Suisse showing that 33% of the loans modified during the third quarter of 2007 were seriously delinquent ten months after modification.

Barriers to Meaningful Mortgage Modification

The high default rates found by the OCC and Credit Suisse confirm that the majority of voluntary mortgage modifications have not included the type of significant reductions in interest rates or loan principal needed to make loans affordable for borrowers. An October 2008 report by Credit Suisse found that modifications involving rate reductions and reduced principal had redefault rates of less than half that of traditional modifications involving only repayment plans, extended loans terms or rate freezes. With a 23 percent redefault rate, Credit Suisse concluded that the post-modification performance of reduced principal loans "is materially better than that of other more traditional modifications," particularly in light of the fact that 80 percent of these loans had been delinquent prior to modification. As the number of borrowers having negative equity continues to increase, Credit Suisse observed "a growing need" for reduced principal modifications that "not only reduce the monthly payment, but also reduce borrower's negative equity, thereby increasing their willingness to stay in the home."

A number of obstacles have tended to limit the willingness of lenders and servicers to engage voluntarily in loan modifications involving meaningful reductions in mortgage principal and/or loan interest rates. The fact that most mortgages are combined in mortgage securities that are sold to many investors makes it more difficult to obtain the consent of all owners to make significant modifications. Loan servicers are hesitant to modify mortgages in ways that may cause disproportionate losses for certain classes of investors for fear of investor lawsuits. Mortgages with second liens also present obstacles to loan modification, either because the subordinate loan is already in default, or holders of the second lien refuse to absorb losses to benefit first lien holders. In addition, the compensation system for loan servicers, which provides payment for foreclosures but not loss mitigation, creates a built-in bias against engaging in more labor-intensive loan modifications.

These obstacles help explain why the spreading foreclosure crisis cannot be resolved through voluntary efforts by the financial services industry. A mechanism is needed to enable courts to implement economically rational loan modifications where mortgage lenders or servicers are unwilling or unable to do so. Court-supervised loan modification through the bankruptcy courts offers quick and effective relief for millions of homeowners at risk of losing their homes. And it can accomplish this without significant added cost to taxpayers.

Why AARP Supports H.R. 200 and H.R. 225

AARP supports H.R. 200, the "Helping Families Save Their Homes in Bankruptcy Act of 2009," and H.R. 225, the "Emergency Homeownership and Equity Protection Act," and urges Congress to enact the broadest possible bankruptcy reform provision as part of the economic recovery legislation. Both proposals seek to remove the current prohibition in Sec. 1322 of the Bankruptcy Code against modification of primary residential mortgages in Chapter 13 proceedings.

Currently, judicial modification of loans in bankruptcy is available for owners of commercial properties, investment properties, vacation homes, yachts, family farms and other securitized property, yet it is denied to struggling homeowners to protect the home they live in. Eliminating this exception to the Bankruptcy Code would create a number of immediate and important benefits:

- It would allow bankruptcy judges to cut through the various obstacles that have doomed loan modifications from being successful, even by the most proactive mortgage services;
- It would provide a process for loan modification that recognizes all debts a household is facing and provide sensible loan workouts that will be affordable and sustainable;
- It provides a process in which the legitimate interests of lenders, servicers and investors are recognized and where all parties can realize greater returns than in foreclosure;
- It would stimulate greater numbers of voluntary mortgage modifications, creating an incentive for lenders and servicers to work with borrowers rather than have bankruptcy judges do it for them.

A clear precedent exists for providing this relief to homeowners. Congress enacted a similar measure in response to the farm crisis of the 1980s when an economic downturn and depressed land values were pushing thousands of family farmers into foreclosure. The Family Farmer Bankruptcy Act of 1986 removed a similar restriction in Chapter 12 of the Bankruptcy Code that prevented bankruptcy judges from modifying mortgages on family farms that included their primary residences. This change proved so effective in helping farmers through the crisis that it was made a permanent part of the Bankruptcy Code in 2005.

Claims by the financial services industry that allowing judicial modification of residential loans will adversely affect the cost or availability of mortgage credit can be easily countered not only by the courts' experience in modifying loans on family farms under Chapter 12, where no adverse cost impact occurred, but also in the bankruptcy courts' prior experience in modifying loans on primary residences under Chapter 13. Between 1978 and 1993, numerous bankruptcy courts modified mortgages on primary residences by placing the portion above the market value of the house on par with other unsecured debts. The financial services industry has produced no evidence to show there was any adverse effect on the cost or availability of credit for mortgages on primary residences, either as compared to other court jurisdictions that did not allow such modifications during this period or as compared with mortgage lending in the same jurisdictions after 1993.

In addition, H.R. 220 and H.R. 225 provide a number of limitations on loan modifications to ensure adequate protection of the interests of lenders, investors and servicers. Bankruptcy relief is available only to homeowners who would otherwise lose their home in foreclosure and who have sufficient means to sustain a market rate mortgage. H.R. 225 also limits loan modification only to mortgages made before the bill is enacted. Both bills place limits on key terms of loan modifications—requiring that interest rates be set at commercially reasonable, market rates, that loan terms not exceed 40 years, and that principal balances not be reduced below the value of the property. Finally, a bankruptcy judge must be satisfied that a homeowner is acting in good faith in seeking mortgage relief.

Conclusion

Mr. Chairman, AARP strongly believes that judicial modification of primary mortgages must be part of any solution to the foreclosure crisis. Continued reliance on voluntary approaches to loan modification will not adequately address the problem, even if incentives can be provided through TARP or other programs. Chapter 13 bankruptcy offers an existing structure, and an impartial and trusted process, that can help hundreds of thousands of families save their homes. As a matter of basic fairness, it is time Congress provided average homeowners with the same rights and opportunities to protect their primary assets in bankruptcy that corporations, investors, farmers and others have relied on for many years.

Mr. CONYERS. Thank you very much, Mr. Certner.

I am now pleased, of course, to recognize Mr. Mason, Matt Mason, from UAW-General Motors Legal Services, located in Detroit, Michigan.

We welcome you for your testimony, Mr. Mason.

TESTIMONY OF MATTHEW J. MASON, ASSISTANT DIRECTOR, UAW-GM LEGAL SERVICES PLAN, DETROIT, MI

Mr. MASON. Thank you, Mr. Conyers. Now the mike is on.

My name is Matthew Mason, and I am an assistant director with the UAW-General Motors——

Ms. LOFGREN. Would the gentleman pull his microphone a little bit closer so we can hear?

Mr. MASON [continuing]. Located in Detroit, Michigan.

I wish to thank the Chairman, Mr. Conyers, and the Ranking Member, Mr. Smith, and all the Members of this Committee for allowing me to testify today on behalf of the UAW-GM Legal Services Plan concerning the two bills pending before this Committee, H.R. 200 and 225.

I believe these bills deserve your support. It is critical. The bills both allow bankruptcy judges the power to modify mortgages on personal residences in Chapter 13.

From our perspective in the field, this power is necessary to break the tide of unabated mortgage foreclosures and to end the barriers to meaningful, voluntary modifications both inside and, I must say, outside of bankruptcy.

The voluntary loan programs—we have heard comments. They are just not working. From our experience in Detroit and around the country—and I have also surveyed the 3,300 members of the National Association of Consumer Bankruptcy Attorneys—it is very clear to us that the programs in existence now not only aren't working but, in fact, are working less well than they had previously.

In early 2008, to me, loan modifications seemed promising. I met with Mr. Conyers at a symposium in Detroit on a cold winter day, he may remember, and we had some hopes that actually the modification programs that were constantly being rolled out would actually have some effect.

Pressure had been mounting on the mortgage companies to rewrite the loans voluntarily, not only to reflect the economic reality but also to keep from adding to the volume of foreclosed homes on the market.

And our attorneys did have some limited success in obtaining some modifications in early 2008. Perhaps an adjustable-rate mortgage was converted to a low-rate 30-year fixed mortgage. Arrears were either waived or added to the end of the mortgage. And a modest reduction was accomplished in the principal balance.

But true, the vast majority of the modifications were no modifications whatsoever. Those were clearly the exceptions, but they were somewhat encouraging.

A typical modification was nothing more than a forbearance program. You would double up on your payments. Maybe you would add a few to the end of the loan. But there would be no substantive change to the mortgage terms. If there ever was an interest rate offered, it was small, and it was for a very short period of time.

But by the summer of 2008, even our limited success ground to a halt. And this fall, in meetings I have had even similar experiences reported to me—the modifications we were able to obtain even before don't really exist now.

And just this week, I re-surveyed our staff and the bankruptcy attorneys around the country to see if things had improved. Not to much surprise, they had either stayed the same or gotten worse.

Attorneys reported that fewer modifications were approved inside or outside of bankruptcy, the time to complete modifications had increased, more lenders demanded bankruptcy petitions be dismissed before considering modification and then no guarantee of the modification after the dismissal. And the size of the interest rate reductions not only decreased, but the length of time that they are allowing to decrease the interest rate decreased as well. When working families see layoffs, cuts in hours, cuts in benefits, wholesale closings of factories for weeks at a time, a small reduction in interest rate is simply not enough.

And finally, there was no consistent pattern to the modifications that we saw. There is no way to tell why one borrower qualified for a modification and another did not.

Now locally, in Detroit, turning to 2009, one might have thought that all the foreclosures that could have happened had, but in fact that is not true at all. There is still over 12,000 foreclosed homes for sale in Wayne County and the vast majority in the city of Detroit. Foreclosures are increasing nationally, as we have heard, and in fact they have doubled from 2007 to 2008.

Locally, for the week of January 12 through 16, this is just last week, there is an average in Wayne County of 126 homes each day being foreclosed upon.

If lenders cannot voluntarily address this crisis, then borrowers should be given the opportunity to reorganize. Just like any other obligation in bankruptcy. The goal is not to encourage bankruptcy filings, that is clear, or to reward the undeserving. And in fact, by filing bankruptcy, people do just the opposite. They have the opportunity now to walk away from their homes, but undertaking a modification in bankruptcy, they elect to stay in their homes.

They submit to the court their payments for 3 to 5 years, whatever money is left over gets paid to unsecured creditors, including mortgage companies, and it is in a process that is verifiable, a process that is quick, designed to work and it is effective.

From our perspective, Mr. Conyers, we believe that it deserves a chance and deserves a chance that we think will be successful. Thank you.

[The prepared statement of Mr. Mason follows:]

PREPARED STATEMENT OF TESTIMONY OF MATTHEW J. MASON

My name is Matthew J. Mason and I am an Assistant Director of the UAW-GM Legal Services Plan located in Detroit, Michigan.

I wish to thank the Chairman, Mr. Conyers, the ranking member, Mr. Smith and all of the members of the Committee for allowing me to testify today on behalf of the UAW-GM Legal Services Plan concerning the two bills pending before this committee, H.R. 200, "Helping Families Save Their Homes in Bankruptcy Act of 2009" and H.R. 225, "Emergency Homeownership and Equity Protection Act." These bills address what is one of the most pressing issues of my legal career, the unrelenting pace of mortgage foreclosures and the failure of any voluntary system of modifications to arrest this crisis which is now in its third year nationally and what seems like forever in Michigan. This statement reflects my views on this current crisis and does not and is not intended in any way to reflect the views of the General Motors Corporation or any of its subsidiaries or the International Union, UAW.

I have been a practicing attorney and administrator for almost 35 years. I have been active in the practice of bankruptcy law for over 30 years and previously testified before this Committee in 1998 on what became the far reaching amendments to the bankruptcy code that took effect in 2005.

The UAW-GM Legal Services Plan and its sister Plans, provide legal services to over 700,000 eligible UAW members on a wide variety of subjects. We have 65 offices in 20 states that handle all types of non fee generating civil matters. In the housing area, we handle buys and sells, loan modifications, work out agreements, deeds in lieu of foreclosure as well as provide foreclosure defense for active workers and retirees alike. We also provide legal services for bankruptcy, but only as a last resort.

I also currently serve as a member of the Board of Directors of the National Association of Consumer Bankruptcy Attorneys (NACBA), an organization of over 3300 consumer bankruptcy attorneys located in all fifty states and Puerto Rico.

I believe that these bills deserve your support, if for no other reason, than the simple fact that both bills allow bankruptcy judges the power in Chapter 13 to modify mortgages on personal residences. This power is necessary to break the unabated flood of mortgage foreclosures and end the barriers to meaningful, voluntary modifications outside of bankruptcy.

I. THE VOLUNTARY LOAN MODIFICATION PROGRAMS ARE NOT WORKING

In preparation for NACBA's 16th Annual Conference in May 2008 I surveyed both our legal plan attorneys and the members of NACBA to determine what was actually happening inside and outside of bankruptcy concerning loan modifications.

In early 2008 pressure had been mounting on mortgage companies to rewrite the loans not only to reflect economic reality but also to keep from adding to the volumes of foreclosed homes already on the market.

By May of 2008 our legal plan attorneys reported that in most cases lenders were offering forbearance agreements, with no changes in term, interest rate, principal reductions or changing the term of the loan. The terms of the forbearance agreements also varied greatly, from adding a few payments to the end of the loan to allowing an arrears to be paid over a period of time, perhaps as much as a year.

They also reported some very modest success in obtaining a meaningful modification, typically where a variable rate mortgage was converted to a 30 year fixed, arrears either waived or added to the end of the terms and a modest reduction in the principal balance.

However counterbalancing those cases were modification proposals that were unreasonable, such as one where the lender wanted upfront money before they would even process a loan modification. ($6000 in 5 days.)

I also surveyed the NACBA membership who reported similar results, though not even as encouraging. Specifically, they reported in early 2008 that:

1. About 60% of the attorneys assisted with loan modification for clients, whether in or outside of bankruptcy.
2. The vast majority of responders (68%) said that they obtained modifications in less than 10% of the cases.
3. When they referred clients to mortgage counselors, virtually all of the clients came back. Again the vast majority responded (78%) that less than 10% of those clients received a modification through a mortgage counselor.
4. Modifications on average took more than 4 weeks, and many of them took in excess of six weeks.
5. In about 30% of the cases where a modification was available, the lender required that the bankruptcy be dismissed.
6. In cases where the lender required dismissal of the bankruptcy, it caused almost 75% of those clients to reject the modification.
7. Many modifications involved interest rate reductions, 75% of which were reduced by 4% or less.
8. Interest rates for ARM's were typically frozen for the life of the loan.
9. In the few cases where principal was reduced, in 85% of the cases the reduction was for $30,000 or less.

By the summer of 2008 even those limited successes seemed to evaporate. Our legal plan attorneys reported that meaningful modifications seemed to grind to a halt. The initial problem with not being able to reach lenders continued. By the end of 2008 our bankruptcy filing rate increased and our percentage of Chapter 13 cases where we could save the home decreased.

In the last few days I re-surveyed the NACBA membership and my staff to see what experience they were having with loan modifications in late 2008 and early 2009.

The results are unchanged if not worse. My staff reported that effective modifications, typically involving a long term rate reduction and decrease in principal were nonexistent. In a few instances they were able to accomplish those modifications but only after initiating some kind of litigation proceeding, such as an objection to a claim, a forced modification in bankruptcy or an adversary proceeding alleging some kind of fraud in the transaction.

The survey of NACBA attorneys produced a similar picture of fewer modifications being offered with poorer terms. For modifications obtained from October 1, 2008 to the present, they reported:

1. Less than ten percent (10%) of their clients who need a modification obtained one.
2. Even after the clients were referred to loan counselors, still less than ten percent (10%) received loan modifications.
3. The approval rates for modification have actually decreased from early 2008. 64.7% of the respondents reported that approval rates for modification dropped since October 1, 2008.
4. The time to complete a modification has increased. 56.7% of the respondents reported that it took in excess of six weeks to get a modification approved as compared to 38. 6 % who responded to the same question in April, 2008.
5. A higher percentage of lenders are now requiring borrowers to dismiss their bankruptcy petitions before giving a modification. (42.2% in 2009 and 28.4% in 2008) In both cases, the overwhelming majority still reported that the requirement to dismiss the bankruptcy resulted in the client rejecting the modification and surrendering the home. (88.9% in 2009 and 73.9% in 2008).
6. Most modifications still involved interest rate reductions, but even there, the size of the rate reduction decreased. Relatively few borrowers received a decrease in excess of 2% and almost no borrowers received a rate decrease of 4% or more.
7. The length of time interest rates were frozen decreased. Now more attorneys reported that the rate was frozen for three years or less, not the life of the loan. In 2008 the overwhelming majority (87%) reported that the rate was frozen for the term of the loan. In 2009 that decreased to 42%.
8. The respondents still reported very few reductions in the principal balance of loans and then only in relatively small amounts, under $30,000.

In a couple of instances the lenders were taking an even harder line. In one case a large lender in the FDIC program offered to reduce the borrower's payments for a few years, provided he prove monthly income of at least double what he actually has (and which he had on the date of loan origination) while proposing to increase his mortgage balance by more than $84,000.

II. NEW MORTGAGE FORECLOSURES CONTINUE TO BE A SERIOUS PROBLEM IN 2009.

In his recent article, Rewriting Contracts, Wholesale Data on Voluntary Mortgage Modifications from 2007 and 2008 Remittance Reports, (Working Draft), Alan M. White, Assistant Professor Valpariso School of Law, Professor White undertook an empirical review of loan modification data taken from subprime lender reports to its investors. In the article he concluded that the foreclosure crisis continued unabated thorough June, 2008.

Professor White found that the number of mortgage defaults and foreclosures increased steadily in the 2007–2008 time frame. In July 2007 the average delinquency rate in the mortgagte pools he studied was 19%. In addition 1.4% of all loans entered into foreclosure that month. That translated into a 16.8% annual rate of new foreclosures as a percentage of that portfolio.

By June 2008 he found that the delinquency rate had nearly doubled to 34% and new foreclosures were occuring at an annual rate of 27%.

In an article from January 15, 2009 the Associated Press just reported that mortgage foreclosure rates doubled in 2008 compared to 2007

"WASHINGTON—More than 2.3 million American homeowners faced foreclosure proceedings last year, an 81 percent increase from 2007, with the worst yet to come as consumers grapple with layoffs, shrinking investment portfolios and falling home prices.

Nationwide, more than 860,000 properties were actually repossessed by lenders, more than double the 2007 level, according to RealtyTrac, a foreclosure listing firm based in Irvine, Calif., which compiled the figures."

Our experience locally supports those findings. For example, for the first six months of 2007 there had been 28,075 foreclosures in Detroit and Wayne County Michigan, a 26% increase over the last six months of 2006, and over 90% of them in the City of Detroit. There were over 14,000 properties listed for sale on foreclosure.com just in Wayne County Michigan.

Now in January, 2009 Wayne County still has almost 12,000 homes listed on for sale on a single website, foreclosure.com. Nationally over 2.2 million homes are listed for sale on this same site as homes in some stage of foreclosure.

In reviewing our local Detroit Legal News we found that on January 20, 2009 there were 551 homes slated for foreclosure sale, all of them in Wayne County. On a daily basis now homes were added to the list at an alarming rate.

In just six days, from January 12, 2009 through January 19, 2009 there were, on average, 126 homes each day listed for foreclosure sale for the first time

Professor White also sees no bottoming out of the foreclosure crisis at least as of June, 2008. As credit for refinancing dried up and borrowers have become less credit worthy because of job losses, cuts in wages and hours, the mortgage foreclosure rates increased into June 2008.

III. THE MODIFICATIONS OFFERED DO NOT SOLVE THE PROBLEM

Professor White also noted that the modifications currently being offered do not solve the fundamental problem, that is lower the payment to an affordable rate as well as reduce the principal balance to reflect the market value of the home.

Most of the modifications involved recasting arrears, which is adding delinquent payments to the balance of the loan or a modest, temporary reduction in the interest rate. Very few loans had principal balances reduced. Furthermore in 23% of the reported modifications, the monthly payment even increased. Page 20–21.

Professor White concluded that, at best, the current modification programs were only putting off the day of reckoning. He stated at page 27:

"More importantly, homeowners have not been relieved of the devalued debt, either through completed foreclosures sales or loan concessions. Many are still stuck in a "sweat box" struggling to pay above-market interest rates on above-market loans."

Therefore it would not be surprising to see even those borrowers who are listed as having "modified" their loan, default in the future, placing that home in the new foreclosure start category.

Finally Professor White noted in his research that there was no consistency among servicers in their approach to loan modifications. Our experience bears that out as well.

For example, in Saginaw, Michigan a foreclosure case was commenced for a client who was behind on their mortgage. We were told by the foreclosing attorneys that we had to deal with the servicer directly. We called the mortgage company and asked for loss mitigation. They said they would send a loan modification application but that it would take 30 days or more to process. We asked for an adjournment of the mortgage sale to allow time to process the modification. Three (3) times we called the person with the authority to adjourn and each time we got the voice mail message that the voice mail box was full. We faxed a request for an adjournment but received no response. We filed the loan modification application but have not received a response. In the meantime the loan is proceeding through the foreclosure process.

In Dearborn, Michigan we applied for a modification to stop another sale. We were able to reach that company but they only offered to suspend payments for three (3) months and then add those three months to the existing arrears. The effect would have just been to increase the total amount due. There was no offer to reduce the interest rate, principal or amount of monthly payments.

Even when we try loss mitigation such as deeding the property back to the lender we have run into great difficulties. In one case out of Indiana we initially asked for a loan modification which was denied. We then offered to provide the lender with a deed in lieu of foreclosure. Now eighteen months later the mortgage company has yet to complete the documents to accept the deed in lieu of foreclosure, even though no payments are being made.

Talking with local loan counselors confirmed my view that some large lending institutions are actually getting worse in their modification practice. They have hired outside firms to do loss mitigation and are adding the fees of those firms onto the modification. They only offer interest rate reductions and then not much. They will still not talk to borrowers who are not yet in default. Even if they are in default, the response from the lender typically comes within days of the foreclosure sale, if at all.

IV. MODIFYING MORTGAGE LOANS ON PERSONAL RESIDENCES IN BANKRUPTCY IS THE ONLY PROPOSAL THAT GIVES HOMEOWNERS RIGHTS THEY CAN ENFORCE.

Currently the various proposals for loan modifications all start with an application to the lender. The lender determines who gets the modification, what kind it is and for how long it will last. It has been our experience that the modification terms vary wildly between clients, for no apparent reason. The modification terms also do not take into account, in most instances, the value of the property and what the borrower can really afford.

As a consequence borrowers are often encouraged to abandon their homes, especially when they can rent or perhaps even buy a new home in the same neighborhood for a fraction of the cost of their existing home. However that process is slow and has enormous costs. There are costs to foreclose, costs to move and costs to maintain abandoned properties that will never be recovered. In addition neighborhoods continue to deteriorate and house values continue to fall.

Allowing a borrower to propose their own modification in bankruptcy puts a plan on the table that actually assigns a value to the collateral, and then proposes to pay the loan based on current market interest rates. The plan has to be feasible and is tailored to the borrower's income and expenses. That information is subject to verification through the six months of pay stubs that are required to be filed in every bankruptcy. Tax returns must also be filed. If there is a dispute as to the value of the house, appraisals will be typically exchanged, with the judge having the final decision.

Lenders still have the possibility of recovering some of their losses. The existing loan is split into two parts, secured and unsecured. The creditor always maintains a claim for the unsecured balance of the loan. Payments are mandated on the unsecured balance if the debtor's income or assets warrant it. Furthermore borrowers and lenders could agree to a claw back provision that could return equity to the lender if the home appreciated.

V. BANKRUPTCY PROVIDES A UNIFORM SOLUTION TO THE FORECLOSURE CRISIS AND CUTS THROUGH ALL THE PROBLEMS OF LENDER COOPERATION

Bankruptcy also provides a uniform solution to the foreclosure crisis. Your loan is not evaluated from the lender's perspective that might include the fear of being sued by their investors. Instead it is open to any borrower who has income and can qualify. They propose a plan, it is confirmed or not and the case moves on. Currently bankruptcy courts process hundreds of thousands of Chapter 13 plans each year. The issues presented by modifications are quite familiar to them.

A Chapter 13 modification also addresses the issues of lender liability. Servicers have already been sued on the basis that their voluntary loan modification programs exceed the authority granted to them. To the extent that the threat of suit by investors has negatively impacted the scope of modification programs, bankruptcy eliminates that issue.

Professor White notes that it could take ten to fifteen years to work though the mortgage crisis using the current voluntary methods. It could even take longer, especially if the holding pattern of voluntary modification only leads to another default, starting the cycle of default and foreclosure all over again. Homes remain unsold. The economy never recovers.

