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

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

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

TUESDAY, OCTOBER 30, 2007

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

The Subcommittee met, pursuant to notice, at 1:18 p.m., in room 2141, Rayburn House Office Building, the Honorable Linda T. Sánchez (Chairwoman of the Subcommittee) presiding.

Present: Representatives Sánchez, Conyers, Johnson, Cannon, and Feeney.

Also Present: Representatives Chabot and Miller of North Carolina.

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

Ms. SÁNCHEZ. The Subcommittee on Commercial and Administrative Law will come to order.

I want to welcome everybody. Unfortunately, the Committee's other hearing this morning went unavoidably longer than anticipated, and I want to thank everybody for their patience and their flexibility.

One of our witnesses, Dr. Mark Zandi, unfortunately will have to leave shortly. So to permit him to give his testimony and take questions, we are going to sort of do things in a little bit different way this afternoon. We are going to take his testimony first, followed by a round of questions that any Members may have for him. And then we will return to opening statements and to our other witnesses.

Dr. Zandi is the Chief Economist and the cofounder of Economy.com, which provides economic research and consulting services to corporations, governments and institutions, maintaining one of the largest online databases of economic and financial time series.

Dr. Zandi's recent work includes a study of the outlook for national and regional housing market conditions, the determinants of personal bankruptcy, the location of high technology centers and the impact of globalization and technological change on real estate markets.

In addition to being regularly cited in *The Wall Street Journal, New York Times, Business Week, Fortune* and other leading publications, Dr. Zandi also appears on *ABC News, Wall Street Week, CNN* and *CNBC*.

Dr. Zandi, welcome. Your full written statement will be made part of the record and we would ask that you please limit your oral remarks to 5 minutes. And at this time, I would invite you to please give your testimony.

STATEMENT OF MARK M. ZANDI, Ph.D., CHIEF ECONOMIST, MOODY'S ECONOMY.COM, INC., WEST CHESTER, PA

Mr. ZANDI. Thank you very much. Thank you for the opportunity to present this testimony today. I also would like to thank the Mecklenburg Health Center for the opportunity to use their facility. It was very kind of them, and their hospitality has been wonderful.

I will make six points in my remarks. First, the Nation's housing and mortgage markets are suffering a very severe recession. The housing activity peaked over 2 years, and since then home sales have fallen nearly 20 percent, housing starts by 40 percent and house prices by 5 percent. Over half the Nation's housing markets are currently experiencing substantial price declines with double-digit price declines occurring throughout Arizona, California, Florida, Nevada, in the Northeast Corridor and industrial Midwest.

Further significant declines in construction and prices are likely throughout next year as a record amount of unsold housing inventory continues to mount. Given the impact of the recent subprime financial shock and its impact on the mortgage securities market and, thus, mortgage lenders, it is reasonable to expect national house prices to fall by at least 10 percent from the peak of their eventual trough late next year. This, of course, assumes that the economy avoids recession and that the Federal Reserve will continue to ease monetary policy.

Second, residential mortgage loan defaults and foreclosures are surging, and without significant policy changes, will continue to do so through 2008 and well into 2009. Falling housing values, resetting adjustable mortgages for recent subprime and all day borrowers, tighter lending underwriter standards and most recently a weakening job market are conspiring to create the current unprecedented mortgage problems.

I expect approximately 3 million mortgage loan defaults this year and next, of which 2 million will go through the entire foreclosure process forcing these homeowners to leave their current homes. The impact on these households, their communities and the broader economy will be substantial.

Foreclosure sales are very costly after accounting for their substantial transaction costs in certain significantly depressed, already reeling housing markets, as foreclosed properties are generally sold at deep discounts from prevailing market prices. These discounts are estimated to be well over 30 percent.

Third, there is a substantial risk that the housing downturn in surging foreclosures will result in a national economic recession. The stunning decline in housing activity and prices is sure to severely crimp consumer spending into next year, and the job market appears increasingly weak as it struggles with layoff in the housing-related industry. Regional economies such as California, Florida, Nevada and the industrial Midwest are already near or in recession.

Fourth, without a policy response, mortgage loan modification efforts are unlikely to prove effective in forestalling the increase in foreclosures. A recent Moody's survey of loan servicers found that very little modification had been done, at least through this past summer.

There are a large number of impediments to modification efforts. Some tax, accounting and legal hurdles appear to have been overcome, but large differences in the incentives of first and second mortgage lienholders and the various investors in mortgage securities are proving to be daunting. While the total economic benefit of forestalling foreclosure is significant, these benefits do not accrue to all of the parties involved in determining whether to proceed with the loan modification.

Fifth, the legislation to give bankruptcy judges the authority in Chapter 13 to modify mortgages by treating them as secured only up to the market value of the property will significantly reduce the number of foreclosures. To limit any potential abuses, Congress should provide firm guidelines to the bankruptcy courts, such as providing a formula for determining the term to maturity, the interest rate and the property's market value.

Properly designed legislation could reduce the number of foreclosures through early 2009 by at least 500,000. This would be very helpful in reducing the pressure on housing and mortgage markets and the broader economy.

Six, this legislation will not significantly raise the cost of mortgage credit, disrupt secondary markets or lead to substantial abuses. Given that the total cost of foreclosure is much greater than that associated with a Chapter 13 bankruptcy, there is no reason to believe that the cost of mortgage credit across all mortgage loan products should rise. Indeed, the cost of mortgage credit to prime borrowers may decline.

The cost of second mortgage loans, such as piggyback seconds, could rise as they are likely to suffer most in bankruptcy, but such lending has played a clear contributing role in the current problems.

There is also no evidence that secondary markets will be materially impacted after a period of adjustment as other consumer loans, which already have similar protection in Chapter 13, have well functioning secondary markets.

The residential mortgage securities market will go through substantial changes in response to the recent financial shock and will adjust to these new rules. Abuses should also be limited, given that a workout in Chapter 13 is a very costly process for borrowers. Indeed the number of bankruptcy filings has remained surprisingly low since late 2005 bankruptcy reform, likely affecting the higher cost to borrowers.

Finally, I think it is important that the changes to bankruptcy law in this legislation sunset after several years. Based on historical experience, changes to bankruptcy law can have unintended consequences. I believe the changes in this legislation—proposed legislation, will have significant benefits, both short- and long-run, but lawmakers may decide otherwise after several years of experience.

Allowing the legislation to sunset should also help dissuade concerns that this legislation is an effort to readdress other issues in the Bankruptcy Code. The housing market downturn is intensifying and foreclosures are surging. Odds are quickly rising that is self-reinforcing a negative dynamic of foreclosures beginning house price declines to getting more foreclosures will develop in many neighborhoods across the country. There is no more efficacious way to short circuit this cycle than adopting legislation to allow bankruptcy judges the authority to modify mortgages by treating them as secured up to the market value of the property.

Thank you.

Ms. SÁNCHEZ. Thank you for your testimony Dr. Zandi.

[The prepared statement of Mr. Zandi follows:]

PREPARED STATEMENT OF MARK M. ZANDI

Mr. Chairman and members of the Committee, my name is Mark Zandi; I am the Chief Economist and Co-founder of Moody's Economy.com.

Moody's Economy.com is an independent subsidiary of the Moody's Corporation. My remarks represent my personal views and do not represent those held or endorsed by Moody's. Moody's Economy.com provides economic and financial data and research to over 500 clients in 50 countries, including the largest commercial and investment banks; insurance companies; financial services firms; mutual funds; manufacturers; utilities; industrial and technology clients; and governments at all levels.

I will make six points in my remarks. First, the nation's housing and mortgage markets are suffering a very severe recession. Housing activity peaked over two years ago, and since then home sales have fallen nearly 20%, housing starts by 40%, and house prices by 5%. Over half the nation's housing markets are currently experiencing substantial price declines, with double-digit price declines occurring throughout Arizona, California, Florida, Nevada, in the Northeast Corridor and industrial Midwest. Further significant declines in construction and prices are likely throughout next year as a record amount of unsold housing inventory continues to mount give the impact of the recent subprime financial shock and its impact on the mortgage securities market and thus mortgage lenders. It is reasonable to expect national house prices to fall by at least 10% from their peak to their eventual trough late next year. This assumes that the economy will avoid recession and the Federal Reserve will continue to ease monetary policy.

Second, residential mortgage loan defaults and foreclosures are surging and without significant policy changes will continue to do so through 2008 and into 2009. Falling housing values, resetting adjustable mortgages for recent subprime and Alt-A borrowers, tighter lending underwriting standards, and most recently a weakening job market are conspiring to create the current unprecedented mortgage credit problems. I expect approximately 3 million mortgage loan defaults this year and next, of which 2 million will go through the entire foreclosure process, forcing these homeowners to leave their current homes. The impact on these households, their communities, and the broader economy will be substantial. Foreclosed sales are very costly after accounting for their substantial transaction costs, and serve to significantly depress already reeling housing markets, as foreclosed properties are generally sold at deep discounts to prevailing market prices. These discounts are estimated to be well over 30%.