However bankruptcy cuts through many of these issues. The plan is confirmed or not in a matter of months. The plan lasts from 36–60 months. The modification is not voluntary so the lender cannot be sued for overstepping its discretion. Second liens can be valued and allowed or stripped. Since the bankruptcy court is open to everyone, it provides a fair, expeditious, tested and familiar structure for families to save their homes.

CONCLUSION

The current voluntary programs are a failure. We continue to have difficulty, even in reaching some lenders to propose a timely modification. For whatever reason lenders are still not capable of consistently voluntarily modifying loans in such a way, that would grant to borrowers the repayment terms necessary to save their homes. Typically that would involve an interest rate reduction, a curing of the arrearage, a reduction in the principal balance, whether combined with an equity sharing arrangement or not, and moving the loan from a variable rate to a fixed rate. H.R. 200 and H.R. 225 both cut through the voluntary modification process and provide an effective mechanism to modify mortgage loans in Chapter 13 bankruptcy.

Mr. CONYERS. Our final witness is Professor Christopher Mayer of the Columbia Business School, and we welcome your presence here today, sir.

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

Mr. MAYER. Thank you, Mr. Conyers, Ranking Member Smith and Members of the Committee.

We are witnessing an unprecedented crisis. House prices are in near free fall. More than 2.2 million foreclosures were started last year and things are likely to get much worse.

Over 4 million Americans are at least 60 days late on their mortgages. We must act promptly.

Bankruptcy cram downs may seem appealing, but in fact would exacerbate the crisis. If just 1 in 12 existing homeowners decided to stop paying and pursue bankruptcy, we would have double the current delinquency rate and a larger catastrophe. This is not unprecedented, it has happened before with credit cards.

Proponents of bankruptcy reform argue the cram downs will not cost taxpayers any money. This claim is simply not true. Taxpayers are on the hook for $5.6 trillion in mortgage guarantees from Fannie Mae, Freddie Mac and the FHA. Taxpayers could lose tens or hundreds of billions with cram downs and mortgage losses and money needed to stabilize banks who suffer additional losses.

Yet cram downs are unnecessary. The Government can freely modify 35 million of the 55 million outstanding mortgages it controls through Fannie, Freddie and the FHA. Another 12 million mortgages are in the hands of private lenders, not just money center banks, but community banks and credit unions. These lenders are now undertaking appreciable efforts to modify their own loans. And the Obama administration has promised to spend $50 to $100 billion to reduce foreclosures.

Bankruptcy reform would delay the process of restructuring mortgages, the same costly mistake that Japan made in the 1990's—368 bankruptcy judges now handle an average of 2,630 cases each year. The courts would have difficulty handling a dramatically increased caseload with the care necessary to successfully modify loans. Even with this case load, it is an incredibly important thing to note, more than two-thirds of Chapter 13 plans ultimately fail. Bankruptcy reform is just simply not a panacea.

The best private mortgage modification programs have much better success rates. Given the choice, servicers might prefer bankruptcy to loan modification because a typical securitization agreement reimburses servicers for expenses incurred in any legal proceeding, including foreclosures as well as bankruptcy, but not for modifications.

Finally, cram downs would truly raise the cost of future borrowing and make credit less available to disadvantaged borrowers, even results that show up in tables 2 and 4 of Professor Levitin's study.

Instead, I suggest a comprehensive three-pronged solution to the crisis. It is not okay to just stand where we are.

First, Dean Glenn Hubbard and I propose that the Government arrange for the GSEs to issue new mortgages at a rate that is 1.6 percent above the rate of the 10-year treasury, as low as 4 percent today. Our plan would stimulate as many as 2 million new home purchases and really importantly, if we want to stop foreclosures, puta floor on house price declines. Lower mortgage rates would also allow as many as 34 million Americans to refinance their mortgages, saving $424 to $25 per month, per year, a total of $174 billion per year of a stimulus every year. This is like a large middle class tax cut. Permanent reductions in mortgage payments would also stimulate much higher consumption growth than temporary tax changes.

Next, and important for this Committee, Columbia professors Edward Morrison, Tomek Piskorski and I have developed a new proposal to prevent needless foreclosures. Recent research has showed that banks that manage their own mortgages are one-third less likely to pursue foreclosure than servicers of securitized mortgages. Securitized mortgages represent 15 percent of outstanding loans, but half of all foreclosure starts. That is where the problem is.

We propose that servicers be paid an incentive fee equal to 10 percent of mortgage payments, up to $60 a month. This program aligns incentives between servicers and investors and makes modification the preferred solution. If a mortgage is ongoing, the servicer receives a fee. If it goes to foreclosure, the servicer receives nothing.

Second, the Federal Government should promptly eliminate all contractual restrictions on loan modification. Ambiguous provisions should be clarified via a safe harbor that insulates reasonable good faith modification from litigation.

Our proposal helps homeowners. A homeowner is a prime candidate for loan modification when her income is sufficient to make payments that exceed the foreclosure value of her home, the same standard as envisioned for cram downs.

Our third proposal deals with troublesome second mortgages. Under this plan, the Government would offer second lien holders up to 1,500 to drop their claim if the first mortgage is modified, which could facilitate another 1.4 million new modifications.

These proposals are an alternative to cram downs and they address the current crisis at a cost of $12.8 billion that would be payable through TARP funds. Why risk cram downs when more effective, quicker and less costly solutions are available?

[The prepared statement of Mr. Mayer follows:]

PREPARED STATEMENT OF CHRISTOPHER J. MAYER

TESTIMONY OF DR. CHRISTOPHER J. MAYER
BEFORE THE HOUSE COMMITTEE ON THE JUDICIARY
HEARING: "H.R. 200, THE 'HELPING FAMILIES SAVE THEIR HOMES IN BANKRUPTCY ACT OF 2009,' AND H.R. 225, THE 'EMERGENCY HOMEOWNERSHIP AND EQUITY PROTECTION ACT'"
JANUARY 22, 2009

Good morning Chairman Conyers, Ranking Member Smith, 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.

Accelerating declines in the housing market and growing foreclosures are placing a serious strain on American households and economy. While it is crucial to deal with the broader economic crisis through a comprehensive stimulus package and tax cuts, the economy is unlikely to recover without addressing the housing crisis directly. More than two-thirds of all American households own their own home. Most homeowners have relatively modest stock and pension holdings; the bulk of their wealth is tied up in their home. As house prices keep falling, these households suffer increasing wealth declines, making them more likely to further retrench and cut spending. As well, the increasingly dire problems in the banking sector are first and foremost tied to housing declines and mortgage losses.

The fall in the housing market has been stunning and unprecedented. House prices dropped about 18 percent in the last year according to Case and Shiller/S&P, likely the largest national decline in prices since the Great Depression. This has led to crisis of foreclosures, with 2.25 million foreclosures started last year (Federal Reserve)[1] and the forecast of 1.7 million foreclosures started in 2009 (Credit Suisse Foreclosure Update)[2]. Foreclosures contribute to a further decline in house prices, deteriorating communities, and failing banks. Despite good intentions and appreciable effort, public policy to stem foreclosures has had limited success.

And the problem will likely get worse without prompt action. As of September 2008, there were more than 2.2 million vacant homes, 4 million vacant rental properties, and 4.5 million houses on the market, unsold. If we do not reduce this inventory, house prices will keep

[1] http://www.federalreserve.gov/newsevents/speech/bernanke20081204a.htm

[2] http://www.nhc.org/Credit Suisse Update 04 Dec 08.doc

falling. The likelihood of growing foreclosures looks equally bleak. As of October 2008, sixty-day delinquency rates exceeded thirty-three percent among the 2.8 million outstanding securitized subprime loans and seventeen percent among the 2.2 million securitized alt-A loans. Even worse, many securitized option ARMs will hit negative amortization limits between 2009 and 2011, resulting in rising payments and higher default rates.

I believe we must address the foreclosure crisis immediately for economic and humanitarian reasons. As I will address below, amending the Bankruptcy Code to permit cramdown of first mortgages would generate serious risks and many unintended consequences. Instead, I propose an immediate solution that would appreciably alleviate the current foreclosure crisis more quickly and at a reasonable cost. My solution involves three plans that would encourage as many as a million additional successful mortgage modifications, help remove second liens as a barrier to loan modification and refinancing, and put a floor on house price declines and save tens of millions of homeowners an average of $450 per month, every month. These plans in total would cost taxpayers around $12.8 billion and start to turn the crisis around.

It is crucial to address the foreclosure crisis in a manner that yields quick results and does not bankrupt taxpayers and our financial system. While proponents of bankruptcy reform tout the fact that it will not cost taxpayers any money, as I show below, this claim is not true. Taxpayers are at risk for trillions of dollars in mortgage guarantees from Fannie Mae, Freddie Mac and the FHA that could be extremely costly if mortgage cramdowns are allowed. In addition, taxpayers have sunk hundreds of billions in the banking system, a cost that would also rise with cramdowns. The Obama administration has promised to spend between $50 billion and $100 billion reducing foreclosures as part of the second $350 billion that was authorized under TARP. So the government has already committed a large sum of money to reduce foreclosures. Bankruptcy reform is not only unnecessary, but it would delay the process of stopping unnecessary foreclosures.

The Problems with Bankruptcy Reform

Moral Hazard Could Make the Situation Worse

While 4 million borrowers are 60 days or more delinquent, 51 million borrowers are current on their mortgages. We know that one-third or more of these borrowers owe more money on their mortgage than their house is worth, and thus meeting one of the new criteria to qualify for bankruptcy protection. For these borrowers, the financial benefits of bankruptcy protection become real and appealing once cramdown is possible. The option of bankruptcy might lead millions of additional borrowers to stop paying their mortgage.

Easier bankruptcy laws for credit cards have led to millions of bankruptcy filings. It would be a catastrophe if most borrowers get the idea that they do not have to pay their mortgages. While many commentators have downplayed this argument as scare tactics, it is not hard to envision late night TV advertisements informing homeowners that they no longer need to make their mortgage payments and yet they could still remain in their home.

Overwhelmed Judiciary may lead to Delayed Resolutions

Bankruptcy reform would likely delay the resolution of the crisis for years, especially if millions of borrowers file for Chapter 13 bankruptcy. Currently the federal judiciary has 368 bankruptcy judges.[3] During the 12-month period ending June 30, 2008, there were 967,831 bankruptcy filings.[4] Thus the average judge managed 2,630 bankruptcy filings in the past year, even without bankruptcy cramdowns. Now these judges would be asked to oversee a new process on potentially millions of additional filings.

One of the lessons we should have learned from Japan was that quick resolution of a financial crisis is far superior to a slow response. Our public policy goal should be to as quickly address the foreclosure crisis as quickly as possible. This means stepping up private efforts to modify loans as well as creating strong financial incentives and legal protections for servicers to work with borrowers. Our proposal, below, allows a much quicker resolution to the crisis than bankruptcy expansion would.

The Government and Motivated Lenders Already Control Most Mortgages

We do not need the bankruptcy courts to intervene in the foreclosure process. Most recent data show that taxpayers already control the fate of 35 million of the 55 million outstanding mortgages through Fannie Mae, Freddie Mac, and the FHA; nearly two-thirds of all mortgages.[5] So the government is now in a position to control the bulk of workouts without bankruptcy reform. Cramdowns would just delay this process. This also means that taxpayers would bear the bulk of all losses from cramdowns. Securitized lenders control another 8 million mortgages.[6]

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[3] The most recent data we could find are from Sept. 30, 2007, and appear in "Judicial Business of the United States Courts" by the Administrative Office of the U.S. Courts, available at http://www.uscourts.gov/judbus2007/contents.html. This publication reports that Congress has authorized the appointment of 352 bankruptcy judges. However, as of Sept. 30, 2007, there were 11 vacancies. In addition, 27 retired bankruptcy judges had been "recalled" to serve on a part-time or full-time basis. This means that there were (352-11)+27=368 judges handling bankruptcy cases as of Sept. 30, 2007.

[4] This statistic is reported by the Administrative Office of the U.S. Courts at http://www.uscourts.gov/bnkrpctystats/statistics.htm#calendar

[5] According to the Mortgage Bankers Association, there are about 55 million mortgages outstanding. Fannie Mae and Freddie Mac control 30.7 million as of Sept 30, 2008 (http://www.fhfa.gov/webfiles/406/FederalPropertyMgrReport11609.pdf). The Federal Housing Administration controls another 4.8 million (http://portal.hud.gov/portal/page?_pageid=73,1828027&_dad=portal&_schema=PORTAL).

[6] Authors calculations from data from Black Box Logic, LLC as of October, 2008.

The remaining 12 million mortgages are presumably in the hands of private lenders, including not only the large money center banks, but also community banks and credit unions. These private banks are undertaking appreciable efforts to modify loans. It is really only the privately securitized mortgages where modification efforts have been failing. Our proposal addresses these mortgages directly, as opposed to imposing a costly system on the taxpayers and the bulk of lenders and servicers who are already modifying mortgages.

Losses to Taxpayers and Lenders Could Be Enormous

Taxpayers have a very large exposure to bad mortgages and thus have the most at risk under cramdowns. Outstanding debt and mortgage guarantees from Freddie Mac and Fannie Mae represent more than $5 trillion. As well, the government has hundreds of billions of loans at risk that were originated by the Federal Housing Administration. The FDIC has many billions more at risk for loan guarantees through takeovers of Indy Mac, Washington Mutual, and other failed lenders. Similarly, the government has other guarantees for debt from loans to AIG, Citigroup, and now Bank of America. The Federal Reserve has risks from former Bear Stearns securities and many other securities it now holds as collateral. So the taxpayers bear by far the biggest risks from cramdowns.

Bankruptcy may be especially harmful for lenders who have come up with other alternatives that may be equally or even more successful in reducing unnecessary foreclosures, but are less expensive for lenders. Forbearance is one such an alternative. The FDIC/Indy Mac program provides for reductions in both interest rates and forbearance on principal payments.[7] The recently announced 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 that do not rely on principal write-downs.

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 cramdown 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, cramdowns 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 and raising costs to lenders and taxpayers.

[7] Forbearance reduces the amount of principal that a lender applies interest to when computing monthly mortgage payments.

Potential Harm to Consumers

Bankruptcy is no panacea for consumers. Around two-thirds of all Chapter 13 cases terminate prematurely (see Wenli Li), leaving the homeowner liable for her original mortgage debt and creditors in a much worse position relative to having addressed the problem at the time of the bankruptcy filing. Equally devastating, third-party servicers might find it more attractive to deal with a homeowner in bankruptcy than to attempt a loan modification outside of bankruptcy. Proponents argue that bankruptcy reform would give borrowers a tool to fight back against servicers. Yet, the opposite might be the case. Servicers might prefer bankruptcy to loan modification for the same reason that servicers now prefer foreclosure to modification. Under most PSAs, servicers would likely be able to recover expenses incurred in connection with a homeowner's bankruptcy filing, just as they now recover expenses incurred in connection with a foreclosure. There is no reimbursement for costs incurred in performing a loan modification. This could result in millions of Chapter 13 bankruptcy filings that harm consumer credit and appreciably delay a resolution of the crisis.

One Size-Fits-All Approach to Mortgage Modification

Bankruptcy reform applies a one-size-fits-all approach to all mortgages. But different modification strategies may be appropriate for homeowners with different incomes and credit scores. Lenders and servicers have discovered this, especially during the past several months, as they have experimented with new strategies for minimizing losses to investors and default by homeowners. Bankruptcy reform would inhibit this kind of experimentation. Proposed legislation[8] would invoke a standard set of modifications—reducing principal to current market value, reducing interest to the rate on conventional mortgages plus a reasonable risk premium, and extending the duration of the loan.

Higher Cost of Future Credit

Finally, empirical evidence suggests that if mortgages are subject to strip-down in bankruptcy, the cost of future credit will rise as lenders incorporate this new risk into their lending decisions. Future mortgage amounts will be smaller and borrowing costs will be higher. While many would argue that cheap and easy credit was what got us into this economic crisis, lenders are likely to raise the cost of borrowing already as a result of this crisis. Bankruptcy reform would increase borrowing costs further, resulting in even less borrowing and likely further reduce demand for housing. While we do not want overly subsidized credit, we want mortgages to reflect the true costs of borrowing and do not want to raise the costs of making mortgages to inefficiently deter future lending.

[8] See House Bill H.R. 200, the "Helping Families Save Their Homes in Bankruptcy Act of 2009" and H.R. 225, the "Emergency Homeownership and Equity Protection Act".

Alternative Approaches to Reducing Foreclosures

Instead of bankruptcy reform, I am here to suggest a three-pronged approach to stabilizing the housing market and preventing foreclosures. First, I address a new proposal prepared with Professor Edward Morrison of Columbia Law School and Professor Tomasz Piskorski of Columbia Business School to reduce foreclosures through a combination of an incentive fee program to encourage servicers to avoid foreclosures and a legislative initiative to modify servicing agreements to clarify that servicers have the right to modify any loan where modification makes better economic sense than foreclosure.[9] The cost of this proposal is incredibly modest compared to other proposals. We estimate that as many as one million foreclosures could be prevented at a cost of $10.7 billion that could be paid for by TARP funds.

A second proposal with these same co-authors addresses the problems created by second lien holders, who are currently slowing the process of modifying or refinancing primary mortgages. Our proposal uses financial incentives to encourage second lien holders to cooperate with efforts to modify primary mortgages. This proposal could facilitate about 1.4 million modifications that would reduce foreclosures at a cost of $2.1 billion from TARP funds.

Third, I address a proposal prepared with R. Glenn Hubbard, Dean of Columbia Business School. We believe the federal government should act immediately to reduce mortgage rates and stabilize the mortgage market. Lower mortgage rates represent the single best way to reduce foreclosures by stabilizing house prices. Academic studies show that falling house prices are the single strongest contributor to the growth in foreclosures. Lower mortgage rates could attract new homebuyers to absorb inventory and allow as many as 25 million existing homeowners to refinance their mortgages, saving about $450 per month. This would provide a fiscal stimulus of $175 billion PER YEAR. This plan is not a substitute for the currently considered $775 billion stimulus, but unlike that program, the stimulus from lower mortgage rates would require no new federal appropriations. The government could simply arrange for lower rates by issuing US Treasury securities to fund new mortgages.

A New Proposal to Reduce Foreclosures and Help Struggling Homeowners

Even if we stabilize the housing market, millions of Americans may lose their homes in the coming years because of the economic downturn, the resetting of mortgage rates, and the end

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[9] This proposal has been distributed to Committee Members and is available on my website along with other research on the housing and mortgage crisis at http://www4.gsb.columbia.edu/realestate/research/housingcrisis/mortgagemarket.

of negative amortizing mortgages. It is essential for the government to take prompt action to help prevent this crisis.

I have developed a plan for prompt action. The proposal, co-authored with Professors Edward Morrison and Tomasz Piskorski of Columbia University, is attached to this testimony, along with supplemental cost-benefit calculations and constitutional analysis. In this proposal, we offer a new approach to foreclosure prevention. We focus on what has been the most intractable part of the foreclosure problem: the behavior of third-party servicers who manage portfolios of securitized portfolios. Why focus on servicers of securitized mortgages? Because securitized subprime, alt-A, and prime/jumbo loans accounted for more than one-half of foreclosure starts in 2008 despite representing about fifteen percent of all outstanding mortgages.[10] While the Fannie Mae, Freddie Mac, the FHA, and the largest private banks and portfolio lenders have announced their own aggressive programs to pursue mortgage modification, servicers of securitized mortgages lag behind.

Our approach to combating foreclosures builds on research by Tomasz Piskorski, Amit Seru, and Vikrant Vig[11] showing that portfolio lenders—lenders who service loans that they own—are significantly more successful in stemming foreclosures than third-party servicers, who service loans owned by other parties. This research shows that portfolio lenders achieve foreclosure rates that are nineteen to thirty-three percent lower than the rates experienced by third-party servicers. In fact, portfolio lenders are even more successful in reducing foreclosures for the highest quality loans, where current delinquency rates are rising the fastest (portfolio lenders achieve foreclosure rates thirty to fifty percent lower than third-party servicers). Third-party servicers, however, are often unable or unwilling to use the same tools as portfolio lenders are currently using.[12] Recent research documents the failures of servicers to successfully modify loans.[13]

Our proposal eliminates barriers that prevent third-party servicers from effectively managing the foreclosure crisis. Commentary and evidence suggests servicers face two appreciable barriers: 1) Servicing contracts makes little economic sense in the current crisis. No

[10] According to the Mortgage Bankers Association, about 1.64 million loans started the foreclosure process as of the third quarter of 2008. Our own calculations from data obtained from Braddock Financial shows that about 900,000 securitized loans began the foreclosure process as of October, 2008.

[11] See "Securitization and Distressed Loan Renegotiation: Evidence from the Subprime Mortgage Crisis" by Tomasz Piskorski, Amit Seru, and Vikrant Vig available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1321646

[12] Of course, many other foreclosures come from FHA programs and Fannie Mae and Freddie Mac, where the government already has appreciable influence in guiding programs to reduce foreclosures.

[13] See "Rewriting Contracts, Wholesale: Data on Voluntary Mortgage Modifications from 2007 and 2008 Remittance Reports" by Alan White available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1259538 and a recent update available at http://www.hastingsgroup.com/Whiteupdate.pdf.

one anticipated the extent of the current crisis and servicers are poorly compensated as a result. As well, servicers have too few incentives to pursue loan modification instead of foreclosure, even when modification makes good economic sense for investors. Most securitization agreements compensate servicers for costs incurred during the foreclosure process, but not for expenses associated with loan modification. Even if modification is successful, it typically does not generate sufficient fees to cover the costs of modification. Consequently, servicers often choose to foreclose, even when modification makes good economic sense for borrower and investors. 2) Servicers face explicit and implicit legal barriers to modifying mortgages successfully. Some pooling and servicing agreements (PSAs) place explicit limits on loan modifications. In other cases, vague provisions in the PSAs, and the consequent threat of lawsuits, serve to limit servicers' ability to modify loans successfully.

We propose two steps to get around these barriers: 1) an Incentive Fee structure that increases payments to servicers and better aligns their incentives with investors, and 2) a Legislative Proposal that removes explicit barriers to modification in PSAs and that reduces the litigation exposure of servicers who do modify loans. Our proposal might prevent as many as one million foreclosures at a cost of no more than $10.7 billion that can be funded by TARP money. Other proposals do not address both barriers that servicers face. As well, our proposal would cost taxpayers considerably less money than other programs currently under consideration, with no requirement to provide costly loan guarantees. Losses for bad loans remain with private investors rather than taxpayers.

Incentive Fees: We believe that servicers need greater resources and stronger incentives to modify loans. We propose that servicers of privately securitized mortgages be paid a monthly Incentive Fee equal to ten percent of all mortgage payments made by borrowers, with a cap for each mortgage of $60 per month ($720 per year). The servicer would also receive a one-time payment equal to twelve times the previous month's Incentive Fee if the borrower prepays the mortgage, rewarding servicers that accept short sales. These payments would be in addition to the normal servicing fees as specified by the PSA. The program would be limited to any securitized mortgage that is below the conforming loan limit at the origination date. The Incentive Fees, which would equal about $9 billion, can be paid from money authorized under the US Treasury's TARP program. The Incentive Fees should remain in place for a period of three years, after which improvements in the economy will likely reduce the need for the incentive program.

Our Incentive Fee program would substantially encourage servicers to modify mortgages. Servicing fees would now more than cover the direct costs of modifications, estimated to be as much as $750 to $1,000.[14] Equally important, the Incentive Fee program better aligns servicers' interests with those of investors by giving them a percentage of all cash flow. By paying an

[14] See for example Barclays 2008 Global Securitization Annual.

Incentive Fee only when borrowers make payments, we reward successful modifications. A servicer whose loan modifications are unsuccessful and result in a quick re-default would collect few Incentive Fees.[15] Our proposal, therefore, rewards servicers for keeping future payments as high as possible without putting the homeowner in a position where he or she is likely to re-default soon after modification. This is exactly the tension that a portfolio lender deals with in its own loans. Of course, there will still be circumstances when costly foreclosure will be unavoidable, but the Incentive Fee will encourage servicers to look for other options.

Legislative Proposal: We propose specific, temporary legislation to eliminate legal barriers to loan modification in PSAs for all securitized loans. We believe that Congress has the authority, under the Commerce and Spending Clauses, to modify the terms of securitization contracts.

We propose two kinds of legislated changes to PSAs. First, Congress should enact legislation that eliminates explicit limits on modification, including both outright prohibitions and provisions that constrain the range of permissible modifications. The legislation should be temporary, lasting only three years. Second, Congress should create a "litigation safe harbor" that insulates servicers from costly litigation, provided they modify loans in a reasonable, good faith belief that they are acting in the best interests of investors as a group. The safe harbor is an affirmative defense, which servicers can assert in the event of litigation. Importantly, the defense is based on evidence that the servicer held a reasonable, good faith belief in the benefit of modification, not on evidence that the modification was in fact successful or not. If investors bring suit, but a servicer successfully invokes the safe harbor, the investors will pay the servicer's actual legal costs, including attorney and expert-witness fees. Finally, our proposal therefore requires servicers to make public the details of any modification.

Our Legislative Proposal raises no meaningful constitutional concerns and has been vetted by leading constitutional scholars. The Proposal is a temporary program to moderate an avalanche of foreclosures during an economic crisis. It is more tailored and potentially less burdensome on investors than temporary legislation enacted during the Great Depression and upheld by the Supreme Court. Indeed, our program should benefit investors, because it fosters loan modification only when it increases returns—relative to foreclosure—to investors as a group.

Our Legislative Proposal addresses a number of flaws in existing PSAs, which were created when investors and underwriters did not envision a housing collapse of the magnitude we are now seeing. Although the proposed legislation will abrogate contractual rights of investors, it will also free servicers to undertake loan modifications that increase payments—relative to a

[15] Evidence suggests that more than one half of loan modifications in the first quarter of 2008 re-defaulted within 6 months, so it is important only to reward servicers for pursuing successful loan modifications (OCC/OTS Report, 12/2008).

foreclosure—to investors as a group. Thus, the bulk of investors will benefit from this legislation, despite the loss of contractual rights. Most PSAs do not explicitly limit modifications, but instead contain vague language that can paralyze servicers. With respect to these securitizations, our proposal can best be viewed as clarifying the interpretation of the PSAs.

Our Legislative Proposal is slightly more complicated for the minority of PSAs that contain explicit provisions barring modifications, limiting the types of available modification, or requiring that a servicer purchase any modified loans—at par value—from the securitization trust. Our proposal will abrogate provisions like these. It is important to note, however, that our legislation enables modification only when it increases overall investor value. To be sure, some junior tranche holders might be harmed. We believe that policymakers should provide compensation to these investors, who have suffered economic losses. Note, however, that compensation to junior-tranche investors will be necessary only when legislation abrogates contractual provisions that would have guaranteed, absent abrogation, cash flow rights to these investors. Our computations indicate that the total cost of this compensation would be no more than $1.7 billion.

A key feature of our proposal bears emphasis: it benefits homeowners as much as servicers and investors. A homeowner is a prime candidate for loan modification when her income is sufficient to make payments that, over time, exceed the foreclosure value of her home. Competing proposals do less for homeowners, do more harm to investors, or are more costly to taxpayers.

Second Liens and Mortgage Modifications

There is one other appreciable barrier to modifications that appears to be a major concern—the existence of second liens on properties with a delinquent or potentially delinquent first mortgage. According to our calculations from deeds records, about one-third of mortgages originated after 2000 have either a second lien or a piggyback loan (a piggyback loan is a second lien that is taken on at the same time as the first mortgage).[16] Typically, these loans provided additional credit for homeowners to purchase the house or to finance additional expenditures after the purchase.

Second liens can be a barrier to successful modifications of first mortgages. There are some cases in which modification of the first mortgage might yield greater recovery than a foreclosure to first mortgage lenders, but the servicer of the first mortgage is unwilling to pursue modification unless the second lien lender agrees to relinquish its claims. If the second lien

[16] About 81 percent of mortgages with a second lien have only a second lien, while another 15 percent have a second and third lien, and 4 percent have 3 or more additional liens.

lender does not relinquish (or reduce) its claim, a modification of the first mortgage will just allow the homeowner to allocate more of her income to the second lien.

Even if the first mortgage exceeds the home's expected foreclosure value—implying zero recovery to the second lien lenders in foreclosure—the second lien servicer has little incentive to agree to a modification that extinguishes the second lien. As long as there is some uncertainty surrounding foreclosure value, no matter how small, the servicer of the second lien would prefer foreclosure to loan modification. The former offers a slight chance of recovery to second lien lenders; the latter offers no recovery. Moreover, terms of pooling and servicing agreements might prevent the second lien servicer from agreeing to any modification that extinguishes the mortgage. As well, by delaying and appearing obstinate, the second lien lender might convince the first mortgage servicer to "buy out" the second lien at a price above its true value. This is often called a "hold-up" problem.

Professors Morrison and Piskorski and I are developing a new, voluntary proposal that would give second lien lenders financial incentives to relinquish their claims whenever a first mortgage servicer pursues modification. Under our proposal, the government would pay compensation to a second lien holder who agrees to relinquish all of its claims against the home and the borrower. This compensation would equal five percent of the current balance of the second lien, capped at $1,500 per property. If multiple liens exist, this payment would be split between the liens. This compensation could be paid using TARP funds.

In order to limit taxpayer costs, and focus primarily on foreclosure prevention, we would limit compensation to second lien lenders who relinquish their claims in response to a decision by the first mortgage servicer to conduct a significant modification of the primary mortgage. By significant, we mean a modification that reduces the borrower's monthly payments by at least 10 percent. This program would only apply to primary residences. As well, compensation would be available only when the first and second liens are held by different lenders. Finally, our proposal would apply to all second liens, because the hold-up problem applies beyond just privately securitized mortgages.

The cost of this proposal would be approximately $2.1 billion. As with our other proposal, the cost of this plan is quite moderate compared to the possible expenditure of $50 to $100 billion to reduce foreclosures. We compute the cost of compensation as follows. Using deeds records, we estimate that about 13.3 million homes are subject to both first mortgages and second liens as of Octoer 2008. Among these homes, the loan-to-value ratio exceeds 92 percent. (In our calculations, we assume a loan-to-value ratio equal to 92 percent; this allows for future house price declines of 8 percent or more.) When the loan-to-value ratio is only 92 percent, a second lien lender is unlikely to agree to relinquish its claim, for obvious reasons. We assume that around one-quarter of these mortgages are at risk of foreclosure. Among those, modification might make sense half of the time. Thus about 1.4 million second lien mortgages might require compensation for the relinquishment of their rights. If all second lien holders agree to relinquish their rights, the total cost of compensating them would be no more than $2.1 billon.

This proposal would deal with the one remaining impediment to loan modifications that impacts all mortgages. We believe that this proposal is superior to bankruptcy cramdown for many of the same reasons we do not think cramdown makes sense for first mortgages.

Stabilize the Mortgage Market and House Prices

I briefly describe a program to return mortgage markets to normal operations and stabilize house prices. Along with R. Glenn Hubbard, I have proposed that the government allow new mortgages to be issued at a rate that is 1.6 percent above the rate of the 10-year Treasury bond. With 10-year Treasury rates as low as 2.4 percent, this would immediately lower mortgage rates as low as 4 percent for conforming mortgages.

Lower mortgage rates would accomplish many things at once. Lower rates will stabilize house prices. A recent paper that I wrote with R. Glenn Hubbard suggests that house prices have already fallen at or below where fundamentals suggest, but are likely to continue to decline due to the mortgage market meltdown and the deteriorating economy.[17]

Lower mortgage rates also provide a strong fiscal stimulus, allowing as many as tens of millions of American households to refinance their mortgages, with a monthly savings of $425 that is not a temporary stimulus but permanently lower payments.[18] These lower mortgage payments could make the difference for millions of homeowners in allowing them to obtain affordable mortgages and avoid foreclosure. As well, lower rates would provide a fiscal stimulus that would total more than $174 billion per year and would almost surely induce an increase in consumption relative to a temporary tax stimulus.

Moreover, a low mortgage rate will raise housing demand significantly. We estimate that anywhere between 800,000 and 2.4 million additional owner occupants could enter the housing market in 2009.[19] These gains in new homeowners would help absorb the inventory of vacant houses, putting a floor on house price declines. TARP money might facilitate larger gains in new homeowners by helping finance low down payment mortgages through the Federal Housing Administration.

While lower mortgage rates do not require any additional government expenditure, TARP funds could provide additional help to homeowners struggling to pay off a mortgage on a house that is worth less than the mortgage. The federal government could also help facilitate many of the refinancings by offering to share some of the losses with lenders in return for taxpayers

[17] See "House Prices, Interest Rates, and the Mortgage Market Meltdown" by Christopher Mayer and R. Glenn Hubbard available at http://www2.gsb.columbia.edu/faculty/cmayer/Papers/Mayer-Hubbard-BEP-10-2008-v7.pdf
[18] Calculations are available at http://www4.gsb.columbia.edu/null?&exclusive=filemgr.download&file_id=53340
[19] See calculations at www4.gsb.columbia.edu/realestate/research/mortgagemarket

receiving a portion of the future appreciation of houses that participate in these new refinancings. These losses would be funded from the TARP. Our initial estimates were that a plan to share losses 50-50 with lenders would cost the government $121 billion. It would allow millions of additional homeowners to refinance their mortgages to an affordable level. The government would recoup some of its expenditures by retaining a stake in the future appreciation of houses refinanced under this program.

Moreover, trillions of dollars of refinancings would retire a large number of the existing mortgage-backed securities. This would reduce uncertainty about the value of existing mortgage-backed securities. It would flood the market with additional liquidity that the private sector could deploy to other uses such as auto loans, credit cards, commercial mortgages and general business lending.

Conclusion

I believe it is essential for the Administration and Congress to address the foreclosure crisis. House prices continue to spiral downward in much of the country. Foreclosures are already taking place at an alarming rate and will only grow if we do not take immediate action.

Nonetheless, it is important to pursue sensible policies and protect taxpayers. Bankruptcy reforms that allow judges to cramdown mortgages on a primary residence will only delay the resolution of the crisis and may cost taxpayers tens or hundreds of billions of dollars.

Instead, I have put forward three plans that will provide immediate relief and appreciably benefit taxpayers, homeowners facing foreclosure, other homeowners, and banks. One plan addresses the large growth in foreclosures in securitized mortgages. That plan relies on incentive payments and legislated changes in securitization agreements to induce servicers to undertake modifications that would benefit both homeowners and investors, without relying on changes to bankruptcy laws. The plan can prevent up to a million foreclosures at a modest cost to taxpayers of $10.7 billion. The second plan deals with second liens that inhibit loan modifications and would facilitate as many as 1.4 million loan modifications at a cost of $2.1 billion. The third plan helps restore the normal functioning of the mortgage market at little cost to taxpayers. It would put a floor on house price declines and might provide a fiscal stimulus of as much as $175 billion per year. Together these programs put us on the road to recovery.

I appreciate the opportunity to address you today and look forward to answering any questions that you might have.

Mr. CONYERS. This bankruptcy seminar conducted by the 39 Members of the House Judiciary Committee has had presentations by two very distinguished professors. I now invite Professor Levitin to make his response, and then I will allow Professor Mayer to make yet another presentation.

Mr. LEVITIN. Chairman Conyers, I came here today prepared to discuss H.R. 200 and H.R. 225, not to get into the merits and the problems of Professor Mayer's proposal.

That said, I think it is important to note this. There is some merit to what Professor Mayer says, that he correctly notes that there are problems with servicer incentives and that there are problems with restrictive contracts. These are things that any solution to the foreclosure crisis must deal with. However, these are not the only problems. And I do not believe that Professor Mayer's plan, which ultimately relies on the private market to get this right, will necessarily work.

I would hope it would, but that is a big gamble to take. And in a—if you think how long the legislative process takes, it is—if Congress decides that it wants to run with Professor Mayer's proposal, that is going to take many months before it actually gets—it would become law. Those are months in which thousands and thousands of families would lose their homes.

I don't know that we have the time to find the perfect solution. I think we need to find the most immediately workable solution. Bankruptcy is immediately available. The bankruptcy courts are over-staffed relative to the historical level of filings. And what I think is really a major misconception about bankruptcy modification is the role of bankruptcy judges.

Bankruptcy judges do not go and micro-manage each Chapter 13 case. Most of that other work on a modification is performed by the debtors council and by the Chapter 13 trustee. The bankruptcy judge does not propose the modification. This is a common misconception. Instead, the bankruptcy judge decides whether or not to approve the modification proposed by the debtor if it conforms with the statutory requirements.

This is not a proposal that would—the bankruptcy modification proposal would not result in a tremendous amount of additional work for the courts. The courts are ready, willing and able to handle this.

I urge all of the Members of the Committee to go and speak to the bankruptcy judges in your districts. Ask them, can the courts handle this? And I tell you, they will almost unanimously say yes, we can do this.

Actually, Chairman Conyers, if I may just add one other comment. About the two-thirds failure rate in Chapter 13. That is correct. Two-thirds of Chapter 13 plans fail. But that alone is a misleading figure.

First of all, of course, to where we have a high failure rate in Chapter 13 plans. If you can—the home mortgage is typically consumers' single largest debt. If you can't fix that, if you can't restructure that debt, then it is not likely that you are going to be able to fix your finances. So it is not surprising that currently we see a very high Chapter 13 failure rate.

The second thing to note is that just saying that two-thirds of Chapter 13 plans fail doesn't tell us what failure means. That a Chapter 13 plan is going to be between 3 and 5 years. If the plan failed 4 years and 9 months into the plan, that is very different than if the plan fails in the first month. And what we don't know is when plans fail.

Also, a lot of mortgages are simply not dealt with in Chapter 13 plans because there is nothing—there is really very little one can do with them. Instead, the consumers simply try to ride their mortgage through a bankruptcy.

So I don't know that, that two-thirds statistic, as scary as it sounds, actually tells us very much.

Mr. CONYERS. Our other professor, Christopher Mayer.

Mr. MAYER. So I think the—again, there are parts of what Professor Levitin's comments that I agree with. I certainly do not think if we went this route we would see the mortgage finance system collapse, but I think I would, again, highlight that what would happen, and we know this from lots of research, not only Professor Levitin, but looking around the world, that we would see the cost of borrowing rise moderately for mortgages, and we would also see particularly disadvantaged borrowers, either ones that are pulled out of the market, they are the ones at risk of failing. They are the ones who are likely to lose credit. It is not going to be the medium borrower, it is going to be disadvantaged borrowers who disproportionately lose credit.

The second thing is that the two-thirds failure rate, I think a lot of the comments that I have heard in favor of bankruptcy reform really think of it as something that is this is going to solve our problem. And I think it is—there is no evidence that it will.

Maybe bankruptcy reform will do better than it has done. But so far, it hasn't solved problems. And if we end up a couple of years from now with two-thirds of the people failing and all the mortgage debt back on our books, we are Japan. And that is incredibly costly to all of us, as taxpayers, and it is a huge risk to take from the balance sheet.

The third thing is, there are programs that are successful. The statistics that almost everybody quotes about the failure of loan modifications really come from observing securitized mortgages by servicers who are conflicted, who face disincentives to modify. And those are really serious problems. So I think when we sort of look at the evidence, and I can point to some evidence and point to some studies that show there are some very, very successful loan modification programs being done privately that have failure rates that are much, much less than two-third.

Mr. CONYERS. Robert Goodlatte?

Mr. GOODLATTE. Thank you, Mr. Chairman.

Mr. Mayer, Professor Mayer, is there evidence that the bank loan modification programs that are being enacted right now by many banks are working?

Mr. MAYER. Yes. There is a couple of different pieces. A colleague of mine, Tomek Diskorsky, along with two other co-authors, have a recent paper, which compare the performance of securitized loans versus portfolio loans. This study, which is a unique, and new study only finished in the last several weeks, shows there are appreciable differences in foreclosure rates, and the banks foreclose on their own loans much less frequently than servicers. Third-party servicers are the problem, and we should focus our attention on getting that problem fixed.

Mr. GOODLATTE. Are there specific things that Congress could take in that regard to make it easier for those securitized mortgages to be more readily dealt with by somebody to help people work through them?

Mr. MAYER. Yes, I mean I think we need to immediately change—I think this is a place that legislation is needed. I think we need to immediately get rid of all impediments to securitization. This is a constitutional proposal, and it has been vetted by leading constitutional scholars. It is perfectly legitimate for the Government to do this, so I think we should get rid of that.

And the second is—and this is even where I differ from Sheila Bair. Sheila Bair's proposal, which I think is very well-intentioned, pays the servicer $1,000 to modify a loan, and it could default the next day. Under our proposal, servicers only get paid if that loan is performing month by month for 3 years. Very strong economic incentives to keep loans going, which is what we all really want to accomplish.

Mr. GOODLATTE. And could these bankruptcy proposals that we heard about this afternoon undermine the tools the Federal Government already has to modify the loans that it control?

Mr. MAYER. Absolutely. The Federal Government already controls the bulk two thirds of the mortgages through the conservatorship of Fannie and Freddie and the FHA. We have seen them undertake different programs than we see in the cram-down legislation. I think this just delays that process.

Fannie and Freddie could much more quickly—and this is the growing part of the problem—our conforming loans. Fannie and Freddie, through the Treasury's leadership and conservatorship, could much more quickly deal with this problem than pushing it into the courts, and I expect the new Administration is going to be much more successful in doing this. That is two thirds of the loans out there.

Mr. GOODLATTE. You mentioned this in your testimony, but let me ask you to elaborate on it. How would current legislative proposals to modify bankruptcy laws for those facing foreclosure affect prospective homebuyers, people who want to get into this market that have the prospect of being able to meet the qualifications to buy a home? Are they going to be impacted by our changes in the bankruptcy laws here?

Mr. MAYER. Yes. I mean, I hate to make the slippery slope argument because you always hear that argument here, but it really is true. The issues about putting first liens into bankruptcy predate this hearing and predate this crisis, and there is a large constituency of people who believe that should have been true and will be true now, so there is going to be an enormous political pressure. Once we go down the route and allow this to happen, there is going to be enormous political pressure to do this.

And I think that that is just going to be really costly to our efforts not to subsidize the heck out of home ownership but to allow fair and equal credit to disadvantaged borrowers. They are the ones from lots of evidence who lose when you end up with a process that creditors lose track of. And you don't have to look at the United States. You can just go to other countries. Look at Spain. Look at Latin America and see places that don't give lenders any rights. And when you take away lenders' rights, you reduce the availability of credit, and that effect is a directly proportional effect.

Mr. GOODLATTE. I have in front of me a Bloomberg.com article by Jody Shenn dated yesterday, which I would ask Mr. Chairman to submit for the record.

Mr. CONYERS. Without objection, so ordered.

[The information referred to follows:]

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Bankruptcy Bill May Hurt Banks on Mortgage-Bond Quirk (Update1)

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By Jody Shenn

Jan. 21 (Bloomberg) -- A proposed change to bankruptcy law to allow judges to reduce homeowners' mortgages may boost the capital needs of banks and insurers by hundreds of billions of dollars, First Pacific Advisors LLC's Julian Mann said.

The issue, identified by investors such as Mann and analysts at JPMorgan Chase & Co., stems from language buried in the more than one hundred pages of prospectuses for many "prime jumbo" and "Alt-A" home-loan securities.

Some of the contracts state that bankruptcy-related losses greater than an amount sometimes as little as $100,000 get allocated equally among all investors in bonds backed by the loan pools, rather than lower-ranking debt first. Holders such as banks and insurers of senior classes may see their payments cut or interrupted, potentially forcing writedowns and ratings downgrades. That, in turn, could raise their capital needs.

It would be "the coup de grace for many banks," said Mann, who helps manage about $4 billion in bonds as a vice president at Los Angeles-based First Pacific, whose Robert Rodriguez and Thomas Atteberry were Morningstar Inc.'s fixed-income managers of the year in 2008.

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Prospects for bankruptcy changes increased this month as Citigroup Inc. endorsed a Democratic proposal letting judges adjust the principal, interest rates and terms on mortgages. The deal has yet to win support from the rest of the banking industry, which joined Republicans last year to kill similar legislation aimed at slowing U.S. foreclosures.

Writedowns, Credit Losses

U.S. financial companies have already been promised more than $300 billion in capital from the federal government, as the housing slump sparked writedowns and credit losses since the start of 2007 surpassing $1 trillion.

The loss of mortgage-bond payments because of the bankruptcy changes would require financial firms to mark down more securities to market values, usually at least 15 percent less than the carrying amount, Mann said in a telephone interview yesterday. Banks and insurers aren't required to write down bonds held under the most-popular accounting designation if they can convince auditors the debt may be held to maturity and recover.

Also, under so-called risk-based capital tests in which banks' needs are smaller for safer assets than riskier ones, securitized debt with non-investment-grade ratings requires 10 times as much in reserves as AAA rated bonds, according to Federal Deposit Insurance Corp. rules. The risk-weighting rises to 200 percent, from 20 percent.

The fallout may also affect other investors, according to a presentation from New York-based JPMorgan analysts led by Matthew Jozoff. After the writedowns are taken, the "risk of bank and insurance company liquidations is enormous," according to a slide shown to investors last week during a conference call.

Jumbo Loans

Jumbo mortgages are larger than what government-chartered Fannie Mae and Freddie Mac can buy or guarantee, currently $417,000 in most areas and as much as $625,500. Alt-A loans went to borrowers who wanted atypical terms such as proof-of-income waivers, investment-property collateral or delayed principal repayment, without compensating attributes.

About $500 billion of prime-jumbo bonds and $800 billion of Alt-A securities are outstanding, according to Memphis, Tennessee-based FTN Financial. Bank of America Corp., an ING Groep NV unit and Citigroup on Sept. 30 held the most "non- agency" mortgage bonds among U.S. banks and thrifts, which owned $315 billion, according to newsletter Inside MBS & ABS.

Mann, who oversees holdings of some jumbo and Alt-A mortgage bonds, said that he also agrees with critics of the bankruptcy plan who say the proposed changes would raise the cost of loans and cause foreign investors to flee American debt by creating doubt about U.S. contracts. He also thinks many borrowers will end up defaulting on debt reworked by bankruptcy judges.

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Mr. GOODLATTE. Thank you, Mr. Chairman.

But I would also like each of the panelists to comment briefly on this. It suggests that the change we are examining here today would allow—allowing judges to reduce homeowners' mortgages may boost the capital needs of banks and insurers by hundreds of billions of dollars, costing both the taxpayers through the guarantees they already have and the ability of banks to continue to function, and let me just go right down the line here.

Professor Levitin, have you seen this article and are you familiar with this issue?

Mr. LEVITIN. I have not seen that particular article. I am familiar with the issue, and I think it is important to compare what the impact would be with foreclosure, that if we continue as we are today, we are going to see lots of undercapitalized financial institutions because they are going to lose money in foreclosure. That, as long as they lose less money in bankruptcy modification than foreclosure, bankruptcy modification is a really good deal.

Mr. GOODLATTE. Mr. Certner.

Mr. CERTNER. I would agree with that notion exactly, and we are talking about here, while there are a large number of families who could potentially benefit from the bankruptcy legislation, we are probably talking somewhere in the range of less than 2 percent of all outstanding mortgages, so the impact will not be as dramatic.

Mr. MAYER. I think it is an unfortunate view that this doesn't cost taxpayers any money. It costs—bankruptcy cram downs would cost taxpayers an enormous amount of money and would severely hamper the existing banks that are still around, and that hammers all of us through the credit crisis.

I also think it is important to note, to respond to Professor Levitin's comment, that banks already understand this process. It is servicers who don't, and it is really important to make the distinction because banks are modifying loans, and there is evidence they are successful at it. It is servicers who aren't, and that is where we have to focus.

Mr. GOODLATTE. I am not sure that Professor Levitin and Mr. Certner really addressed the issue that is raised here. Let me read a portion. It says, "The issue identified by investors stems from language buried in more than 100 pages of prospectuses of many prime, jumbo and ALT-A home loan securities. Some of the contracts state that bankruptcy-related losses greater than amounts sometimes as little as $100,000 get allocated equally among all investors in bonds backed by the loan pools rather than lower-ranked debt first. Holders, such as banks and insurers of senior classes may see their payments cut or interrupted, potentially forcing write-downs and rating downgrades that, in turn, could raise their capital needs."

And it is those capital needs that these banks are concerned about being raised dramatically that could put them out of business or require merger or takeover by the FDIC that we are talking about here, not just whether they save more money or lose more money by being able to reorganize a debt, which bankruptcy certainly under certain circumstances can allow them to do.

Mr. LEVITIN. I have looked at dozens of securitization agreements. I have never seen that particular language, so that is new to me. But I think it is important to keep a focus on there being two risks for investors. There is a risk caused by actual defaults when homeowners don't pay, and therefore, the securitization trusts don't have the money to pay the coupons to their investors.

But there is also, and maybe much more importantly, there is a market risk that even if you are holding AAA paper and it has been paying the coupon timely every time, you may not be able to sell that paper for anything close to its face value, and that is because nobody knows how high these default rates are going to go. There is too much uncertainty in the market.