Third, there is a substantial risk that the housing downturn and surging foreclosures will result in a national economic recession. The stunning decline in housing activity and prices is sure to severely crimp consumer spending into next year, and the job market appears increasingly weak as it struggles with layoffs in housing related industries. Regional economies such as California, Florida, Nevada and the industrial Midwest are already near or in recession.

Fourth, without a policy response, mortgage loan modification efforts are unlikely to prove effective in forestalling the increase in foreclosures. A recent Moody's survey of loan servicers found that very little modification had been done, at least through this past summer. There are a large number of impediments to modification efforts. Some tax, accounting and legal hurdles appear to have been overcome, but large differences in the incentives of first and second mortgage lien holders and the various investors in mortgage securities are proving to be daunting. While the total economic benefit of forestalling foreclosure is significant, these benefits do not accrue to all of the parties involved in determining whether to proceed with a loan modification.

Fifth, the legislation to give bankruptcy judges the authority in a Chapter 13 to modify mortgages by treating them as secured only up to the market value of the property will significantly reduce the number of foreclosures. To limit any potential abuses, Congress should provide firm guidelines to the bankruptcy courts, such as providing a formula for determining the term to maturity, the interest rate, and the property's market value. Properly designed, the legislation could reduce the number of foreclosures through early 2009 by at least 500,000. This would be very helpful in reducing the pressure on housing and mortgage markets and the broader economy.

Sixth, this legislation will not significantly raise the cost of mortgage credit, disrupt secondary markets, or lead to substantial abuses. Given that the total cost of foreclosure is much greater than that associated with a Chapter 13 bankruptcy there is no reason to believe that the cost of mortgage credit across all mortgage loan products should rise. Indeed, the cost of mortgage credit to prime borrowers may decline. The cost of second mortgage loans, such as piggy-back seconds, could rise, as they are likely to suffer most in bankruptcy, but such lending has played a clear contributing role in the current credit problems. There is also no evidence that secondary markets will be materially impacted after a period of adjustment, as other consumer loans which already have similar protection in Chapter 13 have well functioning secondary markets. The residential mortgage securities market will go through substantial changes in response to the recent financial shock and will adjust to the new rules. Abuses should also be limited given that a workout in Chapter 13 is a very costly process for borrowers. Indeed, the number of bankruptcy filings has remained surprisingly low since the late 2005 bankruptcy reform, likely reflecting the much higher costs to borrowers.

Finally, I think it is important that the changes to bankruptcy law in this legislation sunset after several years. Based on historical experience, changes to bankruptcy law can have unintended consequences. I believe the changes in this proposed legislation will have significant both short and long-term benefits, but lawmakers may decide otherwise after several years of experience. Allowing the legislation to sunset should also help assuage concerns that this legislation is an effort to re-address other issues in the bankruptcy code.

The housing market downturn is intensifying and mortgage foreclosures are surging. Odds are quickly rising that a self-reinforcing negative dynamic of foreclosures begetting house price declines begetting more foreclosures well develop in many neighborhoods across the country. There is no more efficacious way to short-circuit this cycle than adopting legislation to allow bankruptcy judges the authority to modify mortgages by treating them as secured only up to the market value of the property.

Ms. SÁNCHEZ. We will now begin with a round of questioning because we know that you cannot stay long with us. So I will recognize myself for 5 minutes.

It is a little interesting because you have not heard the testimony of our other panelists, and yet my first question deals with some testimony that was presented by Mr. Kittle in his written testimony that he submitted.

He states that if these provisions were enacted, it would increase the cost and reduce the availability of mortgage credit for principal residents; and I am interested in hearing your response to that statement.

Mr. ZANDI. You know, I don't think that will be the case. I think, most fundamentally the reason is that the cost of foreclosure, the total cost of foreclosure, is measurably higher than will be the cost of a bankruptcy in Chapter 13 under this proposal.

In terms of the cost of foreclosure they are quite significant. It is not only the difference in the mortgage amount and the market value of the property. It is all of the transaction costs involved, including the legal cost, the maintenance cost, the cost associated with realtors selling property post-auction.

It also is the time involved. There is a period of a year or two that could pass before foreclosure actually takes place and a person is asked to leave the home, and there is lots of depreciation and other costs associated with that.

And, finally, I don't think we should discount the cost to the broader economy of foreclosures and the impact that has on the communities and the broader economy. It serves to reduce market values for all homes in those communities, and that is also a cost.

So I think the point is that when you consider the wide range of costs involved in a foreclosure it is very, very significant. Someone bears it, and those costs are measurably greater than the cost that would ensue in a Chapter 13 bankruptcy under this proposed legislation.

So, in my view, it is hard to argue that the cost of mortgage credit will rise in aggregate. You may argue that certain groups will suffer higher costs, that those folks that are making piggyback seconds definitely will have higher costs, but for the vast majority of mortgage buyers I don't think it will make a difference.

Ms. SÁNCHEZ. Thank you.

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

Mr. ZANDI. I don't think that will be the case either. It is a change, and therefore, the secondary market will have to adjust to that change; but I think it is a relatively straightforward thing to do.

The issue for the secondary market is, what is the loss on the mortgage in a foreclosure and how is that different from a loss that would incur in a Chapter 13 bankruptcy under this proposed legislation. I mean, the worst-case scenario for the securities market would be just to assume what they are assuming now about the loss in foreclosure. That would be sort of the most conservative outside estimate of the cost. But I do think with time they will figure it out.

The other point is—and they can do that relatively quickly.

And the other point is, the market is broken; as it is, it is not functioning well. A lot of changes have to occur to make this market function appropriately. And this is a perfect time to ask them to make this kind of a change because they have to, in a sense, redo the plumbing because the plumbing is broken. And why not put in better pipes while you are at it?

Ms. SÁNCHEZ. Great.

And the final question, also in his prepared testimony—and, again, it is kind of weird because you have not heard the testimony. Mr. Kittle states that the proposed reform to section 1322(b)(2), which allows a Chapter 13 debtor to modify a home mortgage, would result in higher down payments and that the borrower would have to pay 1 to 3 points on the entire loan, an additional three-eighths of a percent in the mortgage interest rate; and he also estimates that borrowers would see a 200 basis point jump in interest rates with a 5-to-10-percent down payment home mortgage with no points or fees at closing.

And I am interested in getting your reaction to that assertion.

Mr. ZANDI. I don't agree. This is very similar to the first question about the interest rate costs.

There are numerous ways that you can raise the cost to the borrower. One is the interest rate, the other is the size of the down payment. I think, in aggregate, when you consider all mortgage borrowers and all mortgage lending, that we will not see any significant increase in the cost, whether it be through an interest rate, whether it be through the size of the down payment or other lending terms that are offered up to borrowers.

And just to reiterate, there will be some groups where the cost will rise. I mean, I do think that some borrowers wished to put very little down and relied on a piggyback second to be able to fit into the home 100 percent cumulative loan-to-value ratio or above. Those borrowings will be, under this legislation, will be more difficult. But in my view, a large part of the foreclosures or problems that we are facing are related to that kind of a lending; and I don't see any downside to having that be restricted to some degree by the marketplace.

Ms. SÁNCHEZ. Great. Thank you.

My time has expired, so at this time I would like to recognize our distinguished Ranking Member, Mr. Cannon, for 5 minutes of questions.

Mr. CANNON. Thank you for joining us, Mr. Zandi. I am actually looking forward to the time when we cannot not all be here together and participate the way you are participating. I think this is the first time we have actually had a witness on a videoconference.

Ms. SÁNCHEZ. Yes.

Mr. CANNON. So thank you for breaking the ice here and setting a precedent. Mr. Chairman of the whole Committee, I hope you are taking note that this works pretty well.

Mr. Zandi, you made a comment that made me wonder if we are talking about the same thing. You mentioned a sunset, but the Miller bill does not have a sunset. Do you think it needs a sunset?

Mr. ZANDI. I do. I think that any legislation should have a sunset provision, because as we all know from previous bankruptcy reform changes, there are always things that we do not anticipate. And I fully believe that this proposed change is a good idea that will work out in the short run and the long run. But I would counsel that a sunset provision will be advisable so that we can go back 3, 5 years down the road and evaluate whether this was an appropriate change or not.

Mr. CANNON. We have people saying that this problem may be very short-term, others saying that the resets in mortgages may happen over a long period of time through 2010—2009.

How long, if you had to put a number on it, how far out would you put that sunset?

Mr. ZANDI. I would put it out at least 3 years, because the problems will be very severe through the spring, summer of 2009; post that, the recent tightening in underwriting standards will have benefits and the foreclosure problems will abate significantly by late 2009 into 2010. And by that point, we will have enough data points to really judge whether this was appropriate or not.

Mr. CANNON. Given what I think is a risk—and you sort of presented a no-cost solution here; I don't agree with that. But given what I think are the risks, should we think in terms of a 2-year sunset so 2009, about this time, we have to reauthorize it if it has worked and if it is necessary.

Mr. ZANDI. Well, I think 2 years might be a little too short because you need to get the data, you need to see it come in, and there are lags involved.

Now, suppose that, as I am anticipating foreclosure problems, continue into the spring of 2009. It will take at least until the end of 2009, early 2010, to get all the information in and be able to really digest it, make sense of it and make sure that things are working properly.