What bankruptcy modification does is it cuts through that uncertainty, that right now we actually, I think, are in the situation that looks like Japan in the 1990's where financial institutions are unwilling to take the write-downs necessary, and they keep holding non-performing loans on their books. What bankruptcy modification does is it forces those write-downs. It forces a housecleaning, and then that lets us have really a financial fresh start, not just for homeowners but for the whole system, that when one financial institution wants to deal with——

Mr. GOODLATTE. When those financial write-downs occur, the banks are required to change their entire lending practice because they are then required by the bank examiners to have more assets on hand that they don't have that are performing that could simply put them out of business. We may inadvertently force action that would ultimately lead to what you are talking about but in the meantime cause major disruptions in our banking industry. That is what I think is expressed by this article.

Mr. LEVITIN. We are already there, unfortunately, and I think that the mistake would be to try to sweep the problems in the banking system under the rug rather than deal with them up front. Bankruptcy modification will cause some upfront dealing with the financial problems. We are going to have to bite this bullet sooner or later, and the danger is that we wait too long to do this, and we lose the decade.

Mr. GOODLATTE. Well, thank you, Mr. Chairman. You have been very kind with the time you have allotted to me.

Mr. CONYERS. Bobby Scott?

Mr. SCOTT. Thank you, Mr. Chairman.

Let me, Professor Levitin, let me follow through on that. How is the bank any worse off with cram down under bankruptcy—the fact is that the security they have is the cram-down amount—the value of the house is the security for the loan, and if it is now down, whether it is crammed down or not, they don't have any more security than anything actually there?

Mr. LEVITIN. You hit the nail on the head there, that if the bank's choice is between having a modified loan in bankruptcy, where it gets a secured claim for the value of the property and an unsecured claim for the deficiency, that is exactly what they get in foreclosure. And frankly, unless you think bankruptcy judges are systematically going to do worse jobs than foreclosure sales in valuing property, it is going to be a lot better for the bank.

I don't know how many of you have been to a foreclosure sale, but most foreclosure sales, the only one who shows up to bid is the foreclosing creditor. In New Jersey, for example, foreclosure sales, the bidding starts at $100 by the foreclosing creditor. Most sales, that is the only bid there is. The property goes for $100.

Now, that foreclosing creditor might try and resell the property later, but they are carrying a property on their books for a while that is not performing, not producing any income. And in this market, good luck selling it at anything close to what the price was when they made the loan.

Mr. SCOTT. Professor Mayer, why is the bank worse off under a cram down, since that is all the security they have anyway?

Mr. MAYER. I think it is important to recognize that there is lots of evidence about why people miss mortgage payments. It isn't because their loan-to-value is above 100 percent. It is because they have trouble making their payments. So the right solution to dealing with this is really making sure people can make their payments on their homes.

The cram-down portion actually erases the possibility that the lender can ever be made whole when there is temporary reductions in income. So if we look at previous cycles, many, many homeowners sat with the loan-to-value above one and made their payments. So if we want to keep people in their homes, we really have to worry about the payment issue.

The difference for the lender and the reason that lenders—you know, lenders aren't stupid. It is not as if they think this is in their interest, you know, that this is in their interest, and somehow they are all saying it is not. We have to sort of take them at their word if they think it is not.

The difference—and this is where the huge write-downs come—is by cramming down the loan amount and giving the lender no chance of ever getting it back instead of reducing payments so people can stay in the house, and as the market recovers, lenders get some of that additional money back, you are immediately forcing a bigger loss on lenders than they would otherwise get. And that is a really important distinction, and there is lots of evidence in the academic literature to support that.

Mr. SCOTT. But if they found that from the bankruptcy the bank would be in exactly the same situation they would be with the cram down.

Mr. MAYER. No because the mortgage amount is crammed down. What you are doing is you are taking away a secured claim and giving them—taking away their secured claim, which forces a much bigger write-down——

Mr. SCOTT. Yes, but you have a secured claim on the value—the value of the property is all the security you have. Under bankruptcy, that is all the creditor is going to get at most.

Mr. MAYER. But I made, you know, as a bank, I made a loan that is a secured loan, and I thought I had collateral to protect that, and I am willing to make a secured loan very differently. And we all understand a secured loan is a much lower cost loan than an unsecured loan. It is because the losses on unsecured loans——

Mr. SCOTT. Yes, but the only security you have is the house, and the value of the house is the extent of the security.

Mr. MAYER. No, that is not true.

Mr. SCOTT. And the cram down is to the true value of the house.

Mr. MAYER. I have two things when I have a mortgage. I have a promise to pay from a borrower, and then I have a security as a fallback. If I can keep that borrower paying, then I actually have something that is worth more than just the value of the house, and that is why the cram downs kill lenders.

With all due respect, I apologize. I am used to an academic-style discussion. I apologize.

Mr. SCOTT. Well, I mean, what you have is the homeowner over a barrel, didn't want to have to leave the house and be homeless, and you are gouging them for more than you could get under the legal process because you have that leverage over them. It is not legal. It is leverage because they don't want to be homeless. I am sorry?

Mr. MAYER. I am sorry.

Mr. SCOTT. No, go ahead.

Is that not the leverage you have, the fact that they would be homeless and you can get more—you can gouge them now that you have got them over a barrel? And that is the security that you are talking about.

Legally in bankruptcy you can get the cram down costs? That is all you ever get. And you won't even get that because you have got more expenses in foreclosure.

Mr. MAYER. I wouldn't characterize in my own view of lenders as trying to gouge. What a lender is trying to do is to get the most payments they can with at the same time keeping someone in their house. The fundamental idea of my proposal is to have the lender receive as much payments as they can, the servicer, but if the payments stop, the servicer gets nothing.

And so the idea is to keep people in their house, but I do think when you take out a loan, you have a responsibility to pay as much as you can back of that loan as possible, and I think that is an important responsibility.

Mr. SCOTT. Mr. Chairman, if I could add.

Professor Levitin, a quick question. Is there any point in making, if we pass the bill, to effect only present loans and not future loans?

Mr. LEVITIN. I think it actually would be a good thing if it affected all loans. But, you know, I am willing—I would rather see a half loaf than nothing at all here.

Mr. SCOTT. Five years, 10 years from now, we are not going to be right back where we are—the argument that when you made the loan, you knew who you were lending and what the rules where and, if we went down the road a little bit, we would be changing the rules retroactively? Wouldn't it make more sense, in fact, to file a future loan rather than past loans?

Mr. LEVITIN. Well, there is no—on past loans, there was reliance that there wouldn't be bankruptcy modification. In the future, we have a lot of certainty about this. And I think that would actually be a very good thing because the possibility of loan modification in bankruptcy actually instills some discipline in the lending process.

We would not have had the craziness of the last 6 years or so in the lending market had bankruptcy modification been possible. Bankruptcy modification is really a defense against systemic risk caused by out-of-control consumer lending.

Mr. SCOTT. Thank you.

Mr. CONYERS. Judge Louie Gohmert?

Mr. GOHMERT. Thank you, Mr. Chairman. And I appreciate the members of the panel. Of course, I have to comment on a few things, one earlier in the panel—in the first panel had comment the bailout bill vote we just showed—just took showed how people feel in the House about the bailout.

I would only submit that had the Senate disapproved the bailout money, then the vote would have been substantially different. This, in the House, was a free vote so people could go back and tell their constituents we voted against the bailout knowing there had to be a vote of disapproval in both houses in order to keep the next $350 billion from being squandered as the first was. My opinion.

As far as the banking business, I am not a big fan of what has been going on by the investment banks. I think they are terribly at fault in much of our crisis these days. But I am very concerned about the community banks who have had very good lending practices and have been caught in the cross-fire between the loose standards of investment banks with the regulators who are now requiring more in reserve.

I met with regulators, and they are saying, well, they are more nervous since—so they are requiring banks to hold more in reserves because of the situation and the chance that more may have to file bankruptcy.

Now, Professor Levitin, I notice in your article—and I want to be fair. But when you say in the your article courts have interpreted the bankruptcy codes mortgage anti-modification provisions to apply only to single-family principle residence mortgages, that is correct. Thus, you surmise from that single-family principle residence mortgages may not be modified in bankruptcy.

All other mortgages may be modified in bankruptcy. Therefore, you draw the hypothesis that, therefore, one would expect that if the market were sensitive to bankruptcy modification, there would be a risk premium for mortgages of the type properly currently modified.

Isn't the truth of the matter that those second home mortgages, in order to be modified, still must require that the principle that is reduced—that difference in the reduction—has to be paid within 5 years? Isn't that correct?

Mr. LEVITIN. That depends on the court. And I think it is important to note that the second homes are really a red herring. The second homes are not the right comparison. It is the two-family homes that are really the good comparison, where you rent out the basement——

Mr. GOHMERT. Yes, but I am talking about this part and why so many deal with courts who say if you are going to lower the principle in these second home mortgages, you have to pay the principle within 5 years. Most people who are in bankruptcy cannot pay that difference in principle within 5 years. Therefore, it really has not had much effect on those situations because they know they are not going to be able to go in and ask for a reduction in principle on the second home because they can't pay that other principle in 5 years.

And I would submit to you that, that is really more the reason that, that has not had much effect. Whereas, what we are talking about in this bankruptcy change would not have that requirement that the difference in principle be paid within 5 years. So I am very concerned about the lending drying up even further. We were told by King Paulson that if we gave all this money to these banks, that credit would just be enhanced, lending would flow. It hasn't.

Banks have done different things with it, of course, as I am sure you well know. Some have bought up competition. Some have used it for bonuses, but they won't come out and say because they say well, it went into the general banking revenue, therefore, we can't say exactly what happened with it.

But most of them have made lending more difficult. We are bailing out the car dealers and yet lending for the—I mean, we are bailing out the car manufacturers, but lending for the dealers is drying up. Lending for car buyers is drying up.

The banks are telling me the regulators are getting tougher because of the economic conditions. We have got to have more in reserve. And all I can see is that if we approve this bankruptcy change where a bankruptcy judge—and there are a lot—and you know what will happen—they will flood into the—you know, of course, you are talking about local bankruptcy judges. But they will find the best judges, because usually there is more than one, and they will push to get the right judge so that they can avoid paying all of the principle that they contracted to pay.

And once banks have no reliance on the principle that they contract for, then the lending is going to dry up even further. And I can guarantee you, just from my 4 years in Congress, we are going to see another big bailout proposal—let us bail them out again. And it will come back to the fact that we dried up more lending by what we are doing today.

And I realize my time has expired. And I am sorry. I appreciate the indulgence. Thank you, Mr. Chairman.

Mr. CONYERS. Does any Member wish to respond? All right. Two responses.

Mr. MASON. If I could just—we talk a lot about the banks and the liquidity issues of the banks and the amounts of money that they might be required to have on hand in terms of dealing with the restructured loan situation.

But I would like to bring the Committee back to the real fundamental problem, which is people are losing their homes. We really want to encourage people to stay in their homes. We don't want to have more homes foreclosed on the market, further depressing the market. We would like people to stay in their homes who can continue to maintain a stream of payments that has been discussed so much here.

And the fear of people somehow manipulating the system really, to me, is not justified. You have to commit your full amount of your income. And, therefore, if you come in with $2,000 of income over and above expenses mandated by the Internal Revenue Service for food and clothing, you have to pay all of that to your creditors.

So even if the principle amount of the loan is reduced, reducing that payment, you still have to pay your excess income to the very same creditor who maintains an unsecured claim. So I think—over 5 years in most of these cases.

And with the frequency of which mortgages turn over now, my guess is that it would be a pretty good deal for lenders if they could have a guaranteed stream of payments for 5 years in bankruptcy compared to a foreclosure situation where a house sits on the market.

Mr. LEVITIN. Well, Congressman Gohmert, I certainly hope you won't crucify me for Hank Paulson's since I want to disavow any responsibility for his decisions.

But I want to address three things that you raised that I think are very important. First, whether mortgages do have to be paid off in the 3 to 5 years of a plan. Secondly, I think the community banks are something that are an issue that deserves some attention. And, thirdly, the questions about how many more filings we will see as a result of passing bankruptcy modification legislation.

So first, the uncertainty. I am sorry. First, the 3 to 5 years repayment. There is actually a lot of disagreement among courts. Most courts that have reported decisions about whether a modified loan has to be repaid within the 3 to 5 years of plan have said, yes, it has to be repaid within those 3 to 5 years. But it is not unanimous. There is only one circuit court of appeals that has touched on the issue. That is the 9th Circuit where panels frequently overrule each other.

This is something that law professors argue about and can reach no agreement. I can give you a very good statutory reading that says that, certainly, that is not the case; that what has to be paid is value, not cash, over those 3 to 5 years. And value can be in the form of a new 30-year note or something. That is what we do in Chapter 11.

But the point is not whether it actually has to be paid in those 3 to 5 years or not. The point is that there is uncertainty that no lender actually knows what a bankruptcy court is going to doa bout that. And I can tell you, underwriting models just aren't this sensitive. They don't—when a financial institution is figuring out what is going to happen in bankruptcy, it assumes that, that modification can and will happen on a two-family property, on a three-family property, even on an investment property.

So I think that it is actually a real thing that we—that we are not seeing the differences. I accept your point that there are some courts that say it has to be paid off in those 5 years. And this legislation would change that. This legislation that is proposed would allow, I believe, up to 40 years. I don't think that we should, therefore, expect that bankruptcy judges would say a loan that has 3 years left on it will become a 40—will get amortized over 40 years. I think, more likely, if it has 3 years left on it, maybe it turns into 4 years.

But the uncertainty is an important point here.

Secondly, about community banks. Community banks really have gotten kind of the short end of the stick in what is going on here. And that is unfortunate because community banks were not the reckless lenders, by and large. They were careful. They knew their borrowers. They did traditional, prudent underwriting. And here they are seeing their large competitors getting bailed out when they are not. That is a very concerning issue.

What is important to note, though, is that community banks, first of all, they have lower default rates, I believe, because they made more prudent loans. And, secondly, they know how to do loan workouts that, as Professor Mayer mentioned, are for portfolio loans. And most community banks don't securitize their loans or portfolio loans. We see a lot more loan modifications working.

So we don't have community banks where—faced with a massive problem of borrowers who can't afford their loans and can't get a workout. Borrowers don't want—homeowners don't want to file for bankruptcy. This is just such a horrible misconception. Bankruptcy is not a drive-by process. This is not fun. This is living for 3 to 5 years on a court-supervised budget. If you want to get braces for your kid, you are going to have to go and bargain about that with the trustee and with the creditors.

Mr. GOHMERT. In your statement——

Mr. LEVITIN. So I don't think—I think people file for bankruptcy because they need to and they have to. They don't do this because they are being strategic. They do it with a great sense of shame, most of them. And it you are concerned about protecting principle, which is something else you raised, you are going have to keep asking yourself how well does foreclosure—that is the alternative that is on the table right now. How will this foreclosure protect principle? It really doesn't.

Mr. CONYERS. Zoe Lofgren?

Mr. GOHMERT. Mr. Chairman, since all of them were allowed to respond to me, might I have a response to——

Mr. CONYERS. You have never been denied in the 111th Congress, but you have come very close to it already. Yes.

Mr. GOHMERT. I will be very brief.

Regarding the comment we want people to stay in their homes. You are right. We want to afford more people the opportunity to stay in their homes. But in Congress, we are supposed to look at the big picture. And what I saw when Speaker Pelosi had all those children up there around the—I was about to tears. It was really a beautiful moment.

But then what hits me was these are the kids that we are saddling with so much debt from what we are spending from this Congress. And now here, we could—if we do the wrong thing through this Committee—keep many of them from ever being able to get a loan to buy a home.

So I want to keep people in their homes, but I do want those loans to be available. And I am hearing from community banks who have, up to now, had good lending practices, we are not going to be able to lend like this any more. We are going to have to cut out so many that we are currently lending to because they won't qualify in the future when we know that a bankruptcy judge can cram down a lower principle.

Thank you.

Mr. CONYERS. Zoe Lofgren.

Ms. LOFGREN. Thank you, Mr. Chairman. I will be brief. This is a very important hearing.

And I have a question for you, Professor Mayer, and I wonder if you could just say yes or no because it is a yes or no question.

You have indicated in your testimony that the Government—Federal Government—is in the position to control the bulk of the workouts without bankruptcy. Is it your contention that in all cases involving Freddie Mac, Fannie Mae, or FHA where we have control that we have the ability to do a modification even where the mortgage has been securitized?

Mr. MAYER. With the safe harbor provision that I put into place, that would absolutely be true.

Ms. LOFGREN. Let me ask you about the pooling service agreement issue that you mention in your proposal. Do we know what percentage of PSAs contain a provision which limits—or prohibit modification?

Mr. MAYER. Approximately a third of pooling and servicing agreements—we have law students in the process of looking at this—we think have explicit limits, but most other—most of the remaining ones have implicit——

Ms. LOFGREN. Okay.

Mr. MAYER [continuing]. Rules which are very hard to determine and are generally viewed as also restricting modifications.

Ms. LOFGREN. And do we know what percentage have been securitized?

Mr. MAYER. Of mortgages?

Ms. LOFGREN. Yes.

Mr. MAYER. It is about standing mortgages today, it is somewhere between 7.5 and 8 million as of October of this year, of the roughly 55 million that are outstanding.

I have my written testimony has documentation for all those numbers.

Ms. LOFGREN. All right.

I am wondering, Mr. Certner, if you know—it was kind of a parade of horribles that have been pulled out in the concept of changing this bankruptcy law, but we have maybe an opportunity to look at a real-life implication.

We changed bankruptcy law relative to farms and also, in the consequence, houses on farms. When we did that, do you know what the impact was in terms of lending for farm housing? And did it have the kind of adverse impact that is being fussed about here today?

Mr. CERTNER. I think the studies that look at that have no way of validly making that assessment, and I can talk about the details of that, but I think I would speak for most sort of academic economists that you can't look at changes over time when lots of things are happening at the same time.

Ms. LOFGREN. Well, that is always true, but one of the things we know is that the economists today also look at real-life examples to sample some——

Mr. CERTNER. Right.

Ms. LOFGREN. I wonder if either Mr. Certner or the other professor has an opinion.

Mr. MAYER. Yes, I think the—and I don't know that I have seen any of the studies or details on that, but I—I think what we can say is it did help the—the family farmers when the act was done back in 1986, the Family Farmer Bankruptcy Act.

And I assume that Congress deemed it to be fairly successful, because we basically ended up after using that provision in the crisis for farmers ended up making that a permanent part of the bankruptcy code.

Ms. LOFGREN. Right.

Mr. MAYER. In 2005, 20 years later.

My assumption from that is that this was a very successful program, and it has not adversely impacted the market but helped people.

Ms. LOFGREN. Professor Levitin?

Mr. LEVITIN. That is correct. I agree with Professor Mayer that it is hard to pinpoint a result, but I think we can say this very clearly.

The sky didn't fall after Chapter 12 was enacted—that farmers are still able to get credit, and the—you know, we are growing crops, and they are getting credit for it—that the—the parade of horribles that was trotted out just didn't materialize.

Ms. LOFGREN. I would just like to make a couple of comments and then let my colleagues ask their questions.

Much has been said in the Congress about this Hope for Homeowners program, and we had hope for the Hope for Homeowners program.

But I asked my staff to take a look at the FHA reports, and the FHA tells us that in the United States of America to date, only 370 applications have actually been accepted under that program, and zero mortgages have been modified. So I think it is important as we discuss what to do next that, that be remembered.

And just a little bit about the need—where we are with the banks needing to have their capital in place. It is important to think about what is really happening in the real world.

And in California, I will just give you an example that came in to my district office recently, of someone who bought their house for $700,000. They put up equity. It wasn't just, you know, that they didn't put—have a stake in it.

You know, there has been a lot of unemployment now coming in. And there was also cancer in the family. So they are having a problem meeting their mortgage. Their monthly payment is over $4,000 a month.

They paid $700,000. The house is probably now worth $200,000, maybe. They could pay probably $2,000 or $2,500 a month if they could restructure in some way.

They couldn't get an answer from the loan servicer, so the house was foreclosed. They are out of luck, and the bank is getting nothing, and the bank has gotten nothing for 6 months.

So to say that the bank isn't going to have a capital problem through foreclosure is simply not the case. If you extrapolate that out across the country, the banks are going to lose a lot of money.

And I personally think the sooner we wash those losses through the system, and understand how much has been lost, and put a floor under it, the better off we are going to be, where we can move forward.

We are not going to have the same kind of mortgage market in the future that we have had in the past. And that is just a fact. It is going to be harder to get credit. And families are going to struggle more to become homeowners. And I say that with some regret, but that is obviously the case.

So it is important that we move forward. I personally think that some kind of bankruptcy provision must be a part of this answer. I was very interested in Congressman Marshall's comments.

The idea of having some kind of equity sharing if there were a cram down, at least during the life of the plan, so if an asset appreciates that the lender could also benefit from that—I think that has—at least should be considered.

I am also interested—and you don't need to answer now, but we have FHA and VA guaranteed lending. I am wondering whether those guarantees ought not to also travel into the bankruptcy court.

And I am also very interested in Congressman Marshall's comment about eligibility if we were to do something here. You know, I will be honest. I really think if it were up to me, I would just remove the whole thing.

But I think we might be able to come to some point of compromise here, where we talk about existing mortgages and move forward. So those are my thoughts.

And I would ask unanimous consent, Mr. Chairman, to put this FHA report into the record.

Mr. CONYERS. Without objection.

[The information referred to follows:]

FHA OUTLOOK

SINGLE FAMILY OPERATIONS

December 16-31, 2008

CONTACT INFORMATION
WILLIAM F. SHAW 202-402-7550
ZENORA HINES 202-402-7544

Applications

- Once again the seasonally adjusted annual rate for applications rose to a historic high. During this period the rate was estimated to be 4,315,200 – a bit above the rate for early December (4,123,500).
- By actual count, application receipts were very high for this time of year – 141,571.
- This is 3.6 percent above the previous period and about 3 times higher than the same time last year. Most were refinanced transactions taking advantage of the very favorable interest rates. So far this fiscal year 630,183 were received – more than twice that recorded for this quarter last year.
- 141,571 applications received this period were broken down as follows: 45,816 purchase cases, 89,465 refinances and 6,290 reverse mortgages. The refinances consisted of 30,596 FHA to FHA, 58,522 conventional to FHA conversions and 347 delinquent conventionals. 50 Hope for Homeowners applications were included in this refinance total.

Endorsements

- 63,679 mortgages were endorsed and they included 35,868 purchase money instruments, 23,144 refinance mortgages as well as 4,667 HECM. Of the refinance group, 4,425 were prior FHA's, 18,685 conventional conversions and 34 delinquent conventionals. With respect to the prior FHA's, 2,445 were streamline without appraisal and 612 streamline cases with appraisal and 1,368 that required full processing. For the total refinances 7,427 were cash out transactions accounting for 32.1 percent of all the refinances.
- As for the purchase cases that were insured, 27,599 covered first time home buyers making up 76.9 percent of the purchase transactions.
- No Hope for Homeowners cases have been insured to date.
- 45,528 endorsement were handled under the Lender Insurance program – 71.5 percent of the total insured.

Automated Underwriting

- During December 111,891 cases were processed and insured with the FHA score card. That represents 85.9 percent of all the cases insured during the month.

FHA OUTLOOK

SINGLE FAMILY OPERATIONS

December 16-31, 2008

FISCAL YEAR COMPARISONS

	PROJECTIONS FY 2009	FY 2009 TO DATE	FY 2008 TO DATE	RATE OF CHANGE 2009/2008	FY 2008 FINAL
TOTAL APPLICATIONS: *	**2,500,000**	**630,183**	**297,625**	**111.7%**	**2,008,157**
Purchase	1,000,000	248,296	113,098	119.5%	977,550
Refinance	1,300,000	337,811	146,183	131.1%	885,972
Prior FHA	287,300	80,411	22,784	252.9%	147,992
Conventional to FHA	1,007,500	256,189	120,063	113.4%	727,225
Conventional to FHA (Delinquent)	5,200	1,211	3,336	-63.7%	10,755
H4H (HOPE for Homeowners)		370			
HECM	200,000	44,076	38,344	14.9%	144,635
TOTAL ENDORSEMENTS: *	**1,750,000**	**436,940**	**169,080**	**158.4%**	**1,199,624**
Minority	525,000	117,863	48,906	141.0%	322,002
% Minority	30.0%	27.0%	28.9%	-2.0% #	26.8%
Purchase	**901,000**	**261,439**	**82,512**	**216.8%**	**631,667**
% Purchase	51.5%	59.8%	48.8%	11.0% #	52.7%
1st Time Home Buyer	721,000	201,737	65,501	208.0%	492,295
% 1st Time Home Buyer	80.0%	77.2%	79.4%	-2.2% #	77.9%
Non-Minority	469,000	125,083	41,223	203.4%	319,449
% Non-Minority	65.0%	62.0%	62.9%	-0.9% #	64.9%
Minority	223,000	63,577	21,256	199.1%	144,623
% Minority	30.9%	31.5%	32.5%	-0.9% #	29.4%
Not-Disclosed	29,000	13,027	3,021	331.2%	28,218
% Not-Disclosed	4.0%	6.5%	4.6%	1.8% #	5.7%
Refinanced	**683,000**	**147,848**	**61,882**	**138.9%**	**455,803**
% Refinanced	39.0%	33.8%	36.6%	-2.8% #	38.0%
Total Cash Out	239,000	51,674	26,205	97.2%	166,475
Total % Cash Out	35.0%	35.0%	42.3%	-7.4% #	36.5%
Prior FHA	150,400	25,650	10,335	148.2%	95,287
Streamline	102,400	16,744	5,640	196.9%	66,785
% Streamline	15.0%	11.3%	9.1%	2.2% #	14.7%
Full Process	48,000	8,906	4,695	89.7%	28,502
Cash Out	23,000	4,666	2,921	59.7%	16,424
Conventional to FHA	525,800	121,955	51,309	137.7%	356,722
Cash Out	212,000	47,008	23,104	103.5%	150,051
Conventional to FHA (Delinquent)	6,800	243	418	-41.9%	3,794
HECM	**166,000**	**27,653**	**24,686**	**12.0%**	**112,154**
% HECM	9.5%	6.3%	14.6%	-8.3% #	9.3%
HECM First	158,000	26,634	23,447	13.6%	107,719
HECM First ARM	154,800	26,052	23,194	12.3%	105,144
HECM Refinance	8,000	1,019	1,239	-17.8%	4,435
% HECM Refinance	4.8%	3.7%	5.0%	-1.3% #	4.0%
HECM Refinance ARM	8,100	1,000	1,227	-18.5%	4,342

Source: * F17 CHUMS # - Percentage point difference

Ms. LOFGREN. Thank you for this——

Mr. CONYERS [continuing]. So ordered.

Ms. LOFGREN [continuing]. This hearing.

Mr. CONYERS. Gregg Harper?

Mr. HARPER. Thank you, Mr. Chairman.

I have a question, Professor Mayer. Professor Levitin argued that the bankruptcy process will actually reduce uncertainty. Do you have any position on that argument or position?

Mr. MAYER. Yes, and I agree to some extent it will reduce uncertainty, but it will do it in a way that is extraordinarily costly, which is it will ensure that lenders bear much bigger losses than they would others.

Mr. HARPER. Okay.

Mr. MAYER. And that is not exactly the way of uncertainty we would like to—the way we want to reduce uncertainty.

The second thing is it puts a floor—sorry, puts a ceiling on the lenders' recoveries, but one of the things we know about bankruptcy—all of the comments here keep talking about bankruptcy as this process that reduces uncertainty and everything works out fine.

All the evidence we have suggests that is just simply not the truth. So what we are doing is putting things into a process where most things fail. That is the track record. And we are hoping that somehow it is going to get better.

What it may well do is continue to push the problem in the future. And as these loans re-default and run into trouble again, it actually is going to put a ceiling on our recoveries and lead uncertainty to be even lower than before.

And I would just sort of highlight again, if one wants to just do—evidence, what happened to the financial institutions the morning after Citigroup's agreement—this legislation was made public. The stocks of all the financial institutions fell appreciably.

And I think to say that something is in their interest—the institutions—I think these are sophisticated enough institutions to understand what is in their interest.

I don't want to subsidize them, but I don't want to dump on them losses that they, you know—that will hammer all of us in the process.

Mr. HARPER. And I certainly want to thank each one of your time and your presentation, and certainly your expertise. It has been very helpful. And if you have addressed this, I apologize.

But what happens in the event you go through this process, you do a cram down, they get—they go through it successfully, then 4 years later, let us say, they sell the property for a significant profit? What happens to that gain?

Mr. LEVITIN. If it is during the course of a plan?

Mr. HARPER. After the plan.

Mr. LEVITIN. Okay, because this is actually an important distinction, and I am sorry that Congresswoman Lofgren isn't here to hear my answer on this, because during a plan, any income, including from a sale of a property, is going to go to creditors.

So if it is a 5-year plan, if there is an appreciation in those 5 years, that appreciation goes to the unsecured creditors, which include the deficiency claim on a cram-down mortgage.

Mr. HARPER. Certainly. But after that is completed.

Mr. LEVITIN. Afterwards, any appreciation is going to be kept by the debtor. And I think it is important to note, though, that if there was a foreclosure, the creditor doesn't get any appreciation.

Once that property is sold, there is no appreciation on it in a— in the foreclosure sale. So whether it is better for the debtor to get the appreciation or have some sort of a shared appreciation or a clawback—I think there are some good arguments to have about that.

But I am not sure that the creditor necessarily has the better claim to that appreciation, given that their—it is just crucial that the—you understand the framing here was not no loss versus bankruptcy-modification loss. It is foreclosure versus bankruptcy-modification loss.

In that case, you know, it is looking like—it is looking a lot—the creditor doesn't have any real expectation of getting—of getting appreciation.

I also just want to note—this is important—that Professor Mayer noted that the next morning after the Citigroup deal was announced that financial institution stocks fell.

But if you go back to when the announcement actually happened that day, if you look at like the next half hour after the announcement—and we assume that we have pretty efficient markets that trade on information pretty rapidly—Citigroup's stock went up about somewhere between 1 and 2 percent. So did its competitors'. So did Bank of America, J.P. Morgan.

To look at the next morning—there is all kinds of other stuff happening. If you look right after the announcement, once it went—was made public about the Citigroup deal, bank stocks went up.

Mr. CONYERS. Sheila Jackson Lee?

Mr. MAYER. May I also answer that question? Thankyou. I do think that equity sharing is an important thing to think about in the process, although I—you know, continue to think that the sort of question of who is to gain—if I made you a loan on a house, and you haven't made all the payments on the mortgage, and the house goes up in value subsequently, I don't understand the argument that given that I made you the loan that, that moneywould be due the borrower and not due the lender.

It is the fundamental basis of secured lending that if you lend on an asset and you haven't made your points in full and paid off your asset that the value and any gains of that before the lender takes any losses are clearly due the lender, not the borrower, so I don't understand the basis to which we would say that the homeowner should get the appreciation after a cram down, not the lender who has just had their interest destroyed in the process.

So I think if I am not going to pay my mortgage in full—and I completely agree with the idea of reducing payments and keeping people in their houses. I couldn't agree more with that principle.

But the idea that what happens afterwards is that windfalls from that don't go to the lender with the losses—that is exactly the reason that lenders are facing big hits on this.

And by the way, I would say that Citi's stock isn't relevant. It is the stock of the other lenders who aren't reliant on the Government, and the private market lenders got hammered that day by middle of the morning.

Mr. CONYERS. Sheila Jackson Lee?

Ms. JACKSON LEE. Let me, first of all, thank all of the witnesses, for their presence here today, late on a Thursday afternoon, speaks to the crisis and the pending necessity to move quickly.

I think this should be the theme of this particular hearing, although we respect the disparate viewpoints.

And, gentlemen, I enjoy an academic discussion. In fact, I miss my days in law school. But I would suggest that we have gone beyond an academic discussion.

Let me just put on the record something that has already probably been put on the record, but let me just read it to you. During 2007 through 2008, mortgage foreclosures were estimated to result in a whopping $400 billion worth of defaults and $100 billion in losses to investors in mortgage securities—my sympathies don't fall too much in that direction, but let me just add that—translating into roughly one per 62 American households.

The current foreclosure rate is approaching heights not seen since the Great Depression. I think that sometimes we don't reinforce that, because there was a period of time in the last couple of months in the previous Administration where there was a hesitancy to use the word recession, and certainly no one wanted to use the word depression.

All of us can't count much of our time having spent—being spent during the Depression, but the stories we read about it—we know that, that was a horrific time in American history.

The glut of foreclosures has adversely affected new home sales and depressed home values generally.

And, Mr. Levitin, that is where I want to go with my questioning, because I think there is a lot of caution and doubt. And if we go on the words of our President, one of the things that we know is that the Federal Government is the last resort, the last big spender, and of course a lot of people run out of the room when they hear that.

But we also know that we are at a point where the Federal Government has to be the one that either frames or infuses capital into the market. We did that with the TARP. We have some guidelines on this second point, second portion that I think—hope you will go back and study—$100 billion for mortgage workouts is sort of instructing the Administration and banks that that is what Congress wants to have happen. To get servicers to service those mortgages.

So my question is, most of the victims, or many of the victims, and I am sympathetic to California and other places, very much so, but what I like about the two bills before us, and I would like your comment on it, is that it is not limiting to where you can say that you have concensus that have enormous amounts of foreclosure. Because there are other states where the foreclosures are there and there are families that need it, but they might not meet, say, a threshold that might be made by legislation.

In the bankruptcy bills, it allows, if I am—as you have read these two bills, individuals to go to the courts and be addressed on their merits, which I think the banks should appreciate. I assume the bankruptcy courts will use the standards that they have typically used, fraudulent persons, others who are glaringly abusing the system will be noted in a bankruptcy proceeding.

And so I want to have you comment on that part. That there is a fairness because you have the courts actually assessing an individual's plight. For example, I had—there is a story about a $700,000 homeowner. I have got a person making $18,000 a year living in an apartment as an able apartment owner—or not owner, a renter for eons of years, 20 years, and finally was pulled out of it, of course, during the period when they were giving mortgages, but they sign an adjustable rate mortgage. They might have survived on just a regular mortgage over 40 years. But they signed an adjustable rate mortgage.

They are in the crux of a foreclosure—a potential foreclosure proceeding. They would benefit. Keeping their little bungalow, keeping the $18,000 a year job, hoping that they can and not being laid off. Microsoft laid off 5,000 people. And not making that block or that neighborhood get any worse.

Would you comment on that individual aspect and the fairness of it for a bankruptcy proceeding? And would you add to that how we can make sure how this bankruptcy proceeding might be helpful to the low-income homeowners and others who are probably going to get lost in the crunch?

Mr. LEVITIN. Bankruptcy empowers debtors to take control of their own fate. Right now, when homeowners are dealing with mortgage servicers, they are really at the servicer's mercy that it can be everything from just if you are working two jobs, trying to get to a mortgage servicer, when you are just waiting on the phone for hours, you can't do that. There is—you have no control over it. And even if you get through to the servicer, you don't know if they are going to offer you any kind of reasonable deal.

They might say, "Sorry, my hands are tied by a contract to which you aren't a party." The bankruptcy cuts through that, it empowers homeowners to save themselves. And that is very important.

It also is very good at screening out abusive debtors. That there are some good, there are some people who take advantage of the bankruptcy system and act strategically. By all accounts, it seems like they are very few, but unfortunately they often become political poster children. But most debtors are not abusing the system and we, especially after 2005, after the bankruptcy abuse prevention in—I can't remember if it is Consumer Protection Act or Creditor Protection Act, that we have even stronger statutory provisions to weed out abusive debtors.

Bankruptcy really is not going to result in wealthy debtors getting a free ride. Instead, most debtors are really pretty low income, that your average bankruptcy filer in 2007 had an income of something like $35,000. That is not a wealthy person.

Ms. JACKSON LEE. May I just finish, and I thank you for you that, by asking this question for all of the panelists? When you look at the two bills that we have, what would each of you add that would refine the process and add to the fairness quotient of each of those bills, across the board? Let me start with Mr. Mason?

Mr. MASON. It seems to me that one of the issues raised here today is the issue about appreciation. While I think it is somewhat of a red herring kind of an issue, I guess there is some merit to some sort of voluntary agreement between the lender and the borrower for some future appreciation. I could see that as a possibility. I don't think that would affect the ability of the borrower to reorganize their debts, and I think that is certainly one possibility that could be done.

I would also like to go back to your point, however, about the $18,000 income kind of a person. Before I came here, I spoke with someone from the Southwest Detroit Housing Coalition, and she was saying that she is now starting to get debtors from outside the county, who used to work for auto suppliers, who have lost their jobs. And these are people with—making $10 an hour.

And I asked, "Well, what about the modifications we are offering?" She said, "Well, a point or two in the interest rate won't keep them in their homes."

And I said, "Well, what if they were able to reduce the principal balance on the mortgage and rewrite the mortgage to a fixed term at a competitive interest rate? Would that allow them to stay in their homes?" She said, "Absolutely, yes."

Ms. JACKSON LEE. Thank you very much. Mr. Mayer? It is a provocative point, Mr. Mayer.

Mr. MAYER. Thank you.

Ms. JACKSON LEE. I am sorry. Did I pronounce it right? Or is it Mayer?

Mr. MAYER. Mayer.

Ms. JACKSON LEE. Mayer. Excuse me. I am sorry.

Mr. MAYER. That is okay.

Thank you.

The first thing I would do is put in a safe harbor and eliminate all restrictions on modifications in all pooling and servicing agreements to allow servicers to do as much modification as possible.

The second thing I would do, and I know this isn't an appropriations bill, but I would try and find some economic incentive to deal with the servicers, to get them to modify loans. That is where half the foreclosures are.

And the third thing is, if we are going down this route, I really feel as if we should deal with the payments, but not get rid of the secured claim by the lenders. So if one wants to write down the payments for some period of time for somebody to get into the mortgage, I think it is really important not to cram down the balance on the owner of the property.

Ms. JACKSON LEE. Thank you. Mr. Certner?

Mr. CERTNER. Ms. Jackson, we think both bills would be helpful that are before the Committee today. Of course we support the bill that provides a broader relief right now.

To consumer fees, I appreciated your comment about listening to this academic argument. And we are here today to have an academic argument. We are here because we are hearing from hundreds of thousands, maybe millions, of our members who are facing foreclosure. And as you know, this is devastating to them personally. This is devastating to them not just in their current economic security, but for their future retirement security. It is devastating to their communities. It is often devastating for the families who have to come in and pick up the pieces.

Our members are looking around at the hundreds of billions of dollars that are being given out in TARP and in other parts of the efforts of Congress to get toward economic recovery, and many of these people who are facing devastating foreclosures, sometimes over predatory mortgage lending practices that you well know should not have been committed over these many years and wondering when the relief is going to get to them.

And this is maybe not the only kind of relief that I can get them, but this certainly should be one component of the relief. And we urge you very strongly to move forward in getting this relief to the individuals who really want to see relief at the local level.

Ms. JACKSON LEE. Mr. Levitin, thank you.

Mr. LEVITIN. Certainly. As between the two bills, I personally prefer Chairman Conyers's bill, that would offer a lot of relief.

Ms. JACKSON LEE. What would you add if you could?

Mr. LEVITIN. Well, what I would add, if you were truly concerned about shared appreciation, you could lengthen the period under which—of a bankruptcy plan, make it, say, 7 years rather than a maximum 5 years. Most mortgages are typically refinanced within a 7-year period anyhow, so looking at appreciation over a 30-year period is not what creditors are assuming in the first place.

But for shared appreciation, it is important to realize that with securitized loans, who gets that shared appreciation? Typically, that goes at—any shared appreciation would go back, not to the investors, there might be pension plans and mutual funds, but it goes back to the originating lender. Now that is the bad actor that may have fraudulently underwritten a lot of these loans in the first place.

So if we have shared appreciation, we need to be very careful that we don't reward bad actors with it. That is a real danger.

But in terms of overall improvements though, I think that there is something to what Professor Mayer says, about thinking about this, about how bankruptcy fits in a larger picture. Professor Mayer's proposed a bunch of carrots to try and create incentives for lenders—for servicers to act. Bankruptcy, as Representative Miller described it, is a stick.

There is no reason we have to have carrots and sticks separately. We can use both of these. And actually they might be more effective combined. You can imagine a plan that both offers—sort of has a clean-up period of, say, 3 months under which servicers have to get their act together and do modifications voluntarily. And if they don't, then the stick comes out. And the stick doesn't need to be limited to bankruptcy modification. It could also be prohibiting the Fannie Mae and Freddie Mac from doing future business with servicers that don't don't comply.

There are lot of tools in the toolbox. Bankruptcy is an important one, but it is not the only one, though.

Ms. JACKSON LEE. Thank you, Mr. Chairman. I think the point is well taken that the house is on fire and this bill is a hose that is probably long overdue, but we have got to get the water where it needs to be. And I want to move this as quickly as possible. And I think, Chairman, our people are suffering out there. Thank you very much, I yield back.

Mr. CONYERS. Maxine Waters.

Ms. WATERS. Mr. Chairman, I want to thank you very much, again, for making this issue your number one priority and holding this hearing today. And I would like to thank all of our witnesses who are here today for taking time from your work to be with us.

Let us be clear, I support loan modifications and bankruptcy, period. Period. And I will tell you why. Because I know about everything else that has been done and is being done now.

How many of you know about the Hope Now Program? Do you understand what that is?

How many of you think it is working?

I am glad none of you think it is working. You didn't raise your hand because the Hope Now Program is the volunteer program that was put together by the Bush administration, and it had all of the financial institutions at the table, and they are using the hired, certified counselors to go out and help people and they hold town hall meetings, they will come to us if we request them to come. And at town hall meetings they claim to be able to help people do loan modifications.

When we went on break, I had about 12 of them in my office, certified loan counselors, and I asked them, "Are you really helping people do loan modifications? Because I do this work, I understand how it is done. And I want to know if you can sit here and tell me that you have been successful," I said to them.

And they all admitted, for the most part, no. We are not.

And I knew why they were not successful.

Number one, they were not trained to do and understand how loan modifications really get done and what real loan modifications are. And the servicers don't have to talk to them. The servicers have a completely unregulated industry. And they don't have to do anything.

And in addition to that, not only do they not respond to these counselors, you can hardly get them on the phone.

Now, Mr. Mayer, you seem to believe and have come to the conclusion that there is some difference between the independent servicers and their willingness and their ability to do loan modifications and the big banks, or banks who do their own servicing of their loans. Now the difference in all of this is, and the difference is between the small independent banks, and you are absolutely correct, they don't have much in their portfolios. They didn't really do this kind of lending that has created this crisis. And, yes, if we had the kind of community banking where they held the loans, Ms. Jones could go in and talk to her banker, who knows something about her. They could do the loan modifications a lot better.

But have you ever tried to talk with the servicers of Bank of America? Of Wells Fargo? Of Countrywide? Have you ever done that? Anybody?

No because most of this is academic. If you watched Nightline last night, you saw that they covered what I do in my office. They stayed in my office for a day and a half. For a full day, they watched me work on three cases. I am working on about 30 of them now.

I have been advised by the Ethics Committee not to do this work. But I have said to anybody who would listen, I don't care what the

Ethics Committee is saying. I am going to do this work. I am going to do this work because people are losing their homes. Their families are being destroyed. And communities are being destroyed. So I have one person in my office dedicated in Los Angeles, and whether I am in LA or there, I continue to work on loan modifications. So I dial, and I dial Bank of America.

First of all, they are understaffed. You stay on the phone for hours. As a matter of fact, I called the CEO of Wells Fargo after I stayed on the phone 1 hour with his servicing company, a separate entity, awaiting for them to come. They play music and the recordings go over and over again to tell you to wait. That is number one.

The average homeowner cannot negotiate with this mess. Waiting on the phone while some people are at work every day and they are trying to call a servicer on their lunch hour or steal some time from their employer to try and get it straightened out.

They are understaffed. And guess what? The servicers are undertrained. You could not, for life of me, tell me what the definition of a loan modification is because there is none. And we have servicers at some of these companies, first of all, they try to have a cookie-cutter thing for them to follow.

They can't tell you what to do, how they would do it if you throw a little something extra in there, extra problem in there. They are not trained. You cannot get to them easily. And they can't really do great loan modifications. Do you know what I have run into? I have run into people who have mortgage interest rates at 10.5 that they got in 2006 and 2007 when the market was at about 6 percent or 6.5 percent.

So there are predatory loans, and they should be written down immediately to 4 or 5 percent. They don't do that. They don't reduce that for the most part. We know that Hope Now does not work. Hope for Homeowners, that is the Chairman's bill of the Financial Services Committee says to the banks and the financial institutions if you write these loans down, I think, at about 10 percent, we will help you to get FHA financing. We restructured and strengthened FHA to be able to do this.

The banks are not taking advantage of this at all. And guess what? If this written-down loan refinanced by FHA is defaulted upon, we pick it up. The Government will pay for it. Now, I want you to tell me why the financial institutions are not taking advantage of that.

Finally, let me say this. We know that Sheila Bair has hit upon something with the IndyMac portfolio. We know that she is paying the servicers a thousand dollars. We know that she has done about 6,000 modifications, more than anybody, really. And able to talk about what she has done.

When she sent the letters out to the homeowners, she didn't say, just come in and talk to us as Countrywide did. And that is why Countrywide got no responses. As a matter of fact, they shouldn't even be working on the loan modifications because they were the biggest predatory lenders in the country. Now, they are working on their own loans, for the most part.

But Sheila Bair's letter said, come in; this is what we can do for you. You have an interest rate of 9 percent. We can reduce that.

Come in; you have an adjustable-rate mortgage. And I want to tell you, Mr. Mayer, you talk about people not being able to pay their mortgages. The average person with a 30- to 40-year loan with a reasonable interest rate can pay for their mortgage. And that is what they thought they bargained for.

Unfortunately, there are those who didn't understand adjustable-rate mortgages. They didn't know about these exotic products. There were those who were offered Alt-A mortgages. They didn't know before they talked with the loan initiator that there was such a thing as getting a mortgage without having to verify your income.

You may say it is the people's fault, but I don't think so. These are predatory loans. These are fraudulent loans where Countrywide and others put initiators out in the street without license. And California was a problem in this because we didn't require licenses of all these people on the street.

And so they are in trouble mostly on Alt-A and adjustable rates. Exotic products that should never have been in the marketplace in the way that they were. You take Ms. Jones or Mr. Jones who works everyday, who makes a decent salary working over there at GM or someplace, they can pay for their loan. But when you gave them an adjustable-rate loan where you suckered them into for little or nothing down and it resets in 6 months, 1 year, 2 years, and it doubled, quadruples, those margins that they put on top, you are right. They will not be able to afford them.

But because Wall Street was greedy and they securitized all this junk and they put it in these traunches and they allowed them to invest in it, then I tell you, Mr. and Mrs. Jones got tricked. They got hoodwinked. They got misled.

So I am not here today to try to convince anybody of anything except we should all get on the same track with the correct information. And to say that people who work every day, who got into this mortgage because they believed in the American dream of homeownership are not able to pay for that home is not a correct statement. They are able to pay for it if they had a decent and reasonable mortgage that they contracted with.

What I would like to hear is when you talk about whether or not you are concerned about whether their lenders share in the appreciation, well, we are in a crisis and we—I don't even know how to talk about appreciation when 50 percent of these loans are under water now. We should be doing mark to market. We should be writing down all this mess, all of this crap.

But let me just say this that we should be talking about what we do with regulatory agencies to keep exotic products off the market that is going to get people into trouble. There are some folks who would say we have no right to examine the products before they go on the market. We should have been all over adjustable-rate mortgages.

We should be all over what the margin is when that margin readjusts. We are way behind, and it is shameful. And I am very ashamed of the fact that we have not been able to do what we should have done almost a year ago in getting on top of this. And we watch the defaults and the foreclosures continue to multiply, destroying whole communities.

And the banks are not keeping up the property. The roofs are falling in. Gang bangers are taking over houses. The weeds are growing up. The waters—the basements have water and the mold is setting in. And we are worried about whether or not they are going to share in the appreciation?

If it was left up to me—and let FOX News get this right—I would nationalize the whole industry.

I yield back the balance of my time. You don't have to say anything if you don't want to.

Mr. CONYERS. Well, maybe you should say just a little something.

Mr. MAYER. Ms. Waters, first, I would say I appreciate all your passion for this and also that you really are doing something that is important to help homeowners. And I have written substantially on the impact of subprime, on where it was located, and to whom it is coming. And you will see more research very soon that looks at that question. And it is depressing.

But this is about getting out of the crisis. In many cases, the servicers were contractually prohibited from modifying a loan until it defaulted. There are terrible provisions in these pooling and servicing contracts. It has nothing to do with whether the servicers were good people or bad people. Their contract said this is what you have to do. And they were following the contracts. And they are bad contracts.