So I would counsel 3 years.

Mr. CANNON. We are moving in a world with quicker data; and in a case like this, I would hope that we could focus the data, because the risks, I think, are high. Let me ask one other question.

My experience—and this is anecdotal and that is why we are here; but my sense is that many subprime lenders are now yielding windfall profits by repossessing houses of people who can't sell their house or can't make their payments and then selling them in a market that is actually artificially high, but which has been supported by purchases. And while they are doing it at a discount—you talked about deep discounts for foreclosed houses—my sense is the discounts are not so deep, and that there is a big incentive on the part of the forecloser to take the house and resell it at a profit from the house.

I suspect that if you give the borrower the time frame and context to cram down that loan in bankruptcy that the system will not heal itself so quickly.

Am I wrong about some lenders getting windfall profits from foreclosing? And secondly, do we have to worry about not solving the problem by giving borrowers who are in over their heads more leverage?

Mr. ZANDI. I am not aware of a significant amount of profit being made in the foreclosure, in post sales, post-foreclosure sales. My sense of the data that I am seeing, which is now coming in quite quickly, is that prices are falling and they are falling very rapidly. And all indications are that they will continue to fall very rapidly, at least for the foreseeable future.

Fundamentally, the problem here is that there is a massive amount of unsold inventory, and it is rising because of the fall in home sales and because of the increase in foreclosure. So I would be surprised if what you described is occurring in a very significant broad base; and if it is now, I doubt it will be in a few months because of the market conditions which are eroding exceptionally quickly. So I don't think that is an issue.

Now, with respect—or it soon won't be.

Secondly, with respect to giving more power to the borrower in the cram-down, to some degree that is the idea. That is the purpose here. Lenders and servicers and investors are having a very difficult time coming to terms and figuring out how to make loan modifications work, even though we all sense that in a broad—when you consider all the costs of all the foreclosures, that it would make sense to go through this process because for each one of the individual parties involved in the process, they may not make a profit, they may lose.

So it is very, very difficult for everyone to come to terms on this. And by giving the borrower a little bit more power in the process, I think you crystallize a sense of urgency on the part of the lenders, the servicers and the investors to come together, come to terms and try to figure this out quickly. Because the problem is now, it is not 6 months from now or 12 months from now, it is now.

Mr. CANNON. I notice, Madam Chairman, that my time has expired. But I will just point out, if I might take a moment, that what we are debating here on this bill is exactly what Mr. Zandi has said, which is, Where do we put the thumb on the scale here and how heavily do we press?

Thank you, and I yield back.

Ms. SÁNCHEZ. The time of the gentleman has expired. We have just been notified that we have votes across the street, but I think we have time for Mr. Conyers' round of questions. Mr. Conyers is recognized for 5 minutes.

Mr. CONYERS. Thank you, Chairwoman Sánchez. I want to thank everyone for arranging this.

There are only two questions that I have. One is that the industry tells us that they are on top of the problem and that if we trust them, they can solve this. I know that the "trust me" question always suggests the obvious answer.

But why would they give us this kind of information?

Mr. ZANDI. You are asking me, Congressman?

Mr. CONYERS. Yes, sir.

Mr. ZANDI. Well, I think that many parties involved are well intentioned. They would like to help solve this foreclosure problem. But, you know, there are a lot of countervailing incentives—second-lien versus first-lien holders, the various flavors of investors, the servicers versus the investors.

So I think the problem is that they may be well intentioned, they want to make it work, but given the incentives that are present and the conflicts that are involved, it is going to be extraordinarily difficult for them to come to terms of agreement, at least quickly enough to make a big enough difference for the people who are losing their homes today and next year and the year after.

Mr. CONYERS. In other words, they have got vested interests that don't lead them to be as concerned about resolving this problem as quickly as we can?

Mr. ZANDI. That is one way of looking at it.

Or their view is that they can solve this problem in a different way and a better way, a more profitable way than another person or party involved and can't come to terms.

Mr. CONYERS. Well, you know, the problem that I am finding, Mr. Zandi, is that some of them were in on the predatory lending and the incredible schemes that got people into this mess to begin with.

Mr. ZANDI. Yeah. You know, there are certain cases of that, and certainly there is, I think, evidence that lenders were overly aggressive, many of whom were in the nonregulated part of the industry or the lightly regulated part of the industry.

But I think, broadly the industry wants to do the right thing. They want to do good; they are working hard. But my point is, because of the impediments in their way, they are just not going to be able to get it together quickly enough to make a big difference. And I think with this proposed legislation it will allow for some of those impediment barriers to come down, and we will get something done, something worthwhile, something that will make a difference to this market and to these households before it is too late.

Mr. CONYERS. The last question, Chairwoman, is this to Mark Zandi.

I have just been encouraged by some of my friends that want us to freeze all foreclosures and allow American families to retain their homes. The monthly payments and rent should be made to banks, designated banks, which can use the funds as collateral for normal lending practices, thus recapitalizing the bank system. These payments will be factored into new mortgages reflecting the deflating of the housing bubble and the establishment of appropriate property valuations and reduced interest rates.

Has that occurred to you recently?

Mr. ZANDI. Yeah. I wouldn't agree with that. I think that would be a very significant mistake.

I think—what you are discussing, I think, today in the form of this legislation is a good middle ground and something that will do right by lenders and by borrowers. But by completely shutting down the foreclosure process, I think that would do more harm than good—particularly to the very people that I think you would like to help in the long run.

So I really believe that this legislation is a piece of legislation that will strike the right balance.

Mr. CONYERS. I think so, too. I am a cosponsor of it.

And I thank you very much for your comments, Mr. Zandi.

Thank you, Madam Chairman.

Ms. SÁNCHEZ. The time of the gentleman has expired, and I think this is a good time to take a natural break. We need to go across the street to vote.

Dr. Zandi, I want to thank you for your participation. I know by the time we get back, you will have to run. But Members will be submitting written questions that we will ask you to answer as quickly as possible to be made a part of the record as well. Again, we want to thank you for your patience and all of our panelists for their flexibility.

We are going to be in recess while we vote, and we will come back to finish the hearing.

[Recess.]

Ms. SÁNCHEZ. This hearing on the Judiciary Subcommittee on Commercial and Administrative Law will come to order. We are trying to speed things along, given our late start. And normally we would do full-blown opening statements. I am going to actually recognize Mr. Feeney to give the minority opening statement. The gentleman is recognized. I will respond, and then we will proceed with the testimony of our panelists.

Mr. Feeney is recognized.

Mr. FEENEY. Well, thank you, Madam Chairman. I think it is important that we had a second hearing. Some of us were very concerned that we had rushed through the first consideration. And I remain determined to point out that the unintended consequences that may adversely impact credit markets throughout America in this bill really need to be examined by the Financial Services Committee, which has the bulk of the expertise.

Having said that, that decision is admittedly way beyond my pay grade, as to whether or not the Financial Services Committee ought to consider what potentially could be the most damaging impact on credit availability in the homeowners' market in America of any bill that—in the 6 years since I have been here. I will say that all of us are sympathetic with the plight of homeowners that for whatever reason may be foreclosed on in their homes. So there is an enormous amount of sympathy with the 1 or 2 or 3 percent of Americans that may suffer this.

But ultimately, there is a price to be paid for allowing a judge to arbitrarily cram down the mortgage after the fact. And that price I am afraid could be huge. The protection for home lending in the Bankruptcy Code goes back at least to 1898. In 1978, Senator DeConcini pointed out the intent of section 1322(b)2 of the code was to preserve the availability of residential mortgage funding for individuals of modest means. We need to determine I think as a Congress what it means if we do away with the availability of mortgages for individuals of modest means.

Justice Stevens, no right wing justice, in the case of *Nobelman v. American Savings Bank*, pointed out that it was the intent of Congress all along in enacting that very section to assist with home ownership. And I quote him from that case: "At first blush, it seems somewhat strange the Bankruptcy Code should provide less protection to an individual's interest in retaining possession of his or her home than of other assets. The anomaly is, however, explained by the legislative history, indicating the favorable treatment of residential mortgages was intended to encourage the flow of capital into the home lending market."

I would note that we had an economist earlier—and of course, Ronald Reagan famously remarked that he wished he could find a one-armed economist because you can always find an economist that will say, on the one hand, this may occur, and the other hand, the opposite may occur. To his credit, the economist that testified, he thought on balance this proposal would probably be helpful. Also acknowledged in Mr. Zandi's testimony that the unintended consequences of such legislation often outweigh the intended positive consequences, and so that was the sole entire reason why he suggested that we sunset any reform of the Bankruptcy Code.

There are other economists, presumably who are advising some of the major players in the lending industry, including the American Bankers Association, National Association of Home Builders, the U.S. Chamber of Commerce and others, that are asserting the importance of protecting availability of credit to homeowners throughout the country by preserving this section of the code. And

I would also like, Madam Chairman, to ask for unanimous consent because there is at least one entity that acts as sort of a mutual fund. That would be the National Association of Federal Credit Unions, which is not a profit-making entity. I would like to ask permission, unanimous consent to insert a letter addressed from the National Association of Federal Credit Unions to Chairman Conyers and Ranking Member Lamar Smith.

Ms. SÁNCHEZ. Without objection, so ordered.

[The information referred to follows:]

LETTER FROM THE NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

NAFCU
National Association of Federal Credit Unions
3138 10th Street North • Arlington, Virginia • 22201-2149
(703) 522-4770 • (800) 336-4644 • Fax (703) 522-2734

Fred R. Becker, Jr.
President and CEO

October 23, 2007

The Honorable John Conyers
Chairman
House Judiciary Committee
2138 Rayburn House Office Building
Washington, DC 20515

The Honorable Lamar Smith
Ranking Member
House Judiciary Committee
2142 Rayburn House Office Building
Washington, DC 20515

Mr. Chairman

Dear Chairman Conyers and Ranking Member Smith:

I am writing on behalf of the National Association of Federal Credit Unions (NAFCU) to express our concerns regarding H.R. 3609, *the Emergency Home Ownership and Mortgage Equity Protection Act of 2007.* NAFCU is the only national trade association that exclusively represents the interests of the nation's federal credit unions.

NAFCU and our member credit unions recognize and support the need for both responsible lending and prudent consumer financial management as established by the *Bankruptcy Abuse and Consumer Protection Act of 2005.* While fully recognizing the well-intentioned efforts of H.R. 3609 to address issues related to the current sub-prime mortgage crisis, we believe that the potential impact H.R. 3609 may impose on the credit availability to consumers outweighs its benefits.

While recognizing the intent of H.R. 3609 is to remedy abusive sub-prime loans, our in-depth analysis of the bill indicates that it would cover all mortgages and home equity loans, including those made by credit unions. We believe that such broad based coverage of all mortgages and home equity loans by the *Emergency Home Ownership and Mortgage Equity Protection Act of 2007* will create greater uncertainty in the mortgage market and likely lead to higher costs to credit union members. (Like other lenders, credit unions will have to price for increased uncertainty with their products (as they might be adjusted in Chapter 13 bankruptcy proceedings).) We are also concerned that credit unions that hold their mortgages in portfolio would face increased risk, as not-for-profit cooperative institutions must pass their losses on to other members.

As Home Mortgage Disclosure Act (HMDA) data indicates, credit unions make more of their loans to low-income and minority populations at rates closer to standard Treasury rates than other financial institutions. Unfortunately, the proposed bill would have the unintended consequence of raising mortgage rates for riskier populations as institutions would be forced to price for the additional risk created by its enactment.

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Additionally, given the uncertainty in the secondary market that we believe enactment of H.R. 3609 will create (by permitting the adjustment of mortgages in Chapter 13 bankruptcy proceedings), credit unions will find it more difficult to access this important vehicle for the mortgages that they offer.

Given these facts, we ask you to oppose H.R. 3609 as reported to the full Judiciary Committee. We respect the intent of this legislation and look forward to continuing to work with you on assisting homeowners that are experiencing difficulty in the current housing market. We believe that with further study and examination, a workable solution can be achieved that will effectively remedy abusive sub-prime loans without creating additional uncertainty in the financial markets.

If you or your staff should have any on this matter, please do not hesitate to contact NAFCU's Director of Legislative Affairs, Brad Thaler, or me at (703) 522-4770. Thank you for your leadership on this very important matter.

Sincerely,

Mr. Chairman -
Thanks for considering
our significant concerns.

Fred R. Becker, Jr.
President/CEO

cc: Members of the House Judiciary Committee

Mr. FEENEY. And finally I would point out that the adverse consequences are not just going to be potentially to people of modest means who want to buy homes in the future. If you want to sell your home to somebody of modest means, there could be huge adverse consequences because the pool of buyers that have access to credit may dry up. If you merely want to retain ownership of your home because there are fewer buyers for like homes, the equity that otherwise might grow in your home will be depressed by this variable, this uncertainty that is thrown into the ability to collect markets, so even people that want to hang onto their homes for the next 20 or 30 years, in my view, will be likely to suffer some damage if this is imposed, not to mention realtors, home builders, title companies, mortgage companies, surveyors.

As you diminish on the margins the number of people that could access credit or you reduce the credit availability to people to buy a larger home or a nicer home than they would—if it hadn't been for the uncertainty we are putting in the market here by removing this section of the code, you diminish the value of all residential real estate in the country.

And with that, Madam Chairman, I would yield back the balance of my time.

Ms. SÁNCHEZ. The gentleman yields back.

And I will yield myself just a couple of minutes to respond to some of what has been said.

Last month, this Subcommittee held a hearing on the subprime mortgage meltdown, this very same issue, and we got to hear from experts on how we got into this mess, and we heard their views on how to fix it. We have already heard testimony from one witness today with respect to the proposed legislation that Congressman Brad Miller and I introduced, H.R. 3609. And I am pleased to recognize my colleague and welcome him to our Subcommittee hearing today.

I know it has kind of been a quirky and out-of-order hearing. But I think everybody will agree, and I think all of our witnesses at the last Subcommittee hearing on this issue agreed that foreclosure is the worst possible option for everybody in all instances. And so I think the legislation, as crafted by Mr. Miller and I, while we are open to some suggestions for improving it, I think really strikes at the heart of what could provide some real relief and some reasonable measures that are not going to—not going to over address the problem, if you will.

With that, I am going to yield back my time. And we will, without objection, allow Members to submit their written statements for the record. Without objection, the Chair will be authorized to declare a recess of the hearing at any point.

[The prepared statement of Mr. Cannon follows:]

PREPARED STATEMENT OF THE HONORABLE CHRIS CANNON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF UTAH, AND RANKING MEMBER, SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

STATEMENT OF RANKING MEMBER CANNON
SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW
HEARING ON "STRAIGHTENING OUT THE MORTGAGE MESS"
OCTOBER 30, 2007

Madame Chairwoman, I want to thank you for holding this hearing on H.R. 3609.

H.R. 3609 – the Miller bill – has the potential to cause serious negative consequences to current home owners, future home owners, lenders, investors, federal government loan programs, and the U.S. economy in general.

Hopefully through this hearing we can highlight the serious flaws in the Miller bill and examine whether there is anything we can responsibly do within the Bankruptcy Code to alleviate the problems currently facing borrowers.

What we cannot do is enact legislation that will dry up the flow of capital into the mortgage lending market and raise interest rates and other terms on future borrowers.

The Miller bill will have just that impact.

Indeed, the negative impacts that Miller bill will have are as staggering as they are obvious.

The most obvious problem with the bill is that it will cause lenders to raise interest rates and require much larger downpayments. Such adjustments on the part of lenders will most affect low and moderate income families. Delaying, and in some cases ending, the dream of home ownership.

Another problem with the Miller bill is that it is in no way targeted at the current crisis.

We have been told repeatedly that the crisis that needs to be addressed is with subprime loans. Yet, the Miller bill applies to all home mortgage loans — prime and subprime alike.

We have been told repeatedly that the problem is with interest rate resets that cause monthly loan payments to increase significantly. Yet, the Miller bill applies to fixed rate mortgages that will have one interest rate for the life of the loan.

We have been told repeatedly that the loan resets that are causing the crisis should be completed by the middle of 2009 at the latest. Yet, the Miller bill does not have a sunset — it will continue on long after the current problems have subsided.

In other words, there is absolutely nothing in the Miller bill that targets the solution at subprime loans with interest rate resets that have caused monthly payments to increase dramatically.

One has to question seriously whether the subprime crisis is merely being used as a vehicle to push for changes to the Bankruptcy Code that consumer groups and bankruptcy attorneys have been advocating for decades. Changes they were unable to get enacted with the 2005 bankruptcy reforms.

However, despite my strong misgivings about the bill, if there is something that we in this Committee can do to help alleviate the current problems facing subprime borrowers I am willing to work with the majority towards that end.

But before doing so we need to understand the impact of this legislation on all the entities involved in home mortgage lending:

- What will the Miller bill do to home mortgage interest rates and required downpayment amounts?
- How will it affect the secondary mortgage market and mortgage-backed securities?
- Who's going to pay to purchase loans out of the mortgage-backed securities pool if the modification violates the pooling and servicing agreement or federal tax rules?
- Will it push lenders away from involvement in federal home lending programs for low and moderate income families because of increased risk?

- How will the Miller bill affect other Congressional and regulatory efforts at solving the problem?

Serious concerns have been raised about the far-reaching impacts of this legislation. I hope this hearing will illuminate those concerns. I hope, too, that the Majority will take the time to craft good legislation rather than just rushing to “do something” that ultimately hurts more people than it helps.

The primary residence exception that is afforded to home mortgage lenders under section 1322 of the Code and pursuant to *Nobelman v. American Savings Bank* has its roots in the Bankruptcy Act of 1898. The exception has worked well. We must act deliberately and cautiously before we modify it.

Madame Chairwoman, the size of today's panel did not permit a representative of the secondary mortgage market to testify today. I regret that we were not able to hear from the secondary market, which provides the investment capital for 84 percent of all loans on primary residences. This is especially regrettable considering that we are hearing from the National Association of Consumer Bankruptcy Attorneys for a second time.