And I have proposed that we get rid of these restrictions that are stopping us from modifying loans. So this is—I think, this is sort of a significant problem, and this is not an academic exercise. There is real evidence that people lending their own money have behaved differently, work out loans more frequently, and stop foreclosures more. Real evidence from what is happening that suggests that that is true.

So I do think that this is a serious problem, but I also think that, you know, much as I would like to wipe out everything, if we were to wipe out all the negative equity in this country in housing, we would be looking at $2 trillion to $3 trillion—actually, probably more than that.

That $2 trillion to $3 trillion, the Federal Government can't even run Fannie and Freddie right at the moment. Hopefully, the new Treasury will be able to be effective at this. But how are we going to run Citi? How are we going to get them to make sensible decisions? We are just incapable as a Government of running the financial system nationalized.

And the idea that we would just take losses of $2 trillion to $3 trillion is just simply an extraordinary thing. I think we have to get out of this crisis. We have to stop foreclosures. But I think there is a way—there are ways to do it without completely bankrupting our financial system and taxpayers.

And I think——

Ms. WATERS. No. I think you go too far when you assume that we can't do loan modifications and the banks still make money.

If you take a look at what the market interest rates are now and you take a look at the interest rates that many of our homeowners are saddled with, and the take a look at how much money has been made on these extraordinary interest rates by a whole lot of people up the line, the reduction to 4 percentage points now would not be sacrifice at all.

And I do believe that we could do more wholesale reduction of interest rates similar to where Sheila Bair is going with some of this and still they will not lose money.

Mr. MAYER. Sheila Bair, even with her own performance at IndyMac, was unable to modify loans that IndyMac had as a third-party servicer when she could do them as her own loans.

These contractual restrictions are really serious, and Sheila Bair said so as running the FDIC. So the kinds of things she was doing were things that she did with IndyMac's own portfolio. But the securitization portfolio, she couldn't do it.

Ms. WATERS. Well, what we are finding is, first of all, they are not any contracts that say you may not modify loans. They are just a very few of those. I have done a lot of them. And it has only come up, you know, very seldom that they are written in the contract.

What you are referring to is the ability of the investor to sue the servicer because the servicer did not make every effort to collect the money in the way that they thought they had contracted for it to do. And we are willing to limit liability in these cases. We are willing to do some of that.

And that is really what I want to hear from people as we get on the same track about how to deal with this problem. I am not interested for 1 minute in crying tears of some of these predatory lenders who knew exactly what they were doing. And, as a matter of fact, when you talk about Fannie and Freddie, not many people will say it, but it has been documented that Mozilo over at Countrywide said you will take our crap or we will stop doing business with you.

And in a highly competitive market where they were—they were writing so many mortgages, to talk about squeezing out both Fannie and Freddie, who once had good underwriting standards and fair play, then that is what caused the problem.

Mr. MAYER. Right. I would just make one other comment, which is that they are all—some versions of this bill in the Senate, anyway, restricted the bill solely to so-called subprime and Alt-A loans which are loans which had these adjustable rate provisions in them or negative amortization. Such a provision would deal with them is leading loans and leave away from it the bulk of fixed-rate or much more standard kinds of loan contracts.

So this bill goes well beyond, what I agree with you, were horrible practices by the industry. And somehow, if we could go back and grab all those bonuses and all the other stuff from people who made money, I think we would all agree that they should have to pay a price for having done this. It is just not feasible to do it.

We can't get that money back, but we do have to make the best of the circumstances that we are in and try and help homeowners and protect taxpayers and, as well, not destroy the financial system which is our——

Ms. WATERS. Well, I know that you have been very generous, and I thank you. And we could do that by writing down interest and writing down the principle.

Mr. CONYERS. Trent Franks?

Mr. FRANKS. Well, thank you, Mr. Chairman. Mr. Chairman, first, I would like to ask unanimous consent to place a previously-written statement that I have for the record because I was in another Committee. You and, I think, the Armed Service Committee deliberately try to schedule your Committees all at the same time. This has been my experience.

And so I would like to do that without objection.

Mr. CONYERS. Without objection, so ordered.

[The prepared statement of Mr. Franks follows:]

PREPARED STATEMENT OF THE HONORABLE TRENT FRANKS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ARIZONA, AND MEMBER, COMMITTEE ON THE JUDICIARY

Mr. Chairman, I know that everyone here would agree that we are facing a foreclosure crisis and that this crisis continues to negatively impact the broader economy.

As we search for solutions, I believe we should be extremely wary of the one we are considering today. In the last Congress, we held three hearings in the Commercial and Administrative Law Subcommittee on amending the Bankruptcy Code to allow for modification of home mortgage loans. Throughout those hearings and our consideration of this legislation in the last Congress, I was unconvinced that mortgage bankruptcy legislation was in the nation's best interest. I remain unconvinced today.

In the last Congress, proponents of this legislation continually asserted that bankruptcy relief was the way to go because taxpayers wouldn't have to bear any cost. Bankruptcy relief, proponents asserted, is "costless."

I suspect that same argument will be made today. Yet, no matter how many times the argument is repeated, the fact of the matter is that allowing mortgages to be modified in bankruptcy will impose real costs not only on first-time homebuyers, but ultimately on the U.S. taxpayer.

Through Freddie Mac, Fannie Mae, the Federal Housing Administration, the FDIC's takeovers of Washington Mutual, Indy Mac and other failed institutions, and government guarantees for debt from loans to AIG, Citigroup, and Bank of America, the taxpayer will be on the hook if mortgage cramdown during bankruptcy is enacted. Taxpayers will bear the risks as borrowers move to cram-down the principal on their home mortgages.

This legislation will also impose costs on future borrowers when they look to purchase a new home or refinance. In order to account for the increased risk that mortgage loans will present if they can be modified in bankruptcy, lenders will be forced to alter their lending terms. Lenders will make smaller loans and impose higher costs on borrowers. This will lead to fewer Americans being able to afford to purchase homes in the future.

While some may find this result acceptable, we do not want to limit Americans' ability to purchase housing based on artificial costs imposed by mortgage cramdowns. This is especially the case when we consider that 52 million borrowers are current on their mortgages, while 5 million are delinquent. Mr. Chairman, the vast majority of borrowers are able to make their scheduled payments. Why would we do this knowing that we will put all future borrowers at risk?

Mr. Chairman, this legislation is problematic. It will impose costs on taxpayers, on future borrowers, and I believe will negatively impact other efforts at stemming the foreclosure crisis.

There are many more targeted efforts underway aimed at keeping people in their homes. And we should give those programs a chance to work and allow the housing market to re-adjust rather than turning to unwise legislation that penalizes even those who made economically sound decisions.

I look forward to the witnesses' testimony and yield back the balance of my time.

Mr. FRANKS. And then I would also, if it is without objection, like to insert three documents into the record. The first document is the written testimony of Todd Zywicki. Professor Zywicki teaches bankruptcy law at the George Mason School of Law and has testified several times before the Committee.

The second is the Joint Statement of several leading financial institutions including—including associations—including the American Banker's Association, Independent Community Bankers of America, and the Financial Services Round Table.

And the final one is a letter from the Department of Housing and Urban Development regarding these bankruptcies proposals. In the letter HUD states that these bills will lead to higher mortgage costs for most borrowers.

Mr. CONYERS. There are no objections. So ordered.

[The information referred to follows:]

WRITTEN SUBMISSION OF
PROFESSOR TODD J. ZYWICKI
GEORGE MASON UNIVERSITY SCHOOL OF LAW

HEARING OF THE
SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW
COMMITTEE ON THE JUDICIARY
UNITED STATES HOUSE OF REPRESENTATIVES

JANUARY 22, 2009

It is my pleasure to provide this submission on the topic of mortgage modification in bankruptcy. The nation faces a foreclosure crisis of historic proportions and many homeowners are in deep financial trouble. And there is an understandable desire to "do something" to try confront the problem. Amending the Bankruptcy Code to permit modification of home mortgages must appear especially tempting as a political matter because it doesn't appear to require further expenditure of public funds, thus it appears to be "free" to Washington. Allowing mortgage modification will provide a windfall for some troubled homeowners, but its costs will be borne by aspiring future homeowners and any American who uses credit of any kind, from car loans to credit cards. The ripple effects could deepen the troubles the currently roiling America's consumer credit markets. Finally, because of the federal takeover of Fannie Mae and Freddie Mac, the losses incurred in bankruptcy may eventually come back to the taxpayers anyway.

Called "cramdown" in bankruptcy lingo—because it permits the borrower to "cram the new deal down the throat of the lender"—the ability to modify mortgages in bankruptcy has been allowed for the past thirty years for commercial property, investment properties and vacation homes, and until a few years ago, cars. But it has never been allowed for homeowners' primary residences. Now is not the time to start.

Allowing Cramdown will Increase the Risk of Home Mortgage Lending

Allowing borrowers to rewrite their mortgages in bankruptcy will increase the risk of mortgage lending at the time loans are made. Increasing the risk will increase the overall cost of lending, which in turn will require future borrowers to pay higher interest rates and especially higher upfront costs, such as higher downpayments and points.

Empirical studies of residential real estate markets overwhelmingly demonstrate that there is no free lunch—increasing borrower protections from creditors on the back-end of a loan invariably increases the risk and thereby the cost of borrowing on the front end. And riskier borrowers who are the most likely to file bankruptcy will find themselves particularly adversely affected or even excluded from the market completely (or pushed back into high-cost subprime loans). Those who do get loans will have higher monthly payments than they would otherwise—which could, ironically, make them more prone to being pushed into bankruptcy.

A recent study of the impact of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") confirms this finding in the context of cramdown specifically.[1] Among its provisions, BAPCPA eliminated the power of debtors to cramdown most automobile loans. By reducing the risk of automobile lending, BAPCPA resulted in lower interest rates on car loans for consumers, with the specific effects varying among states.

Allowing Cramdown of Mortgages Could Dramatically Increase Bankruptcy Filings and Have Spillover Effects on Other Consumer Credit

Allowing mortgage modification in bankruptcy could unleash an unprecedented torrent of bankruptcies. To gain a sense of the potential size of the problem, about 800,000 American families filed bankruptcy last year; this year, the weakening economy and rising unemployment has already pushed the number near one million. By recent count, some 5 million homeowners are currently delinquent on their mortgages and some

[1] Donald P. Morgan, Benjamin Iverson, & Matthew Botsch, *Seismic Effects of the Bankruptcy Reform*, FEDERAL RESERVE BANK OF NEW YORK STAFF REPORTS, Staff Report No. 358 (Nov. 2008).

12-15 million homeowners are "underwater" on their mortgages. If even a fraction of those homeowners file bankruptcy in order to reduce their interest rates or strip down their principle amounts to the value of their homes, we could see an unprecedented surge in bankruptcy filings.

Finally, once bankruptcy is filed, it won't just affect the mortgage but will sweep in all of the bankrupt's other debts, including credit cards, car loans, medical debt, and any other debt. Thus, what started as a mortgage problem could have the ripple effect of destabilizing the market for all other types of consumer credit. When combined with the high likelihood that a surge of bankruptcy filings would follow, there could be a serious negative effect on already-precarious credit markets.

Cramdown Will Likely Increase the Possibility of Bankruptcy Abuse

Because of record-low interest rates and the foreseeable prospect that home prices eventually will begin to rise at some point in the future, borrowers have strong incentives to file bankruptcy to strip-down their mortgage principle and reduce their monthly payments with the knowledge that if they sell their house sometime in the future they will be able to capture any appreciation during that period. Traditionally, the ability to modify consumer debt was limited to depreciating assets like cars and boats, thus this temptation for strategic behavior was mitigated because borrowers had little prospect of profiting because the property was unlikely to increase in value in the future. Nonetheless, even modification of car loans was made substantially more difficult by the 2005 bankruptcy law amendments—precisely because it was thought that too many consumers were rewriting car loans in bankruptcy and thereby imposing excessive losses on the automotive lending industry.

Moreover, the primary effect of cramdown will be to increase this potential for abuse. In theory, cramdown permits a bankruptcy judge to modify both the interest and principal on a homeowner's mortgage. But the Supreme Court has noted that to fully compensate the lender, the interest rate on a cramdown loan must be set at the market rate of interest, considering the risk of the borrower and the loan itself. *See Till v. SCS Credit Corp.*, 541 U.S. 565 (2004). A market-based cramdown interest rate would have to consider the unusual nature of the mortgage—including the fact that the borrower himself often was a highly risky borrower to begin with (especially in the subprime market), that the already-risky borrower has become recognized as even more risky by having filed bankruptcy, and finally that the cramdown loan itself has a 100% loan-to-value ratio, the exact sort of high-risk loan that brought the current crisis about in the first place. Given the risk of the borrower and the loan, few borrowers would seem to be actually entitled to an interest-rate reduction if the interest rate is actually set at the "market" rate of interest. This suggests that bankruptcy judges who do reduce interest rates often will be setting the interest rate below the actual realistic market rate. Or, alternatively, that the debtor is seeking mortgage modification for the purpose of writing down the principal on the loan, rather than for an interest rate reduction.

Advocates of mortgage modification believe that concern about an adverse credit mark will deter consumers from gaming the incentives created by the opportunity to rewrite their mortgages. Experience and common sense suggests that this blind faith unfortunately is misplaced. Delinquency and foreclosure also damages one's credit report, yet news reports indicate a growing number of homeowners who are voluntarily walking away from underwater mortgages and allowing foreclosure. And the opportunity to strip-off tens or hundreds of thousands of dollars of debt and to even write-down one's interest rate to boot is one that many homeowners will find difficult to resist.

An Appendix to this submission contains a detailed discussion of the causes of default and foreclosure on home mortgages. Not all foreclosures are triggered by financial distress and a proper remedy for foreclosures must rest on a proper understanding of the causes of foreclosure.

Cramdown of Vacation Homes and Investment Properties are Distinguishable

It is true that current law permits modification of mortgages on vacation homes and other investment properties, but few bankruptcy filers own beach homes and even fewer still are likely to file bankruptcy just to avoid foreclosure on a vacation home (unlike their primary residence). Second homes also are essentially considered business property under the bankruptcy laws, thus while the comparison has emotional appeal it is misplaced as a logical matter. The relative paucity of vacation homes in personal bankruptcy cases also means that any increased cost from allowing modification in bankruptcy is likely to be relatively small and impacting only those wealthy enough to be in the market for investment vacation property. Moreover, lenders knew that they were lending for business purposes when those loans were made and priced them accordingly. This is not the case for residential mortgages.

Conclusion

It is understandable why amending the bankruptcy code to allow modification of mortgages is political attractive, but it is a poor solution for today's mortgage problem. Consumer bankruptcy is a relatively blunt instrument that is designed to give a fresh start to households that have a general debt problem, either because of general indebtedness or some unexpected financial shock (such as unemployment or divorce) that has left them unable to pay their bills. It is not well-designed to deal with the type of surgical intervention implied by the mortgage crisis. Solutions focused on resolving the mortgage problem may be more costly than allowing mortgage modification in bankruptcy, but they are much more likely to be effective and will have many fewer unintended consequences than allowing mortgage modification.

To the extent that it is felt appropriate to nonetheless permit cramdown of home mortgages, it would be prudent to consider the following limitations, among others:

- Limiting cramdown to high-interest loans for which market-based interest rates may actually result in a reduction in interest rates;
- Severely limiting repeat-filings to prevent borrowers from using bankruptcy as a device to stave off legitimate foreclosures;
- Providing for some amount of equity recapture for lenders if the borrower sells the house for a profit after an equity stripdown;
- Making cramdown retrospective only for loans issued before a certain date.

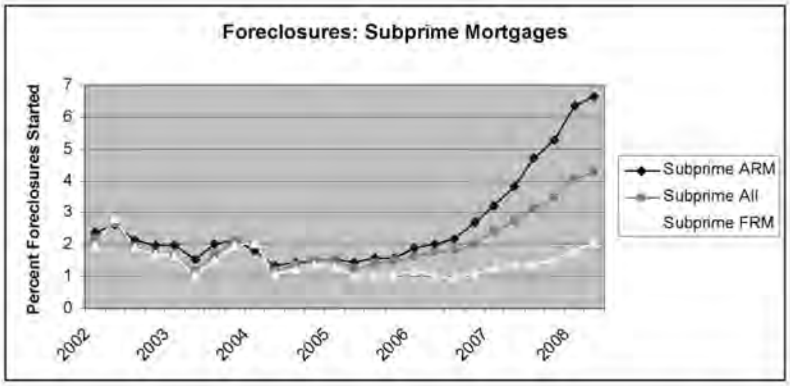
Appendix: Analyzing Foreclosures

Home foreclosures may result from two conceptually distinct, although practically overlapping, reasons. *See* Todd J. Zywicki and Joseph Adamson, *The Law and Economics of Subprime Lending*, 80 U. COLO. L. REV. __ (Forthcoming 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1106907 . First, foreclosure may result from economic distress, resulting in a borrower who wants to keep his home but is unable to do so. This may be an unexpected income shock, such as unexpected job loss, or an unexpected increase in expenses, such as an increase in the interest rate on an adjustable-rate mortgage. But second, foreclosure may result from a debtor's decision to walkaway from a home that has fallen in value and is now "underwater." *Both* theories appear to have some explanation in the current environment. Treating the foreclosure crisis as one of primarily economic distress, however, may open the door to abuse by those who opportunistically avail themselves of bankruptcy in order to game the system.[2]

Interest rate resets connected to adjustable-rate mortgages helps to explain the rapid rise in foreclosure rates. Moreover, it helps to explain the spread of the foreclosure contagion beyond the subprime market into the prime market in many areas. First, consider the trends on foreclosures on subprime mortgages. Figure 4-12 shows the trends for foreclosures starts for subprime mortgages since 2002.

Figure 4-12

[2] The following discussion is adapted from Todd J. Zywicki, *Bankruptcy Law and Policy in the 21st Century* (Forthcoming 2009, Yale University Press).



As can be readily seen, from 2002 into 2006 the foreclosure rate on subprime ARMs was comparable to the foreclosure rate on subprime FRMs. Beginning in 2006, however, the trends diverge, leading to a dramatic rise in subprime ARMs. In fact, although the foreclosure rate on subprime FRMs has risen it actually remains *lower* than at periods in the past. In part this distinction in default rates reflects differential sorting by lenders among subprime borrowers for fixed and adjustable-rate mortgages as subprime ARM borrowers have substantially lower FICO credit scores and higher combined LTV ratios than subprime FRM borrowers.[3] The difference, however, is not huge and it is difficult to imagine that the characteristics of the borrowers alone rather than the characteristics of the loans themselves explain the dramatically different performance of these loans.

But this difference in performance is not limited to subprime loans. Prime loans show a similar pattern of foreclosures (although at much lower base rates), as seen in Figure 4-13:

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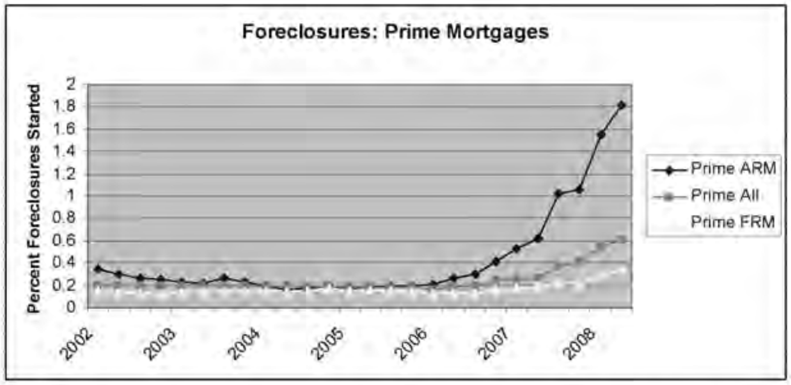
[3] Mayer, Pence, & Sherlund, *The Rise in Mortgage Defaults* at 8.

Figure 4-13



As with subprime loans, prime loans also show a dramatic divergence in performance between fixed and adjustable rate mortgages. Although the foreclosure rate on fixed FRMs is at its highest point during this period, the increase is modest compared to the dramatic rise in foreclosures on ARMs.

In short, the "payment shock" theory may have some validity in the current climate although the mechanism of transmission is difficult to understand. The artificial lowering of interest rates from 2001-2004 pushed down short-term interest rates, allowing borrowers to qualify for larger mortgages than they otherwise could. But this was a phenomenon that was not limited to the subprime market. As during prior times when the spread between short and long-term interest rates expanded, home purchasers gravitated toward adjustable-rate mortgages—both prime and subprime borrowers. As a result, when interest rates began to increase in the 2005-2006 period this may have made payment obligations unaffordable for many homeowners.[4]

[4] This leaves aside the phenomenon of "teaser" or below-market introductory rates. Where teaser rates were present, the impact of payment shock was heightened when the interest rate reset. For instance,

On the other hand, ARM-related payment shock does not provide a comprehensive explanation of all foreclosures. One factor that has been often-cited as a cause of rising foreclosures are so-called "hybrid" mortgages, that have an initial fixed period of two or three years (usually at below-market interest rates) followed by adjustable rates for the duration of the loan. It is contended that these hybrid mortgages are "exploding" mortgages that start with extremely low rates during the fixed-rate period of the loan but then "explode" to extremely high rates after the interest rate reset. But it is doubtful that this phenomenon can explain the rise in foreclosures, at least the early wave. One estimate of subprime loans facing foreclosure in the early wave of foreclosures found that 36% were for hybrid loans, fixed-rate loans account for 31%, and adjustable-rate loans for 26%.[5] Of those loans in foreclosure, the overwhelming majority entered foreclosure *before* there was an upward reset of the interest rate.[6] Most defaults on subprime loans occur within the first 12 months of the loan, well before any interest adjustment.[7] For those borrowers who actually undergo an interest-rate reset, the new rate is higher, but not dramatically so when compared to the original rate.[8] On average,

among subprime loans with initial below-market "teaser" rates, one study predicts that 32% of loans with initial teaser rates eventually will default as a result of interest rate reset, but only 7% of market-rate adjustable loans will default due to reset. CHRISTOPHER L. CAGAN, MORTGAGE PAYMENT RESET: THE ISSUE AND THE IMPACT 44 (2007).

[5] James R. Barth et al., *Mortgage Market Turmoil: The Role of Interest-Rate Resets*, *in* SUBPRIME MORTGAGE DATA SERIES (Milken Inst.) (2007); C.L. Foote, K. Gerardi, L. Goette, & P.S. Willen, *Subprime Facts: What (We Think) We Know about the Subprime Crisis and What we Don't*, FED. RES. BANK BOSTON PUBLICLY POLICY DISCUSSION PAPER 08-02 (2007); C. Mayer, K. Pence, & S.M. Sherlund, *The Rise in Mortgage Defaults: Facts and Myths*, J. ECON. PERSPECTIVES (Forthcoming 2008).

[6] Barth, *supra* note. Of those subprime loans in foreclosure, 57 percent of 2/28 hybrids and 83 percent of 3/27 hybrids "had not yet undergone any upward reset of the interest rate."

[7] Mayer, Pence, & Sherlund, *The Rise in Mortgage Defaults* at 11; Shane Sherlund, *The Past, Present, and Future of Subprime Mortgages*, Federal Reserve Board (Sept. 2008); Kristopher Gerardi, Adam Hale Shapiro, & Paul S. Willen, *Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures*, Federal Reserve Bank of Boston Working Paper No. 07-15. Mayer, Pence, and Sherlund find a dramatic rise in "early payment defaults" well before any interest rate adjustment takes place.

[8] *See* C.L. Foote, K. Gerardi, L. Goette, & P.S. Willen, *Subprime Facts: What (We Think) We Know about the Subprime Crisis and What we Don't*, FED. RES. BANK BOSTON PUBLICLY POLICY DISCUSSION PAPER 08-02 (2007).

the rate for subprime borrowers from the period 2003-2007 adjusted from an initial rate of about 8 percent to about 11 percent. Economists Anthony Pennington-Cross and Giang Ho find that the transition in a hybrid loan from an initial fixed period to the adjustable rate period results in heightened rates of prepayment, not default.[9] They also find that the termination rate for subprime hybrid loans (whether by prepayment or default) is comparable to that of prime hybrid loans. Other studies have also documented a dramatic rise in early payment defaults, an absence of rising defaults at the time of interest-rate adjustments, a tendency toward prepayment rather than default around the time of reset, and an absence of evidence of "exploding" rates. In light of these facts, economists have almost universally concluded that hybrid mortgages (at least alone) cannot explain the rise in foreclosures. After examining the evidence, several economists from the Boston Federal Reserve flatly state, "Interest-rate resets are not the main problem in the subprime market."[10]

Economists generally conclude that of more importance to foreclosures is falling house prices—the interest rate on a mortgage, whether "exploding" or not, is largely irrelevant if the borrower can refinance or sell out of the mortgage. It is only when the borrower is unable to sell or refinance that the interest rate matters, thus hybrid mortgages (or adjustable rates generally) matter for foreclosures only in a falling real estate market. Mortgages with positive equity tend to terminate in a prepayment of the mortgage (either as the result of a sale or refinance) whereas those with negative equity

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[9] *See* Anthony Pennington-Cross & Giang Ho, *The Termination of Subprime Hybrid and Fixed Rate Mortgages* 18 (Fed. Reserve Bank of St. Louis, Working Paper No. 2006-042A, 2006).