If we hold any future hearing on this subject I hope we will follow the lead of Chairman Frank in the Financial Services Committee and endeavor to invite representatives from all of the effected interests to testify.

I ask unanimous consent that the written testimony of the Securities Industry and Financial Markets Association be submitted to the record, along with the written testimony of the

American Bankers Association and the Financial Services Roundtable. I also ask unanimous consent that the testimony of Edward J. Kulik from a 1978 Senate Judiciary Committee hearing on the primary residence exception be entered into the record as well.

Ms. SÁNCHEZ. And at this point, I am pleased to introduce the witnesses for today's hearing. Our first witness is William Brewer, Jr., certified as a specialist in consumer bankruptcy law by the North Carolina State Bar. Mr. Brewer has represented the debtors in a series of cases in the Eastern District of North Carolina dealing with the effect of purchasing money security interest in bankruptcy cases. Mr. Brewer has been an NACBA member since 1993 and a NACBA director since 1997 and has served as an extremely popular panelist at NACBA's previous conventions.

Mr. Brewer served as a law clerk to Judge R.A. Hedrick of the North Carolina Court of Appeals before beginning private practice in 1977. I want to thank you and welcome you for your patience and for being here today.

Our second witness is David Kittle. Mr. Kittle is chairman elect of the Mortgage Bankers Association and president and chief executive officer of Principle Wholesale Lending, Inc., in Louisville, KY. He started with American Fletcher Mortgage Company and became a top loan originator before moving to management in 1986. In 1994, Mr. Kittle opened his own company, Associates Mortgage Group, Inc., and sold it in January of 2006. We want to welcome you here today.

He is the former chairman of MORPAC, MBA's political action committee, a former vice chairman of the MBA Residential Board of Governors and is a member of MBA's Advisory Committee. Mr. Kittle is also a member of the Fannie Mae Advisory Council.

We already heard from our third witness Dr. Zandi a little out of order.

Our final witness is Richard Levin, vice chair of the National Bankruptcy Conference. Mr. Levin is a partner at Skadden Arps, concentrating on corporate restructuring, insolvency and bankruptcy issues. He was counsel to a House Judiciary Committee Subcommittee and was one of the principal authors of the Bankruptcy Code and the Bankruptcy Reform Act of 1978. I will note that this is the second time that Mr. Levin has testified before this Subcommittee during this congressional session. The first being during the executive compensation hearing that we had.

And we welcome you back, Mr. Levin.

Mr. LEVIN. Thank you very much for having me back, Madam Chair.

Ms. SÁNCHEZ. Not at all. Without objection, all of the witnesses' written statements will be placed into the record in their entirety. And we are going to ask that you please limit your oral remarks to 5 minutes. We have a lighting system that starts with a green light. At 4 minutes, it will turn yellow to remind you that you have about a minute left in your testimony. And when the light turns red, we will ask you to summarize your final thoughts so that we may hear from all of our panelists. After each witness has presented his or her testimony, Subcommittee Members will be permitted to ask questions subject to the 5-minute limit.

With everybody understanding the rules, I will invite Mr. Brewer to please begin his testimony.

Can you please hit your microphone? Okay. I might recommend you try the other microphone. Your microphone doesn't appear to be working. And we will reset your time. All right. Is it working? None of the microphones are working. Okay.

We are going to pause for just a moment to see if we can get the microphones working.

Mr. CANNON. Madam Chair, while we are paused, may I ask unanimous consent to introduce several items into the record?

Ms. SÁNCHEZ. Of course.

Mr. CANNON. The first is a statement by Representative Steve Chabot. The second is a Securities Industry and Financial Markets Association statement and the third is a testimony or statement from Financial Services Roundtable, also a statement from the American Bankers Association and a statement of Edward J. Kulik, that is K-U-L-I-K—before a 1978 Senate Judiciary Committee hearing on bankruptcy.

[The information referred to follows:]

PREPARED STATEMENT OF THE HONORABLE STEVE CHABOT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Statement of Congressman Steve Chabot
Hearing on Straightening Out the Mortgage Mess: How can we Protect Our Home Ownership and Provide Relief to Consumers in Financial Distress
October 30, 2007

Madame Chairwoman, I would like to reiterate my thanks to you for agreeing to hold another hearing focusing on the subprime lending industry and the impact of certain subprime mortgages on homeowners. I appreciate your willingness to continue examining the events that caused the lending crisis before moving forward with legislation. I believe that this Committee and Congress must act very carefully to ensure that whatever remedy, if any, that moves forward out of this Committee does not do more harm than good.

I believe this hearing is particularly important since not a day goes by without a news report on the mortgage lending crisis and the impact that certain subprime loans have had on borrowers. These reports link lax, predatory, or other substandard lending practices to the increased number of delinquent mortgages and foreclosure filings over the last several years. In fact, analysts predict that the lending practices that were adhered to between 2001- 2005 will continue to impact the number of delinquent mortgage payments and foreclosures starts over the next several years, which could be especially devastating to subprime borrowers, if housing prices continue to fall.

In fact, statistics released by the Senate Joint Economic Committee indicate that there are more than 3 million outstanding nonprime loans that are vulnerable to foreclosure in the next few years. If these statistics are accurate, these foreclosures have the potential to directly diminish property values by more than $71 billion, in addition to $32 billion in spillover wealth, as neighborhood property values will most likely fall victim to these weak lending practices.

In my own state of Ohio, which leads the nation in the rate of foreclosure inventories and ranks second in the nation in the rate of foreclosure starts, there are more than 293,000 outstanding subprime loans. Of these outstanding loans, experts anticipate that more than 82,000 will be the subject of foreclosure, costing property owners in Ohio more than $3.6 billion in lost wealth.

While a number of legislative remedies have been proposed to address and oversee future lending practices administered by the financial industry, there are a number of individuals who have been victimized by these predatory practices who may have no recourse other than to file for bankruptcy.

I know that many in the industry are reluctant for Congress to revisit Chapter 13, particularly since many of the bipartisan reforms made in 2005 are just now taking hold. As a leader of that reform effort, I can understand their concern. The reforms that were enacted were a long time in the making -- especially those that ensure that bankruptcy protections are available only to those individuals who truly needed it.

Yet, we have a unique set of circumstances before us today, circumstances that do not require Congress to alter these reforms. There is a narrow remedy available under Chapter 13 that, with the help of Congress, could assist victims of predatory lending practices who find themselves facing foreclosure. H.R. 3778, the HOMES Act, which I introduced on October 9, 2007, would authorize a bankruptcy court to modify the principal amount of a mortgage to the fair market value for those borrowers who can prove that they meet certain eligibility criteria. However, the remedy provided by H.R. 3778 is not open ended. It is available for seven years, an adequate period of time to allow those subprime borrowers who find themselves in dire situations to avail themselves of the remedy.

This hearing is critical to determining whether the limited changes proposed by H.R. 3778, or H.R. 3609, the Emergency Home Ownership and Mortgage Equity Protection Act of 2007, which was introduced by Representative Miller and Chairwoman Sanchez, would give those who have been victimized by the industry the relief they need, while at same time safeguarding against any unintended consequences that may harm the lending industry and the cost of obtaining future mortgages.

I look forward to hearing from our panel of experts on this issue. Again, I thank Chairwoman Sanchez and Ranking Member Cannon for holding this hearing.

PREPARED STATEMENT OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION (SIFMA)

Testimony of SIFMA
before the
House Judiciary Subcommittee on
Commercial and Administrative Law

Hearing on Straightening Out the Mortgage Mess:
How Can we Protect Home Ownership and Provide Relief to Consumers in Financial Distress? – Part II

Tuesday, October 30, 2007

The Securities Industry and Financial Markets Association (SIFMA)[1] and the American Securitization Forum ("ASF")[2] are pleased to submit this testimony on Section 3 of H.R. 3609, the "Emergency Home Ownership and Mortgage Equity Protection Act of 2007," (the "Bill").

The Bill proposes to eliminate the nearly three decades of protection that the Bankruptcy Code (the "Code") has afforded to primary home mortgage lenders.[3] Specifically, the bill would permit debtors in Chapter 13 bankruptcy to "strip down" liens secured by the debtor's principal residence.[4] As a result, lenders would only be entitled to receive the value of the secured property, as opposed to the full amount of the debt owed.

The Bill is inconsistent with the intended purpose of the Code to promote homeownership through lower interest rates by protecting home mortgages as secured debt. The bill would undermine the over six and one-half trillion dollar secondary

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[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers locally and globally through offices in New York, Washington D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. (More information about SIFMA is available at http://www.sifma.org.)

[2] The American Securitization Forum is a broadly-based professional forum through which participants in the U.S. securitization market express their common interests on important legal, regulatory and market practice issues. ASF's membership – over 350 organizations in all – includes securitization issuers, investors, servicers, financial intermediaries, trustees, rating agencies, legal and accounting firms, and other securitization market participants. ASF is an adjunct forum of SIFMA. (Additional information about the ASF, its members and activities is available at www.americansecuritization.com.)

[3] *See* 11 U.S.C. §1322(b)(2) (enacted as part of the Bankruptcy Act of 1978).

[4] The term "strip down" refers to the ability of a mortgagor to compel a mortgagee to relinquish its lien upon receipt of payment equal to the value of the property, as opposed to the full amount of the debt. *Dewsnup v. Timm*, 112 S.Ct. 773, 779 (1992).

mortgage market which provides valuable liquidity to our economy by linking mortgage originators with the global capital markets.

In 1978 Congress crafted an exemption for mortgages on primary residences from modification during Chapter 13 bankruptcy proceedings to encourage homeownership, to discourage home owners from rushing to file bankruptcy, and to ensure an availability of capital in the mortgage markets. Supreme Court Justice John Paul Stevens affirmed the intent of Congress in his concurring statement in Nobelman v. American Savings Bank, 113 S. Ct. 2106 (1993), stating "At first blush it seems somewhat strange that the Bankruptcy Code should provide less protection to an individual's interest in retaining possession of his or her home than of other assets. The anomaly is, however, explained by the legislative history indicating that favorable treatment of residential mortgagees was intended to encourage the flow of capital into the home lending market." The cram down provision in H.R. 3609 would negate this long-standing principle.

Before altering mortgage lenders' contractual rights and taking action that would negatively affect the primary and secondary mortgage markets, Congress should ensure that the benefits of the action outweigh its cost, and also that the action is targeted at the root cause of the problem. While it is true that nationally the aggregate numbers of foreclosures are at record highs, the spike appears to be due in large part to a general decline in the real estate market, combined with increased investor speculation, and regional downturns in the employment market.[5] Mortgage lending is, by its nature, a long term, cyclical industry, and stability in the manner of risk assessment, underwriting and contractual relations is critical for the industry to survive the troughs. A political response that would undermine thirty years of practice in the mortgage lending industry, as well as the stability of the financial markets that rely upon the packaging of mortgages for liquidity, should not be undertaken lightly. There are significant long term consequences for all borrowers from the hoped for "benefit" to a small set of subprime borrowers who may end up in bankruptcy because of the terms of their mortgage loans. This is especially true since many of these borrowers debts can be reworked outside bankruptcy.

If, pursuant to the Bill, bankruptcy judges could modify the terms of a loan on a homeowner's principal residence, it would likely reduce the availability of mortgage credit for the very borrowers who need this credit most in order to refinance, result in

[5] For the first quarter of 2007, the aggregate numbers of foreclosure increases were mostly attributable to four states: California, Florida, Nevada and Arizona. But for these states, foreclosure starts would have actually declined nationwide (including those on subprime ARMs). Twenty four states saw a decline in foreclosure starts, while the rest saw negligible increases. In the above four states, foreclosures were impacted by speculators walking away from properties after a decline in the market which impacted their ability to flip the property before the reset in their adjustable-rate mortgages. It is clear that §1322(b)(2) does not apply to such investment activity. The other major influence on foreclosures were the states of Ohio, Michigan and Indiana, which have suffered large declines in manufacturing employment, and account for 19.9% of the nationwide foreclosures. The problems extend across all loans types: Subprime ARM delinquencies are twice the national rate and prime fixed-rate loans are three times higher than the national rate. *See* http://www.mortgagebankers.org/NewsandMedia/PressCenter/55132.htm.

higher interest rates and costs for all home buyers, and may cause disruption in the financial markets because of the uncertainty it would introduce.

Banks and other lenders pool and sell mortgage debt into mortgage backed securities (MBS) to investors through securitization. Securitization allows lenders to move loans off of their balance sheets, thus freeing up capital for further lending. Home mortgage credit has become more widely available at a lower cost because of securitization and the secondary mortgage market. Homeownership rates have increased to nearly 70 percent, due in part to the increased financing provided to lenders by the secondary market for mortgage debt.

Investors gauge the safety of mortgage-backed securities by the predictability of the cash flows on the underlying pools of mortgages. There are a variety of factors that can introduce risks into the predictability of those cash flows, and each of those factors is a source of risk for MBS investors. For example, most mortgage loans allow the borrower to prepay their loan at any time without penalty. Or, borrowers can default on their loans, which can affect both the timing of cash flows and the overall repayment of principal. The risks faced by MBS investors are reflected in borrowing rates for home buyers. The more risk of uncertainty for investors, the higher the borrowing costs for home owners.

By introducing a new source of risk for MBS investors—the risk that a bankruptcy court could reduce the secured balance of a mortgage loan—this legislation raises significant concerns for investors in MBS. If investors cannot be sure of the principal amount of a contract backing a security, those investors cannot estimate the value of the security. Such uncertainty would likely cause market participants, including MBS investors, to "reprice" the risk associated with their MBS investments at higher yields—interest rates—to compensate for this additional risk. Higher yields for MBS investors translates into higher borrowing costs for home buyers. While this risk would prevail for all mortgage borrowers, the effect would be particularly pronounced for those borrowers who are perceived to pose the greatest risk for entering bankruptcy during the life of their mortgage. In the context of the current downturn in the subprime mortgage market, high-risk borrowers have already suffered significantly and many are having extreme difficulty refinancing out of subprime loans made during the height of the real estate boom. This bill would make it even more difficult and expensive for those borrowers to obtain new financing.

An example of what may occur if this bill is passed may be found in the market for mortgages on second homes and vacation properties. Unlike mortgages on primary residences, mortgages on second homes and investment properties can be modified in bankruptcy court. As a result, mortgages on second homes and investment properties generally require greater down payments and have higher interest rates than others. The difference in rates is generally on the order of 1-2 percentage points. If the Code was amended to treat mortgages on primary residences like mortgages on second homes and investment properties, one would expect that lenders and investors would require higher down-payments or additional mortgage insurance coverage for not only subprime mortgages, but *all* primary residence mortgages, including *prime* mortgages, and charge higher interest rates for those loans. This result naturally follows because a borrower's credit would have less bearing on the lender's decision to extend credit than would the value of the asset (the primary residence). The greater down-payments required and higher interest rates charged by lenders could exclude some home buyers from qualifying for a mortgage.

Moreover, only approximately nine percent of second home mortgage originations are securitized.[6] By comparison, roughly eighty-four percent of primary home mortgage originations are securitized.[7] If the Bill were adopted, it could reduce the ability of mortgage originators to securitize loans on principal residences, again making those loans less available and more expensive.

Finally, to the extent the Bill incents consumers to file for bankruptcy in order to reduce the balance of their outstanding mortgages, the Bill may also encourage consumers to recast all of their debts, not just those relating to their homes. Were this to occur, bankruptcy-related losses could be expected to increase on all asset types including, for example, credit cards and auto loans.

In sum, the Bill introduces a significant degree of uncertainty to the process of valuing the collateral that supports mortgage-backed securities, as well as potential delay to lenders in accessing proceeds from loans of Chapter 13 debtors. These uncertainties generate risks that would operate as a significant drag on the availability, pricing and efficiency of mortgage credit and the secondary mortgage markets. This result would not serve the best interests of consumers, lenders, investors or the U.S. capital markets and would be particularly harmful to those borrowers most negatively affected by the subprime downturn.

In the end, the Bill would do more harm than good, even for those it is designed to help, subprime borrowers. Instead of policies that would shrink mortgage lending during such a particularly soft period in real estate lending, Congress should explore other alternatives to help subprime borrowers in need. For example, industry participants are collaborating in new ways to create comprehensive education efforts. Specifically, lenders and servicers are reaching out to troubled homeowners, and assisting borrowers through community programs such as NeighborWorks® America, HOPE NOW and 888-995-HOPE. Many lenders have also increased other loss mitigation efforts including loan modifications, enhanced counseling programs and increased staffing to assist borrowers.

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[6] Second mortgages include home-equity lines of credit and closed-end seconds; some second mortgages are also securitized in subprime and other MBS products. "Securitization Rate Slips in Second Quarter Despite Lag in Nonprime MBS Process," *Inside MBS & ABS* (September 7, 2007).

[7] Primary mortgages include subprime, prime jumbo, conforming, and FHA/VA in the first half of 2007. *Inside MBS & ABS* (September 7, 2007)

Given the current conditions in the mortgage market—lenders tightening credit standards, or lenders going out of business entirely—it is already becoming difficult for some borrowers to access mortgage credit. Amending the bankruptcy code will only serve to exacerbate this problem. This bill will have the unintended consequence of harming those whom it intends to help—borrowers who are currently struggling to repay their mortgage.

As the Subcommittee continues to explore appropriate solutions to assist troubled borrowers and homeowners, we look forward to working with you.

PREPARED STATEMENT OF STEVE BARTLETT, ON BEHALF OF THE FINANCIAL SERVICES ROUNDTABLE

STATEMENT OF STEVE BARTLETT
ON BEHALF OF THE FINANCIAL SERVICES ROUNDTABLE

This hearing is about whether Congress will empower bankruptcy judges to re-write home mortgages, after the fact. Such an action would not help homeowners. Giving judges such sweeping, unchecked power will only make mortgages more risky and therefore more expensive. Those with less than perfect credit would be priced out of homeownership, and even those with perfect credit would pay higher rates.