[10] Christopher L. Foote, Kristopher Gerardi, Lorenz Goette, and Paul S. Willen, *Subprime Facts: What (We Think) We Know about the Subprime Crisis and What We Don't*, FED. RES. BANK OF BOSTON PUBLIC POLICY DISCUSSION PAPERS 2 (May 30, 2008).

tend to terminate in foreclosure.[11] As one report concludes, "Without home price increases, hybrid loans will surely exacerbate the foreclosure problem if interest rates reset upward, but they are not the basic cause of it."[12] Finally, to the extent that hybrid or adjustable-rate loans are associated with higher levels of default and foreclosure, this may be a result of a selection effect bias rather than a reflection of the products themselves—borrowers with the most fragile finances are those most likely to choose (or accept) an ARM or a hybrid loan with a teaser rate, and thus their propensity to default may reflect their underlying riskiness rather than the riskiness of the products that they choose.[13]

The relationship between ARMs and foreclosures appears to have been a manifestation of the unique circumstances of the past several years rather than an inherent problem of ARMs. The percentage of ARMs in the market have been much higher at times in the past yet they did not previously result in the surge of foreclosures that have resulted in the most recent environment. In fact, adjustable-rate mortgages are the norm in most of Europe and the rest of the world without the catastrophic events that have transpired in the United States in recent years.[14] The primary difference, it appears, was that in the United States in the past where the yield-spread between ARMs and FRMs became larger, this reflected a general downward trend in interest rates, with ARMs falling ahead of FRMs and FRMs eventually declining as well. In the most recent

[11] Anthony Pennington-Cross, *The Duration of Foreclosures in the Subprime Mortgage Market: A Competing Risks Model with Mixing* 4-5 (Fed. Reserve Bank of St. Louis, Working Paper No. 2006-027A, 2006).
[12] Barth et al., *supra* note 5, at 2.
[13] *See Ending Mortgage Abuse: Safeguarding Homebuyers: Hearing Before the Sen. Subcomm. on Hous., Transp. and Cmty. Dev. of the Sen. Comm. on Banking, Hous., and Urban Affairs*, 109th Cong. 5 (2007) (statement of Anthony M. Yezer, Professor of Econ., George Washington University).
[14] Richard K. Green & Susan M. Wachter, *The American Mortgage in Historical and International Context*, 19 J. ECON. PERSP., Fall 2005, at 93, 107–08 (2005). Most other countries also have shorter mortgage maturity payments combined with a final balloon payment in contrast to the 30-year fixed-rate self-amortizing mortgage that is standard in the United States.

iteration, however, the interest-rate on ARMs was pushed artificially and unsustainably low, thus the eventual interest rate reset resulted in the interest rate on ARMs *rising* back to the level of FRMs, rather than FRMs falling to the level of ARMs (as was generally the case in the past). It is difficult to argue that ARMs *per se* are therefore unreasonably risky; it is only when ARMs are combined with a monetary policy that pushed short-term interest rates to unsustainably low rates (as was the case from 2001-04 in the United States) that ARMs became a problem.

The decision to maintain homeownership or default and allow foreclosure can be modeled as a financial option. In the option model, the decision to permit foreclosure is driven primarily by a change in the underlying value of the asset. Where the option is "in the money" (i.e., the home is worth more than the amount owed) the homeowner can treat the house as a "call" option—if the homeowner is unable or unwilling to make her monthly payments (perhaps because she is moving) then she can either sell the home or refinance it and pay off the underlying mortgage. Thus, the option to allow foreclosure is of low value to the homeowner in a rising market because the homeowner can instead sell or refinance the house and pocket the equity. But where the house has negative equity (often referred to as "under water" or "upside down"), then the consumer has a put option—either she can continue to pay the mortgage and retain ownership or exercise the "option" to default and allow the lender to foreclose. If this option increases in value or becomes less expensive to exercise, homeowners will become more likely to exercise it.

Under the option theory of foreclosure, therefore, the decision to allow default is essentially a voluntary and rational response to the incentives created by the change in value of the asset—the borrower *could* continue to service the loan but chooses not to.

Default and foreclosure result because the borrower strategically chooses the option of foreclosure over the option of continued payment of the loan. Disentangling the distress and option hypotheses is difficult, because housing prices are inversely correlated with interest rates—as interest rates rise, housing prices will tend to fall.

Empirical studies traditionally have tended to support the option theory of foreclosure.[15] For instance, even though interest rates generally rise uniformly across the country, the foreclosure rate is lower for residential real estate where price appreciation has been higher.[16] This suggests that in deciding whether to default the primary consideration by homeowners is the amount of equity that they have accrued in their property (which might be lost in the event of a foreclosure) rather than "payment shock" resulting from an unexpected rise in interest rates. Similarly, those who have drawn against accumulated home equity through home equity loans or junior liens exhibit a greater propensity to default than those who have retained their equity.[17]

The relationship between home price appreciation and foreclosures is striking—foreclosure rates show a close inverse relationship to changes in house prices:

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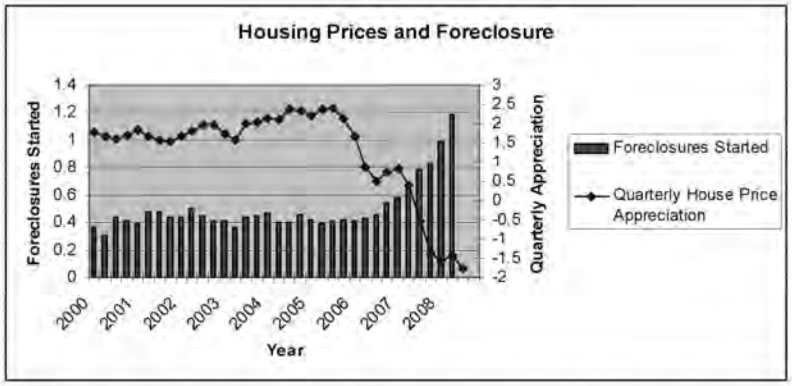
[15] *See* Kerry D. Vandell, *How Ruthless Is Mortgage Default? A Review and Synthesis of the Evidence*, 6 J. HOUSING RES. 245 (1995); James B. Kau & Donald C. Keenan, *An Overview of the Option-Theoretic Pricing of Mortgages*, 6 J. HOUSING RES. 217 (1995); Patric H. Hendershott & Robert Van Order, *Pricing Mortgages: An Interpretation of the Models and Results*, 1 J. FIN. SERVICES RES. 19 (1987).

[16] Mark Doms, Frederick Furlong & John Krainer, *House Prices and Subprime Mortgaged Delinquencies* 1–2 (FRBSF ECON. LETTER NO. 2007-14, 2007); Brent W. Ambrose, Charles A. Capone, Jr. & Yongheng Deng, *Optimal Put Exercise: An Empirical Examination of Conditions for Mortgage Foreclosure*, 23 J. REAL EST. FIN. & ECON. 213, 218 (2001) (higher default rates where home price appreciation slower); Kristopher Gerardi, Adam Hale Shapiro & Paul S. Willen, *Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures* 2–3 (Fed. Res. Bank of Boston, Working Paper No. 07-15, 2008), *available at* http://www.bos.frb.org/economic/wp/wp2007/wp0715.pdf (concluding that dramatic rise in Massachusetts foreclosures in 2006-07 resulted from decline in house prices beginning in summer 2005); Ellen Schloemer, Wei Li, Keith Ernst & Kathleen Keest, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners,* CRL RES. REPORTS, (Ctr. for Responsible Lending, Durham, N.C.), Dec. 2006, at 1, 13.

[17] *See* Michael LaCour-Little, *Equity Dilution: An Alternative Perspective on Mortgage Default*, 32 REAL ESTATE ECON. 359, 369 (2004).



Leading economists have also concluded that the largest factor driving the recent upward trends in the foreclosure rate has been changes in housing prices, rather than interest rates or "trigger events."[18] In particular, it is argued that the primary cause of the foreclosure crisis is to be the dramatic and unexpected fall in house prices that encouraged borrowers to default, rather than dramatically weakened underwriting criteria—if home prices had not declined to the degree that they did then foreclosures would have been dramatically lower, even with all of the other much-criticized practices in the mortgage market over the past decade.[19]

Another factor that has increased the propensity for default and foreclosure is the increase in low-downpayment and interest-only mortgages that meant that borrowers put down or accumulated little equity in their homes. Moreover, this was exacerbated by home-equity loans or cash-out refinance loans that led to equity depletion by many homeowners. In short, many homeowners had minimal equity in their homes. As a

[18] KRISTOPHER GERARDI, ANDREAS LEHNERT, SHANE SHERLUND, & PAUL WILLEN, MAKING SENSE OF THE SUBPRIME CRISIS, BROOKINGS PAPERS ON ECONOMIC ACTIVITY (Douglas W. Elmendorf, N. Gregory Mankiw, and Lawrence Summers eds., Fall 2008);

[19] In fact, Gerardi, et al., find that subprime borrower FICO scores actually rose during the housing boom).

result, they bore little cost from permitting default and foreclosure on these homes—in short, they were functionally the same as renters, not homeowners. Permitting cramdown of home mortgages will be particularly advantageous to these borrowers, giving them a second opportunity for their home to appreciate in value and engage in a subsequent home-flipping.

Loans with little or no down payments (such as those with high LTV or mortgages combined with piggyback loans) offer an unusually powerful incentive to default if property values fall.[20] Lower downpayments are correlated with higher rates of default[21] and lower LTV ratios are reflected in lower risk premiums in interest rates.[22] One study found that conventional mortgages with loan-to-value ratios at origination of 91–95% were twice as likely to default as loans with LTVs of 81-90% and five times more likely to default than those with LTVs of 71-80%.[23]

The incentives to "walk" are especially strong in those states with antideficiency laws that limit creditor's remedies to foreclosure without the right to sue the borrower personally for the deficiency.[24] Empirical evidence indicates that foreclosure default and foreclosure rates are higher where law limits lender recourse through antideficiency laws. In a study of the neighboring provinces of Alberta and British Columbia in Canada,

[20] In fact, LaCour-Little, et al., conclude that negative equity for homes in foreclosure are more often the result of post-purchase cash-out refinancing or home equity loans are more responsible for the presence of negative equity than housing price declines. *See* LaCour-Little, Rosenblatt & Yao, at 20.
[21] *See id.*
[22] *See* Elliehausen, Staten, & Steinbuks, at 43-44.
[23] Robert B. Avery, Raphael W. Bostic, Paul S. Calem, & Glenn B. Canner, *Credit Risk, Credit Scoring, and the Performance of Home Mortgages*, 82 FED. RES. BULL. 621, 624 (1996).
[24] *See* Michael T. Madison, Jeffry R. Dwyer, & Steven W. Bender, 2 THE LAW OF REAL ESTATE FINANCING §12:69 (Dec. 2007), *available in* Westlaw REFINLAW § 12:69. It is difficult to estimate exactly how many states have antideficiency laws as foreclosure rules vary a great deal from state to state, but an approximation may be about 15-20 states including many larger states. *See* United States Foreclosure Law, http://www.foreclosurelaw.com (last visited Sep. 17, 2008) (providing a full list of state laws). In addition, even in states where lenders may seek a deficiency, borrowers may be judgment-proof because of a general lack of other assets, as those with assets presumably would be more likely to provide a downpayment in the first place and would not be as likely to be in a negative equity position in their house.

Lawrence Jones found that "in a period of sizable house-price declines, the prohibition of deficiency judgments can increase the incidence of default by two or three times over a period of several years."[25] Similarly-situated borrowers with negative home equity (that is, where they owe more than the value of the house) "will be observed defaulting in antideficiency jurisdictions but not where deficiencies are truly collectible."[26] In fact, in Alberta (which had an antideficiency law) 74% of those who deliberately defaulted had negative equity; in British Columbia (which permitted deficiency suits) only one homeowner defaulted with negative book equity.[27] Other researchers have also found that prohibitions on deficiency judgments tend to produce higher delinquency[28] and default rates.[29] Limits on collection of deficiency judgments in FHA and VA loans may also explain the higher default rates on those loans compared to private market loans.[30] Because the presence of antideficiency laws increases the risk of lending, these laws also are associated with higher interest rates and other costs, such as higher required downpayments, especially among those marginal borrowers who would be expected to be the most likely to default.[31] This increase in interest rates and other costs may also

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[25] Lawrence D. Jones, *Deficiency Judgments and the Exercise of the Default Option in Home Mortgage Loans*, 36 J. L. & ECON. 115, 135 (1993).

[26] *Id.*

[27] *Id.* at 128–29. Jones states that the one defaulter in British Columbia reportedly left the country. *Id.* at 129.

[28] Brent W. Ambrose & Richard J. Buttimer, Jr., *Embedded Options in the Mortgage Contract*, 21 J. REAL ESTATE FIN. AND ECON. 95, 105 (2000).

[29] Ambrose, Capone & Deng, *supra* note 16, at 220.

[30] Brett W. Ambrose, Richard J. Buttimer, Jr., & Charles A. Capone, *Pricing Mortgage Default and Foreclosure Delay*, 29 J. MONEY, CREDIT & BANKING 314, 322 (1997).

[31] Ambrose, Buttimer, and Capone note that the higher risk of FHA and VA loans associated with limits on deficiency judgments contributed to a substantial increase in the insurance premiums charged by those lenders. *Id.* *See also* Pence, at 177 (finding that average loan size is smaller in states with defaulter-friendly foreclosure laws); Jones, *supra* note 25 (higher downpayments; Mark Meador, *The Effects of Mortgage Laws on Home Mortgage Rates*, 34 J. ECON. & BUS. 143, 146 (1982) (estimating 13.87 basis point increase in interest rates as a result of antideficiency laws); Brent W. Ambrose & Anthony B. Sanders, *Legal Restrictions in Personal Loan Markets*, 30 J. REAL ESTATE FIN. & ECON. 133, 147–48 (2005) (higher interest rate spreads in states that prohibit deficiency judgments and require judicial foreclosure procedures); U.S. DEPT. OF HOUSING AND URBAN DEVELOPMENT, A STUDY OF CLOSING COSTS

increase financial distress and thereby contribute to higher foreclosures at the margin. Moreover, if it is the case (as it appears to be) that the propensity for default and foreclosure is a function in part of state laws regarding the collection of deficiency judgments and judicial foreclosure actions, and that lenders have already priced that risk *ex ante* in the loan, this raises questions about the propriety as a matter of equity and efficiency of governmental "bail outs" for distressed borrowers and lenders. Put alternatively, if California's high foreclosure rate is in part a function of California's extremely borrower-friendly laws one can question whether taxpayers and homeowners from the rest of the country should be taxed (directly or indirectly through higher interest rates and tighter credit) to essentially bribe California homeowners not to walk away from their mortgages.

Many of the states with antideficiency laws, such as California and Arizona[32], are also among the states with the highest foreclosure rates. Other high-foreclosure states, such as Nevada and Colorado, have laws that limit the amount that lenders can recover from borrowers, but which do not bar deficiency judgments completely. Antideficiency laws also appear to affect homeowners' incentives to maintain their property—homeowners in states that have antideficiency laws may be less willing to invest in maintenance and improving their homes.[33] Moreover, although there are costs to "walking"—particularly the negative effect on one's credit report—in light of the

FOR FHS MORTGAGES at p. 50 (May 2008) (finding that presence of antideficiency laws raises costs of loan). *But see* Michael H. Schill, *An Economic Analysis of Mortgagor Protection Laws*, 77 VA. L. REV. 489, 512 (1991) (finding mixed results for impact of antideficiency laws on foreclosure rates depending on specification of regression).

[32] *See* Madison, *et al.*, *supra* note 24.

[33] John Harding, Thomas J. Micelli, & C.F. Sirmans, *Deficiency Judgments and Borrower Maintenance: Theory and Evidence*, 9 J. HOUSING ECON. 267, 271 (2000); *see also* John Harding, Thomas J. Micelli, & C.F. Sirmans, *Do Owners Take Better Care of Their Housing Than Renters?*, 28 REAL ESTATE ECON. 663, 669–70 (2000).

widespread nature of defaults and foreclosures future lenders may discount the impact of this adverse event in comparison to prior eras.[34] In addition, the pure number of mortgage walkers may underestimate the number of truly voluntary foreclosures because during the period that a home is in foreclosure the owner ceases making mortgage payments, thus essentially living rent-free during the foreclosure period. Thus, even if the owner is willing to permit foreclosure she may nonetheless not simply surrender the property immediately, but instead take advantage of the opportunities presented by foreclosure.

[34] Harding, Micelli & Sirmans, *Owners Take Better Care*, *supra* note 132.

Statement for the Record

Hearing on Bankruptcy Cram Down Legislation

Before the
Committee on the Judiciary
United States House of Representatives

January 22, 2009

The undersigned organizations respectfully submit the following statement for the record for the January 22, 2008 hearing by the House Judiciary Committee on H.R. 200 and H.R. 225 ("Cram down legislation"). We have and continue to strongly oppose broad cram down legislation.

Such cram down legislation would give bankruptcy judges the broad power to reduce unilaterally the remaining balance on a mortgage and modify or change the interest rate or term of the loan. Cram down would be available for all mortgage and other loans secured by a primary residence. There are no limitations on the types of mortgages, including prime mortgages, which would be subject to the cram down. Cram down would introduce substantial new risk and uncertainty into first mortgage and home equity lending and further undermine the stability of mortgage backed securities.

According to a recent study by Columbia University, cram down legislation would result in higher interest rates and reduce the availability of mortgages for many borrowers at a time when consumers and the nation are already suffering through a severe economic downturn.[1] Moreover, cram down would encourage many people to file for bankruptcy first and would undermine other efforts to work-out or modify troubled loans. Bankruptcy is an ad hoc process that will overload the courts with millions of new cases that the system could not handle quickly or effectively and the increased costs will be borne by taxpayers.

The housing market is already contracting and enactment of cram down legislation would make things even worse by injecting even more risk into the mortgage market, making it harder and more costly for people to buy and sell homes. Importantly, cram down legislation would disrupt Federal Housing Administration (FHA) and Veterans Administration (VA) loan programs that account for nearly a third of all new mortgages and are now the major source of affordable mortgage credit. FHA/VA programs make affordable, low-down payment loans possible by insuring lenders against the risk of non-payment. Cram down would make these loans more risky since the cram down amount is not covered by FHA/VA insurance. This will drive lenders away from the program and will be bad for veterans, moderate income borrowers, housing recovery, and the economy as a whole.

[1] **"A New Proposal for Loan Modifications" by Christopher Mayer, Edward Morrison and Tomasz Piskowski, Columbia University (1/6/09). <u>See</u> link below.**
<u>http://www4.gsb.columbia.edu/realestate/research/housingcrisis/mortgagemarket?&</u>

Cram down would be costly to Fannie Mae and Freddie Mac (the "GSEs"), the federal government and taxpayers. For instance, when a mortgage that has been packaged into a mortgage-backed security guaranteed by the GSEs is modified in bankruptcy, the value of the mortgage is negatively affected. The GSEs would need to realize a loss on the guarantee, and those losses flow through to the federal government in its role as Conservator of those institutions and thus to taxpayers. In addition, prior to the enactment of the "Emergency Economic Stabilization Act" ("TARP") and recent actions by the Federal Reserve, it was private sector parties owning mortgage backed securities (MBS) that would bear any losses resulting from cram downs. However, under TARP the federal government can buy troubled loans and MBS. The government has also guaranteed losses from some large financial institutions. Cram down of this debt and MBS would trigger massive losses for the federal government and taxpayers.

Cram down could also seriously impair the federal government's commitment to affordable home ownership. Under current law, the federal government cannot insure or guarantee the amount that has been crammed down in a FHA or VA loan. This transfers the loss to servicers, which is not the correct result since the servicer is not the owner of the loan. Therefore, private companies that service mortgages would have a strong incentive to refuse to service FHA and VA mortgages. This would mean that the government would bear the costs and burdens of servicing FHA and VA loans. As the FHA noted in its January 13, 2009, letter to Representative Neugebauer, if private servicers abandon the market and the federal government is required to service FHA loans, the federal government and taxpayers would then be required to absorb the losses associated with cram down.

Better alternatives than bankruptcy have been put in place and these can be expanded to enable lenders and borrowers to work together to modify mortgages to make them more affordable and avoid foreclosures. In particular, we believe that the FDIC's program on mortgage loan modifications could be an effective tool if implemented on a nationwide basis and if money from the Troubled Assets Relief Program (TARP) could be used to support the program's broader availability. There are also other loan modification proposals that have been put forward that have merit and that could be effective if adequate funding is provided. The House Financial Services Committee has recognized that more money is needed for these programs and has made it clear in legislation pending on the House floor (H.R. 384) that at least $40 and up to $100 billion of any further money provided by Congress for the TARP program should be used by the Obama Administration for programs designed to avert foreclosures.

In addition, the Federal Housing Administration, which created the FHA Secure program last year, has helped nearly 410,000 borrowers refinance into more affordable mortgages. The HOPE NOW Alliance, which includes over 30 market participants, is helping at-risk homeowners avoid foreclosure through more than 200,000 workouts and loan modifications each month. On December 15, 2008, the housing GSEs, Fannie Mae and Freddie Mac, working with their regulator and industry partners, implemented a streamlined loan modification program similar to the FDIC's program for Indy Mac loans.[2] In July 2008, Congress passed the Housing Economic Recovery Act, which included the Hope for Homeowners program. This legislation established a new FHA program (Hope for Homeowners) with an additional $300 billion in FHA insurance authority. This program became effective October 1, and is just now starting to be implemented. Hope for Homeowners is being expanded and made more flexible to assist more homeowners by legislation sponsored by House Financial Services Committee Chairman Frank (H.R. 384; "TARP II").

We look forward to continuing to work with the 111th Congress, the Obama Administration, and the regulatory agencies on these and other programs designed to help prevent foreclosures. In the meantime, we strongly urge you give these programs time to work and to not put in place broad bankruptcy cram down provisions that would make it harder for consumers to buy and sell homes.

American Bankers Association
American Financial Services Association
American Securitization Forum
Consumer Bankers Association
Independent Community Bankers of America
Mortgage Bankers Association
Securities Industry and Financial Markets Association
The Financial Services Roundtable
The Housing Policy Council
U.S. Chamber of Commerce

[2] **Under the terms of the program, borrowers receive a loan modification with a maximum 38% down to 31% housing-to-income ratio through the use of interest rate reduction, amortization term extension, and in some cases, principal deferment. See explanation of this program at the FDIC's web site: http://www.fdic.gov/consumers/loans/loanmod/loanmodguide.html**

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

JAN 13 2009

The Honorable Randy Neugebauer
U.S. House of Representatives
Washington DC 20515-4319

Dear Representative Neugebauer:

Thank you for your letter of January 11, 2009, requesting the Department of Housing and Urban Development's assessment of the impact of proposals to allow bankruptcy judges to modify the terms of mortgages of the Federal Housing Administration (FHA) and Ginnie Mae. This is a critical matter for the Department and I appreciate the opportunity to respond.

The key statutory provision of any legislation allowing bankruptcy judges to modify mortgages that affects FHA, Ginnie Mae, and the entire mortgage market, is removal of the special status now provided for home mortgages under Chapter 13 of the U.S. bankruptcy code. The import of that special status is that the courts may *not* bifurcate mortgage loans into separate secured and unsecured pieces, as is permissible with other debts. That special status was first interpreted by the U.S. Supreme Court in 1993, and was then codified by the Congress in Section 303 of the Bankruptcy Reform Act of 1994.[1]

The Department is concerned about the effects of legislative proposals, such as S. 61 and H.R. 200, that would remove the special status for principal residences that exists under the Bankruptcy Act of 1994. The proposed changes would permit the courts to modify or "cramdown" the principal obligation to an amount equal to the current value of the secured property. The residual amount owed would then be recast into an unsecured debt obligation.
In Chapter 7 liquidation cases, the secured loan has primacy over sale proceeds of the security property, while the unsecured piece is grouped with all other unsecured debt in payment priority. In a Chapter 13 bankruptcy reorganization, payment plans are structured first to cover payments on secured debts. The Court then determines the amounts the household can afford to pay toward monthly debt obligations to satisfy unsecured debts, a portion of which may not receive payment. In either Chapter 7 or Chapter 13 proceedings much or all unsecured debt is not required to be paid by the debtor leaving lenders with no option but to write-off the unpaid amount as an uncollectible debt.[2]

<u>Impacts of Cramdowns on FHA</u>

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[1]The Court actually ruled first on Chapter 7 cases in *Dewsnup v. Timm*, 112 S.Ct. 773, 22 BCD 750 (1992), and then on Chapter 13 cases in *Nobelman v. American Savings Bank*, 113 S.Ct. 2106 (1993). Statutory clarfication was in Title III, section 301 of the 1994 Act and can be found at 11 USC 1322.