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

Radical, risky reforms to Chapter 13 will have the effect of increasing risk for lenders to an unacceptably high level Section 3 of the HR 3609 would authorize bankruptcy judges to unilaterally reduce the loan amount of any mortgage and convert part of the mortgage to an unsecured status. It is important to note that this applies to all mortgages, even prime, fixed-rate loans that are fully current. This will force mortgage lenders to charge much higher interest rates for all types of mortgage loans. This will dry up credit for many Americans who may not be able to afford these higher rates.

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

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

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

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

HR 3609 is flawed proposal that will harm innocent investors. As we all know, the secondary market is a crucial source of liquidity, permitting mortgage lenders access to funds to make new loans to more Americans pursuing the dream of homeownership. Bankruptcy law revisions must not have the effect, even if unintended, of reducing liquidity that flows from the secondary market. Mortgages are now routinely pooled and sold to third party buyers who rely on the income stream from borrowers. This has provided for the regeneration of capital to permit lenders to make additional mortgage loans to even more aspiring homeowners. Because of the secondary markets, the capital markets have been making a much larger pool of capital for home mortgages. But if enacted, HR 3609 could have a de-stabilizing effect on the mortgage markets and punish innocent investors who purchased mortgage-backed securities in good faith..

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

Because Roundtable member companies, and all responsible lenders, want customers to be successful, major national lenders and servicers are actively working to contact their borrowers, particularly those facing adjustable rate mortgage resets. In addition, we are helping our customers through a national partnership with NeighborWorks® America and the Homeownership Preservation Foundation. It is estimated that about 50 percent of homeowners facing foreclosure never contact their lender. Our members are trying to overcome that challenge through active efforts to reach out to their borrowers. Our members are aggressively adopting new programs and products to address the specific difficulties subprime borrowers may have, with a particular focus on those with adjustable rate mortgages in this challenging interest rate environment and the slowing housing market. In 2006, over 48,000 homeowners called the HOPE Hotline while in 2007, counselors have already fielded over 80,000 calls from at-risk homeowners, with almost 40,000 of those completing counseling. The average daily call volume in August was 1600. Nearly half of those counseled have avoided foreclosure either through a loan modification or pre-foreclosure home sale. That is, over 120,000 Americans have had the opportunity for free counseling and about 60,000 borrowers have been able to stop a foreclosure. Thus, while a backwards looking study might not capture a true picture of how lenders and servicers are trying to help borrowers today.

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

Chapter 13 has worked well at saving homes while preserving access to mortgage credit and paying unsecured lenders after satisfying secured debt. HR 3609 is a step toward higher interest rates and higher fees and lower rates of homeownership. We stand ready to discuss how Congress might help in the face of the credit crunch, but we are compelled to oppose changes in bankruptcy law that undermine the very foundation of low-cost secured lending.

Attachment A

HOMEOWNER'S HOPE
HOTLINE:

888-995-HOPE

The Homeowner's HOPE™ Hotline is available:

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

888-995-HOPE offers:

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

When a constituent calls 888-995-HOPE:

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

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

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

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

National Supporters of this effort include: American General Financial Services, a member of AIG, Inc., Bank of America, Barrett Burke, LLP, Citigroup, Countrywide Home Loans, EMC Mortgage, Fannie Mae, Freddie Mac, GE Money, GMAC ResCap, Housing Policy Council, HSBC– North America, JPMorgan Chase, LaSalle Bank, Mortgage Bankers Association, National City Mortgage Co., Ocwen Loan Servicing, LLC, Option One Mortgage, State Farm Insurance, SunTrust Banks, Inc., Washington Mutual and Wells Fargo Home Mortgage.

If you need more information:

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

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PREPARED STATEMENT OF THE AMERICAN BANKERS ASSOCIATION AND AMERICA'S COMMUNITY BANKERS

Statement for the Record

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

and

AMERICA'S COMMUNITY BANKERS

Before the

Subcommittee on Commercial and Administrative Law

Committee on the Judiciary

United States House of Representatives

October 30, 2007

Statement for the Record
on behalf of the
American Bankers Association
and
America's Community Bankers
before the
Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
United States House of Representatives

October 30, 2007

The American Bankers Association and America's Community Bankers appreciate the opportunity to submit a statement for the record on possible legislative changes to the bankruptcy code, particularly as embodied in the Emergency Home Ownership and Mortgage Equity Protection Act of 2007, H.R. 3609. The American Bankers Association (ABA), which represents community, regional and money center banks and holding companies, as well as savings associations, savings banks and trust companies, is the nation's largest banking trade association.

Upon completion of its merger with America's Community Bankers (ACB) at the end of November, ABA will represent 95 percent of the industry's $11.5 trillion in assets, and it will speak for the vast majority of the industry's 2 million employees. At the same time, 83 percent of the new ABA's members will be community banks with less than $500 million in assets.

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

Many forces combined to create the problems we face today. After the dot-com bust, money flowed into real estate, helping to fuel a boom in home prices. As home prices rose, non-traditional mortgage products became quite popular as an avenue for real estate investment and homeownership. In many cases, individuals were purchasing homes with the intent of "flipping" them – investing money into upgrades and then hoping to sell quickly at a significant profit. Others purchased houses as mere investment properties with the intent of renting them out to others and then selling once the property had appreciated. In other cases, loans were being made to first-time homebuyers who may not have fully appreciated or understood the terms of their loan agreement. Still others were simply cashing-out their equity by re-financing. With the frenzy that ensued, sound underwriting practices were often sacrificed – primarily by non-bank originators – for immediate gains. In states where economic difficulties were already placing heavy financial stress on both consumers and businesses, the problems in the mortgage sector have had a particularly severe impact.

The fallout of the mortgage markets has been very troubling to the banking industry – an industry filled with institutions that have existed for decades and are committed to serving our communities for many more decades to come. The vast majority of banks were making basic mortgage loans that were underwritten on the basis of borrowers' ability to repay and with adequate documentation. We agree with Congressman Barney Frank, Chairman of the House Financial Service Committee, when he said: "Reasonable regulation of mortgages by the bank and credit union regulators allowed the market to function in an efficient and constructive way, while mortgages made and sold in the unregulated sector led to the crisis."[1] It has been the actions of loosely-regulated non-bank lenders, with little stake in the subsequent performance of the loans that they have made, that have caused much of the damage for consumers and for the industry. In fact, many banks tried to warn local consumers against "toxic" types of loans, only to watch as those consumers went down the road and

[1] *Boston Globe*, September 14, 2007.

took on obligations they did not understand and apparently could not resist – largely from non-bank mortgage originators.

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

If H.R. 3609 becomes law, it will lead to too much uncertainty and raise costs for ***all*** mortgage loans. Banks will not know the value of their collateral and, in order to manage their risks prudently, will be forced to pull back from making some mortgage loans. Simply put, this is no time to change the rules on the way collateral is handled. Banks are in a position to help, but cannot do so effectively if uncertainty is injected into the rules. The ABA and ACB strongly oppose the changes in the bankruptcy code that are being contemplated in H.R. 3609.

In our statement, we emphasize three key points:

- **H.R. 3609 will make it harder and more costly for consumers to obtain mortgages, which is exactly the opposite of what the mortgage market needs now.**
- **H.R. 3609 will encourage more bankruptcies and discourage borrowers from addressing problems early and working with lenders to facilitate a resolution.**
- **H.R. 3609 will eliminate required credit counseling which has helped reduce bankruptcy filings, facilitated workouts, and improved borrowers financial practices that benefit them now and in the future.**

I. H.R. 3609 Will Make it Harder and More Costly for Consumers to Obtain Mortgages

At the heart of the bill are provisions that would allow bankruptcy judges to alter the terms of mortgage agreements. If enacted, H.R. 3609 would allow judges to cramdown a portion of the outstanding mortgage balance on a primary residence, thereby converting it from secured to unsecured debt. The bill would also allow judges to modify other mortgage terms such as the applicable interest rate and repayment period. These provisions will create new lending risks that will certainly raise the costs to lenders for making any mortgage loan and inevitably lead to higher mortgage interest rates and fewer loans made to all borrowers. The impact is likely to be felt most strongly by higher-risk, but creditworthy, borrowers and may mean the difference between owning a home and continuing to pay rent to a landlord.

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

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

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

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

The changes proposed in H.R. 3609 make the underlying collateral less valuable and raise the expected loss on ***all*** mortgages for ***every*** lender. The unpredictability regarding how loan terms might change – whether it be a cramdown in value, or a change in the interest rate or other term of the loan – makes valuing the benefit of the collateral practically impossible. Slight changes in any of these terms can significantly affect the potential to recoup losses in the event the borrower declares bankruptcy. Lenders simply cannot predict at the time the loan is originated what changes in terms a judge may later impose. Therefore, because the value of the collateral is less certain, the interest rate reduction borrowers enjoy from pledging the asset will be less and the interest rate paid on the mortgage will be higher.