[2] It is also the case that many Chapter 13 cases progress to Chapter 7 liquidations where the unsecured second mortgage is completely written-off by the lender.

FHA insurance coverage for lenders is only on secured debt. Thus, the immediate effect of a bankruptcy court cramdown would be that the lender has an uninsured loss. This would introduce a new risk to lenders, and create a situation wherein FHA no longer provides 100 percent insurance coverage of the mortgage amount. Such a change would increase the interest rates charged for FHA-insured loans as lenders purchase other guarantees to cover that risk. If such guarantees are not available, or prove to be very expensive, the availability of FHA insurance will be reduced. Because FHA loans have historically had higher default and foreclosure rates than conventional mortgages, the interest rate increase for FHA-insured borrowers would be more substantial than it would be for conventional borrowers.

If S. 61 or H.R. 200 were adopted, every property in jeopardy of foreclosure would also be a potential candidate for a bankruptcy court cramdown. In theory, Chapter 13 cramdowns would be limited to borrowers with commitments to their properties, meaning they have both the willingness and ability to continue to support the mortgage at some level. However, significant percentages of current Chapter 13 repayment plans fail and a property foreclosure ensues.

Having the option of a cramdown would increase the attractiveness of Chapter 13 filings versus working directly with lenders to find an appropriate loss mitigation workout plan. The fundamental difference between a bankruptcy cramdown and loss mitigation is that typical loss mitigation default workouts do not absolve the borrower of any obligation to repay the entire mortgage.

FHA has been very successful with its loss mitigation program. One tool in this program is known as a Partial Claim. Under this program, FHA pays up to 12 months of mortgage payments to the lender, on behalf of a defaulted borrower, to bring the loan current. The borrower, in turn, signs a promissory note to pledge that any future home equity will be used to repay HUD when the property is sold.[3] That promissory note bears no interest and is secured by a property lien. If implemented, S. 61 and H.R. 200 would potentially render these liens to be worthless. Repayment of those liens today contributes to the health and stability of the FHA Mortgage Insurance Fund. As of December 31, 2008, FHA had partial claims that totaled $464 million.

<u>Impact of Mortgage Cramdowns on Lenders, Ginnie Mae and Homeowners</u>

To the extent that S. 61 and H.R. 200 add increased credit risk to FHA-insured loans, financial regulators could choose to implement capital requirements on federally-insured depository institutions that hold such loans on their balance sheets. If FHA loans were considered to have increased credit risk for lenders, then financial regulators could also revisit the rules regarding zero capital requirements on Ginnie Mae's mortgage backed securities (MBS).

Ginnie Mae guarantees MBS investors no disruption in mortgage-payment cash flows with

[3] Many borrowers choose to repay the note when they refinance their properties, prior to moving and selling the home.

its lenders/servicers responsible for making full pass-throughs to the security trustee until the first-lien mortgage is paid off. Pass-through payments are based on the original mortgage and not any new, reduced mortgage created by a bankruptcy court. Thus, even if a borrower is successful in a Chapter 13 reorganization plan, the lender would always have a cash-flow shortfall because of the cramdown. Therefore, lenders will re-purchase Chapter 13 loans out of Ginnie Mae pools and take the immediate write-off of principal, rather than incur this ongoing responsibility to MBS iuvestors. Should the lender experience an increase in borrowers that receive cramdowns, its financial status could be severely impacted. If a lender then has financial difficulties and cannot meet its other pass-through obligations, Ginnie Mae will step in, take over the servicing portfolio, and itself absorb the residual loss created by the cramdown.[4]

There is one additional problem for homeowners who receive court-ordered mortgage cramdowns: property casualty insurers often limit coverage to the principal balance of the mortgage, which is the minimum required for loan approval. If a catastrophic insurable event occurs, homeowners will be exposed to financial loss because a crammed-down mortgage may not fully reflect the replacement cost of a property even if it reflects its current market value. The most likely outcome would be that the lender receives the proceeds of the insurance policy rather than the property being restored. As occurred in areas damaged by Hurricane Katrina, this leads to property abandonment and other problems in those impacted neighborhoods.

Conclusion

Proponents of bankruptcy court cramdowns of mortgage loans likely intend to induce subprime lenders to be more proactive with foreclosure avoidance options. Broad-sweeping measures that affect all home mortgages fundamentally change the expectations of all parties involved in housing finance -- from originating lenders, to loan servicers, to mortgage insurers, and to ultimate investors. Because those parties have outstanding contracts that specify their respective financial responsibilities to one another, many will be immediately liable for additional costs not accounted for in the initial transaction. Future mortgage contracts will reflect increased interest rates to compensate for this increased risk. Interest rates on new loans will increase not only to cover the projected cost on those new loans but to cover the added cost on outstanding loans as well.

It is the Department's conclusion that S. 61 and H.R. 200 create a fundamental change in the quality and value of residential real estate as collateral for a mortgage loan. It is this uncertainty that will lead to higher mortgage costs for most borrowers.

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[4] Ginnie Mae resells these loan-servicing portfolios, but a portfolio with crammed-down mortgages will sell at a discount that reflects the cramdowns.

Thank you again for your correspondence on this important topic, and I trust this information will be useful as Congress contemplates providing bankruptcy judges the authority to modify mortgages.

Sincerely,

Brian D. Montgomery
Assistant Secretary for Housing –
Federal Housing Commissioner

Mr. FRANKS. Mr. Chairman, I know that the challenges that we face are pretty complex. So I guess I will just—before I direct a couple questions to Professor Mayer—just to point out that the primary difference between our economy and the socialist economies of the world—our economy and the Soviet economy at one time—is essentially what Professor Mayer's central point was and that is when people loan their own money, when they do things that will affect them dramatically one way or the other, they have an entirely different view of how they do it. They still want to make money. They still want to loan money to—if that is their business.

If their business is selling money—which that is what bankers do is sell money—they want to sell it, but they want to sell it in ways they think that are prudent. And when the Government came in and began to back all of these loans, a lot of the private sector simply said "Oh, great. The Government is going to back these loans. That is great. Well we will invest." And it just created a runaway train, and I am convinced that we don't seem to realize that when we try to do cram-down legislation—these kinds of things that change the fundamental structure of loans.

What we do is we tell the private sector that they don't have anything to—to have any predictability on and one of two things is going to happen. Either the private sector is going to come to the rescue of this economy and they are going to come and say "Well, are we going to try and buy these securities—make the best of it we can?" Or it is all going to fall on the shoulders of Government, and if we create—cram down the loans, the private sector is going to say "Okay. You guys take it." And we are going to have more to do with than we possibly know what happened.

Now as to Ms. Waters, I wish you were still here because I will try to temper my remarks—more since she is not here, but the notion that we should nationalize housing—I cannot think of a better way to bankrupt this economy completely than that. And I can't think of a better way you know—Soviet Union had nationalized housing.

I was there a few times, and it wasn't the best plan, and I would just suggest that if we don't step back as a Congress and as a people and recognize that free markets gave us the most productive economy and the most powerful Nation that history-humanity—and still has the hope of bringing us out of this thing, and if we think that just nationalizing everything and telling what—we will just blow ourselves up—sooner or later we are going to be trying to—to repeal the laws of mathematics and thermodynamics economically and we are going to be in a situation where nothing can fix this but a complete depression, and us having to relearn the fundamental laws of economics. And there are a lot of economists that can "prefatorymonatomic polysyllabic obfuscations math gymnastics and verbal circumlapution" on us to the extent we don't know they are talking about, but there still remains that there is a fundamental reality here.

Productivity is the only way we do it. If we simply cut a hole in taxpayer's pocket to fill this hole we still have a hole and the only thing that can make this economy survive and get stronger is to incent private sector involvement and productivity. And I suggest to you that the cram-down legislation here is a way to de-emphasize that and cause the private sector to step back even further than they already are. And so with that I would like to just ask Professor Mayer to tell us what do you think cram-down legislation will ultimately say to the private market to those that might be there with some capital other than taxpayer's capital.

Mr. MAYER. I mean I think it is clear and you know I, as Professor Levitin has, you know some points of agreement that you know one thing that I think is clear is that the intention of the—of many proponents including I think explicitly Professor Levitin are that this—that the idea cram down be made permanently into legislation and go beyond this, and I think the evidence is abundantly clear that such a permanent change in the law or even a temporary one is going to raise the cost of credit.

You don't need an economic model for this. It is really common sense. If you lend somebody money on something and you take away their rights to collect on that they are going to lend less money and they are going to charge more for that money. It is pretty simple intuition. The evidence for this globally couldn't be more clear.

Having spent some time recently in South America with my students in countries like Argentina and Brazil where the governments there do restrict—severely restrict the rights of creditors to collect on their debts. We understand that home mortgages are not freely available and very expensive. So whether this is 25 basis points—it is not 200. I completely agree with Professor Levitin on this. Whether it is the 5 percent of the population that can't get a loan who would have otherwise—we don't know. It really will affect the cost of credit.

Mr. FRANKS. Yes. Well, Mr. Sherman, I am just closing here. I am going to suggest to you that the highway of history is littered with the wreckages of governments that thought that they could incent and produce—create productivity and maintain productivity better than the private sector, and I hope we don't join that litany because I will tell you nothing has dragged more poor people out of poverty more than the free markets of the United States of America. And it is always true that free enterprise is often the unequal distribution of wealth, and that is too bad, but socialism is the equal distribution of poverty. Thank you, Mr. Chairman.

Mr. CONYERS. Brad Sherman.

Mr. SHERMAN. Chairman, I see myself sitting between Mr. Franks and where Ms. Waters was sitting—slightly closer to Ms. Waters. I think divine providence may have sat me in exactly the right chair. The private sector has much to be said for it—it is now providing loans at 4.5 percent rate to those with great equity and great credit. To think that still today even in the worst of times ordinary working people can buy—borrow 3 or 4 hundred thousand dollars is amazing and it is not available in an awful lot of other countries.

Mr. MAYER. Mr. Sherman, I would comment that those mortgages are all being underwritten predominately by the Federal Government through Fannie and Freddie.

Mr. SHERMAN. That is true and so it is not entirely a factor of the private sector, but then Fannie and Freddie are then selling those in the capital markets, which are private, but then there is an implicit Federal guarantee, which is public and scrambling this egg would be particularly difficult. Whatever we do to help today's homeowners we should try to have the least adverse affect on tomorrow's homebuyers, and let us try to come up with something that raises the cost of future mortgages by 2 or 3 basis points and not 200 or even 25.

The Professor Mayer said—estimated at 2 to 3 trillion dollars would be what would be written off if we lowered every home mortgage to no more than the fair market value of the home. My staff has done some research on this. They tell me it is 4 trillion dollars. We as a society cannot afford 4 trillion dollars. The financial sector can't do it. The Government can't do it. We got the $700 billion dollars to bail out the financial sector in a bill that was discussed on the floor today and passed last October. Last thing I want to see is $4—7 trillion dollars.

My hope is that there would be only a slight increase or perhaps a negligible increase in future home mortgage cost if we convince the private sector that what we are doing today is a one time response to a 100-year event.

That we have done—that we have taken the actions to make sure that it is not just a 100-year event, it is a never-to-be-repeated event because future interest rates will not reflect—what happened to mortgages today will be based on expectations of what will happen in the bankruptcy courts 20 years from now. And so I hope that the legislation we pass is temporary and, we will rely on the Financial Services Committee to make sure that the—Ms. Waters chairs the relevant Subcommittee on Financial Services—to make sure that we don't see this happening again.

So we could limit it to mortgages during a certain time. We could limit it to certain types of loans—the subprime loans, the teaser rate loans. We face a particular problem with regard to the stated income loans where first I got to dis' the bond rating agencies because if anyone caused today's crisis it is those who gave triple A to Alt-A.

But with the teaser—with the state of income loans there are many people perhaps persuaded by a mortgage broker or mortgage officer of some sort who signed papers claiming they make a lot more money than they did and whether we provide them with the same relief—usually in bankruptcy courts you don't get relief if you lied on the loan application. Here you have people who may have lied—may have said "Look, this is what you have got to do, everybody is doing it." And I think that is an issue we have to look at carefully.

As to the servicing contracts, Professor Mayer, I think you make a very strong case. We have got to rewrite those contracts in this Committee. We got to tell the servicers do what is smart, which also by the way happens to be what is in the interest of communities and what is in the interest of homeowners. We have got to give these servicers the right to renegotiate where it is in the interest to do so—it is in the interest of their own beneficiaries to do so, and we have to at least fully insulate them from any lawsuit from anyone of the many possible owners of that mortgage. Oh, but you should have done it differently.

So I hope that this Committee and the Financial Services Committee will give servicers the right and the mandate to do what is in the interest of everyone concerned. With that, I think the problem we are going to have with this bill is you got $4 trillion dollars, that mortgages are underwater, and we as a society are not going to provide $4 trillion dollars of relief. We have to ration that relief to those who really need it.

The first thing we ought to do is provide appreciation—goes either to the U.S. government or lender depending on who is suffering from this write down because first—you know taxpayers deserve to get something, but second if you are—I have got people in my district—last I know the first question was why should I pay my mortgage.

And I would like to be able to answer because you don't want to give the Government 100 percent of the profit that you still hope to get when you sell that home 10 or 20 years from now so that those people who aren't getting relief don't feel like suckers. And I hope that we limit the mortgage relief to mortgages at a particular time and of a particular type.

I think I have gone over my time and I thank you for your indulgence, Mr. Chairman.

Mr. CONYERS. Dan Maffei?

Mr. MAFFEI. Yes. Thank you, Mr. Chairman. I want to pick up a little bit on what Mr. Sherman was saying about—by actually asking a specific question about whether these contracts—restricted contracts—could be at least addressed by this Congress. In the Citi Group compromise and that was a few weeks ago—that would require the homeowner to certify that he or she tried to contact the mortgage owner or servicer requesting a modification before filing bankruptcy.

I am concerned that the servicers of these mortgages reportedly are constrained from reaching an agreement with homeowners on an appropriate loan modification because they necessarily had the court authority to do so—to modify these mortgages under existing legal documents. So this would end up driving more homeowners into bankruptcy when an agreement between the mortgage company and the servicers would have otherwise been reached.

Yesterday, we passed in the house the "Top Reform and Accountability Act of 2009" sponsored by Chairman Barney Frank. I, too, serve also on the Financial Services Committee. In searching through our files, that bell would provide a safe harbor to servicers who work with the struggling homeowners to agree to a reasonable modification.

So it seems to me that if such a provision law is considered part of these bills—the ultimate goal of the bills would encourage reasonable modification so that people can stay in their homes would be met. So I do want to ask the panel just—and I will have a follow-up question if—depending on our time left, but if this legislation is included—does this bill include a provision like this section 205? Would there be more of these modifications before we even need to do bankruptcy?

Mr. CONYERS. I guess I will start. We will just start on the left. Yes.

Mr. LEVITIN. I think we will see some more modifications. I would not expect to see a sea of change. It is important to understand that there are problems that are not just contractual for servicers restricted in what they can do, and it is not just that they don't have the proper incentives to do it. It is also that the business model just is not—they are not in the loan modification business.

Mortgage servicers are in a transaction processing business. Their basic business is they collect—they send out bills, they collect payments, they remit them to the trust. This is a highly automated business. It involves no discretion. It involves very, very little manpower.

Trying to do loan workouts involves tremendous manpower, involves a lot of discretion, and it actually involves a fair amount of experience. We don't have the people out there with the experience—we don't have that labor force out there.

It takes about a year to train someone to really be good at this, and unfortunately, they—when you have people working in these call centers doing loan modifications, there is an amazing burnout rate.

This is kind of—this is sort of like debt collection work. There is something like a 100 percent burnout rate every year on these people. We just don't have the staffing to do this, even if we get rid of the contractual problems, and even if we try and change the incentives, as Professor Mayer suggests.

Mr. MAFFEI. Mr. Certner, do you have a——

Mr. CERTNER. I think you need the—essentially to hammer the bankruptcy provisions to give people an area for relief. And I think by having these bankruptcy provisions in place—will also give a greater incentive for these loans to be worked out in advance of bankruptcy.

Mr. MAFFEI. You know, I am not necessarily saying that I don't—disagree with that. What I am saying is is that—is there a chance that we—that even with—that we could prevent bankruptcies even with this legislation if we had this sort of safe harbor provision?

Okay, yes, Professor Mayer?

Mr. MAYER. Yes. I think that the section 205, which I think came from part of this proposal at one point, is—you know, is a very valuable step. Unfortunately, I think it is not enough.

I agree with Professor Levitin that servicers—just giving them legal protection is necessary but is not sufficient to solve the problem. I disagree that incentives are an issue, but I think it is really clear—a couple other things.

One of them is that loan modification just doesn't pay for a servicer to do it. So even if you get indemnity, you are going to spend upwards of $750 to $1,000 or more to modify a loan, and you just don't get paid to do it.

If you put the safe harbor provision into this law, unfortunately what you get is servicers who will say, "I haven't got enough money. My business model doesn't allow me to do this." What they will choose is just let the trustees handle it, so essentially all loan modification will go into bankruptcy.

That is the financial incentive the servicers have, because their pooling and servicing agreements tell them that they can get reimbursed within judicial hearings. I am not—may not be legally saying this right. They can be reimbursed for the fees inside a judicial process. They cannot be reimbursed for the fees outside a judicial process.

So what we do by doing that, without some additional piece of sort of payments to servicers to modify outside, all their incentives are still going to be to do it inside the bankruptcy process.

If we want good modifications, we have to change what the servicers are doing, and I think if you offer somebody the payment—in my proposal, it would be as much as $2,500—if you keep a loan going for 3 years—I may be a little bit, you know, optimistic, but I think if you take a for-profit person, there are businesses out there who will do this for much less than that who you can contract out and do the servicing.

I think we will very quickly see people like the idea of collecting that money. A financial incentive is just crucial to getting the servicers to do this out of bankruptcy. It is not a—205—the provision is wonderful, but we still have to change the economics of what we are doing if we don't want to see many millions of bankruptcy filings.

Mr. MAFFEI. Okay, Mr. Mason. I am a freshman, so I don't want to go over time too much.

Mr. MASON. Yes. Just briefly, I would be very leery of increasing incentives to servicing groups. I just talked with a mortgage counselor in southwest Detroit, and she said the most recent thing is that the servicing groups are outsourcing their modification work and paying them $800, which they are then charging back to the borrower.

Now, if you are going to create an incentive where they are going to pay them $2,500, I ask you, is that also then going to end up back on the borrower, added to the mortgage and increasing the whole cost of the transaction?

It seems to me the bankruptcy modification process is really simple. It cuts through the stuff. It cuts through lender liability. It gives them insulation because the loans are modified involuntarily.

It can deal with second mortgages, which none of these proposals have really addressed, but bankruptcy can do. And it seems to me it is a much cleaner and efficient method than trying to create these other incentives, which at this moment we know don't work.

Mr. MAFFEI. Well, would you have a problem with the safe harbor that Section 205—Mr. Mason?

Mr. MASON. I really don't have an opinion on that.

Mr. MAFFEI. Okay. Well, thank you very much.

You know, Mr. Chairman, looking at this, I think obviously, I would like to see the TARP Reform and Accountability Act become law. But at this point, it is a little unclear what the Senate's going to do with that.

And I would urge the Committee to—the one thing I did get from all the panelists, I think, is that it wouldn't harm—you know, maybe it wouldn't solve the problem, maybe it is—for some, it is not enough, for others, it is—it, you know, doesn't maybe solve the problem totally.

But I would urge the Committee to look at that in the markup to include a similar provision in our legislation. Thank you very much.

Mr. CONYERS. Thank you.

To the witnesses and all of the Members of the Committee, we are going to leave the record open because many of you have additional submissions you would like to have added into the record.

We thank you so much for your time.

The Committee stands adjourned.

[Whereupon, at 5:36 p.m., the Committee was adjourned.]

A P P E N D I X

Material Submitted for the Hearing Record

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

Statement by Chairman John Conyers, Jr. for the Hearing Before the Committee on the Judiciary on H.R. 200, the "Helping Families Save Their Homes in Bankruptcy Act of 2009" and H.R. 225, the "Emergency Homeownership and Equity Protection Act"

Thursday, January 22, 2009, at 2:00 p.m.
2141 Rayburn House Office Building

Statement

Our Nation is in the middle of a major economic crisis that is without doubt going to worsen in the coming months.

And, at the very heart of this crisis is the endless spiral of mortgage foreclosures, which is uprooting families, decimating our communities, causing precious local tax revenues to be expended for increased police and firefighting resources, and depressing property values of virtually all American homeowners. I don't want to sugar coat things.

Last year, 1 in 10 American homeowners fell behind on their mortgage payments or were in foreclosure. Over the next four years, it's estimated that there will be *more than 8 million foreclosures*. If the recession deepens, that figure could top *10 million*. We are experiencing foreclosure rates approaching heights not seen since the Great Depression.

The plight of families facing foreclosure grows more serious by the day, and yet efforts to offer them any relief has taken a back seat to the bailout of the financial institutions responsible for the crisis we now face.

I don't know how much worse the crisis has to get before Congress decides to act.

There are three reasons why we need to address this crisis by amending the the Bankruptcy Code to allow mortgage modification.

First, voluntary modifications are simply not working. Despite much fanfare by the industry and the Bush Administration, it is clear that allowing the industry to pick and chose which mortgages can be modified and under what terms has been an utter failure.

The reasons are complex. They include the fact that those who service these mortgages often lack the financial incentive to agree to a modification in lieu of foreclosure. Another fact is that most mortgages are now securitized and thereby subject to servicing agreements that restrict mortgage modifications.

This explains why the Hope for Homeowners program, which went into effect last October to help hundreds of thousands of distressed homeowners, has only processed a little over 320 applications.

And, even when the industry does allow a mortgage to be modified, more than half of these restructured mortgages later default because the terms of the modification were unworkable, leaving the homeowner deeper in debt.

Judicial modification, on the other hand, would cut through all of this legal morass.

Second, allowing judicial modification would be good for our Nation's economy because it would help keep families in their homes, keep communities intact, and preserve home values for the lender and other homeowners.

Judicial modification would convert many non-performing loans into performing assets, which would be good for all concerned. Society does not gain when families face foreclosure. Too many homes now sit abandoned, dragging down the property values, undermining the tax base, creating crime and public health problems, and further eroding the value of mortgage backed securities.

The value of judicial modification explains why its supporters include Governors, numerous State Attorneys General, the U.S. Conference of Mayors, leading economists, AARP, and many community and consumer organizations, and even some in the industry – such as the National Association of Home Builders and Citibank.

Third, judicial modification addresses an anomaly and basic inequity in current bankruptcy law.

The Bankruptcy Code provides a safety net for families in economic distress. It is designed to preserve value, treat creditors fairly, and provide an individual with a financial fresh start.

One area where the Code has consistently failed families, however, is how it treats mortgages secured by a primary residence. Unlike every other secured debt – including debts secured by second homes, investment properties, luxury yachts, and private jets – a home mortgage cannot be modified in bankruptcy.

That does not make sense, and the consequences, especially in the current crisis, are devastating. There is no rational reason to single out the family home for more draconian treatment than
a speculator's holdings.

Judicial modification in bankruptcy helps homeowners get back on their feet under the supervision of a court, a private trustee, and the Justice Department.

It gives all parties an opportunity to be heard before an impartial court. And, the Bankruptcy Code prohibits any modification unless the debtor can prove to the court's satisfaction that his or her repayment plan is feasible.

Put another way, the Bankruptcy Code provides more transparency and independent supervision than any of the bailouts we've voted on to date. If the Treasury Department had required this level of accountability and transparency when bailing out the banks, we'd all be in better shape.

I note that my colleagues, the gentleman from North Carolina (Mr. Miller) and the gentleman from Georgia (Mr. Marshall), will be offering their views on this important issue. I look forward to the testimony of all of our outstanding witnesses.