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

Investors in the Secondary Mortgage Markets Will Demand Higher Returns: Another important cost that helps to determine the interest rate on any mortgage loan is the cost of funding. The low mortgage interest rates and broad availability of credit that characterize the U.S. mortgage markets are attributable to an active secondary market for mortgage-backed securities. Today, market conditions have made investors wary of mortgage-backed securities (particularly those that are not backed by prime loans). Investors have become concerned about changes in the payments being made on the underlying mortgages backing their investments. If H.R. 3609 were to be enacted, it would significantly add to the uncertainty about the performance of and expected income stream from mortgage loans. This will be particularly true of securities that are supported by pools of subprime loans where the likelihood of default, by definition, is much greater than for prime loans.

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

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

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

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

> Cram-down makes default more costly for the lender and less costly for the borrower. But ultimately the losers from cram-down are the borrowers. By removing the disincentive to default, cram-down would substantially reduce – and potentially eliminate – the gains that consumers reap from this form of lending.
>
> There is concrete evidence of the adverse effects of imposing cram-down on borrowing contracts. In response to increasing agricultural distress in 1978, Congress instituted a temporary provision for mortgage cram-downs for family farmers under Chapter 12 of the Bankruptcy Act. Bankers confirm that Chapter 12 cram-down has indeed made lending to small farmers a substantially riskier proposition, and they consequently have largely withdrawn funds from this business line.

> The withdrawal of agricultural lenders took place when family farmers sorely needed capital from all sources. Cram-down radically affects credit allocation and does not support orderly and efficient allocation of resources in bankruptcy. Cram-downs significantly hurt mortgage lending in agriculture in the 1980's. Cram-downs for home mortgage debt would result in the same type of credit contraction witnessed in the agricultural sector.[2]

Moreover, in studying the impact of cramdowns for farm real estate in Chapter 12 bankruptcy, the United States Department of Agriculture (USDA) estimated that cramdowns raise the interest rates on farm real estate loans by 25 basis points to 100 basis points.[3] This means as much as a 10 percent increase in the monthly mortgage payments just because of the uncertainty surrounding the collateral value.

II. H.R. 3609 Will Encourage More Bankruptcies and Discourage Borrowers From Working With Lenders To Facilitate a Resolution

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

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

Rather than helping to facilitate refinancing or restructuring of mortgage loans to avoid foreclosure, the proposed changes embodied in H.R. 3609 will have the opposite effect by encouraging even more people to take the issue to the courts. In fact, the bill moves the entire bankruptcy system backwards and encourages debtors to use bankruptcy not as a last resort, but as a financial management tool.

Bankruptcy provides a fresh start for those that truly need it. This was true before Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) and it remains true today. Recognizing that the bankruptcy system had been providing billions of dollars of debt relief without ever questioning whether filers truly needed relief or to what degree, Congress enacted BAPCPA to help restore personal responsibility and integrity to the bankruptcy system. This legislation implemented an objective income/expense test designed to ensure that debtors (who earn more than the median income in their state) who can repay a portion of their debt should be required to do so. BAPCPA also requires debtors to receive credit counseling before they are determined to be eligible for bankruptcy. The purpose behind this provision is to ensure that debtors understand the alternatives to bankruptcy and the consequences of filing for bankruptcy. Debtors that do eventually file for bankruptcy are required to participate in a financial management course prior to receiving their discharge, thus helping them avoid future financial difficulties.

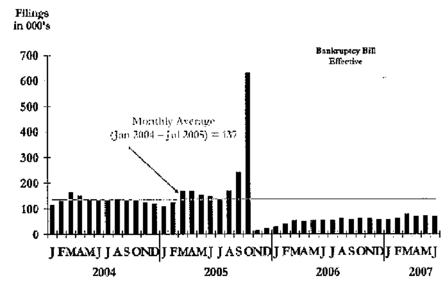
In the nearly two years since BAPCPA became effective, average bankruptcy filings have fallen to roughly half of what they were prior (see chart on the next page). This is evidence that borrowers are, in fact, employing alternatives to bankruptcy. It also indicates that debtors are reaching out to lenders to try and negotiate workable repayment plans. Moreover, it suggests that debtors are no

[5] "Do farmers Need a Separate Chapter in the Bankruptcy Code?" *Issues in Agricultural and Rural Finance*, United States Department of Agriculture, Economic Research Service, October 1997.

longer looking at the bankruptcy system as a financial planning tool and abusing the protections it affords.

The lower number of bankruptcy filings since the law became effective also verifies the notion that many debtors who seek bankruptcy protection actually have the ability to repay at least a portion of their debt. Since enactment of BAPCPA, the share of Chapter 7 bankruptcy filings relative to all filings (in Chapter 13 and Chapter 7) has also declined considerably (see chart below). In the years leading up to enactment of BAPCPA, the share of Chapter 7 filings was nearly 73 percent. Since enactment of the new law, that share has fallen to just over 60 percent.

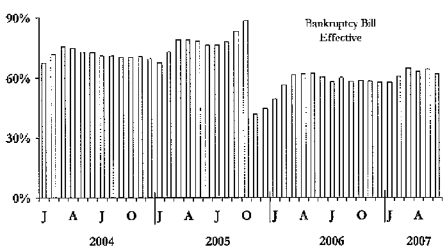
Pre- and Post-Bankruptcy Filing Rates



Source: Administrative Office of the U.S. Courts

Effect of Bankruptcy Bill on Chapter 7 Filings

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



Source: Administrative Office of the U.S. Courts

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

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

Filing for bankruptcy remains an important avenue for debtors that truly need a fresh start. However, many individuals still do not fully realize that options other than bankruptcy are available to them – including working with lenders to find an appropriate payment plan on the debt. Many bankers have told us that prior to the change in the bankruptcy law, the first time they knew that a borrower was having difficulty was when they received the bankruptcy notice. These banks did not have ample opportunity to address this situation and help the borrower avoid bankruptcy.

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

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

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

Conclusion

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

While we appreciate the desire of the Committee to find helpful solutions for homeowners that are having difficulty meeting their mortgage payments, the proposed changes in the bankruptcy law will make it more difficult for those homeowners in financial distress or facing higher interest rates to refinance – just the opposite of what is needed in today's market. For other borrowers, H.R. 3609 will end up increasing the cost of obtaining a mortgage loan and reducing the availability of mortgage credit – particularly to those with lower incomes, weaker credit and smaller downpayments.

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

Prepared Statement of Edward J. Kulik, Senior Vice President, Real Estate Division, Massachusetts Mutual Life Insurance Company before the Committee on the Judiciary, United States Senate

BANKRUPTCY REFORM ACT OF 1978

HEARINGS

BEFORE THE

SUBCOMMITTEE ON

IMPROVEMENTS IN JUDICIAL MACHINERY

OF THE

COMMITTEE ON THE JUDICIARY

UNITED STATES SENATE

NINETY-FIFTH CONGRESS

FIRST SESSION

ON

S. 2266 and H.R. 8200

NOVEMBER 28, 29 AND DECEMBER 1, 1977

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chandise or service. They should be given some additional protection in bankruptcy.

We ask that these provisions be enacted into law.

I thank you for letting me speak today on behalf of Mr. La Follette of the State of Wisconsin.

Senator DECONCINI. We thank you very much for your testimony and your statements. We appreciate the interest of the National Association of Attorneys General. I am aware of the consumer fraud routes and protection agencies that your offices command.

I wish you would please extend my thanks to your attorneys general for taking the time in having you come to make these presentations today and also speaking for the entire National Association of Attorneys General.

We have attempted to reach out to have consumer groups testify in support or opposition, as the case may be. You were one of the few groups that responded in coming to us. We received no answers from some of the other groups. We appreciate your presence. We appreciate your putting forth the time and your suggestions will be highly considered.

We thank you very much.

Our next group of witnesses are representing the Independent Bankers Association of America; the Mortgage Bankers Association of America; the National Association of Mutual Savings Banks; the National Association of Real Estate Investment Trusts, Inc.; and the United States League of Savings Associations.

Mr. Kulik, we welcome you.

STATEMENT OF EDWARD J. KULIK, SENIOR VICE PRESIDENT, REAL ESTATE DIVISION, MASSACHUSETTS MUTUAL LIFE INSURANCE CO., ACCOMPANIED BY ROBERT E. O'MALLEY, ATTORNEY, COVINGTON & BURLING

Mr. KULIK. Thank you, Mr. Chairman.

My name is Edward J. Kulik. I am senior vice president, real estate division, of the Massachusetts Mutual Life Insurance Co.

I appear before you today on behalf of: The Independent Bankers Association of America; The Mortgage Bankers Association of America; The National Association of Mutual Savings Banks; The National Association of Real Estate Investment Trusts; and The United States League of Savings Associations.

Appearing with me is Mr. Robert E. O'Malley of the law firm of Covington & Burling of Washington, D.C.

We appreciate the opportunity to testify regarding comprehensive revision of the Federal bankruptcy laws, as proposed in S. 2266 and H.R. 8200. We are particularly interested in the impact of any proposed revisions on the secured real estate lender.

I should like to make clear at the outset that I am not an expert in the field of bankruptcy and I shall not attempt a detailed technical discussion of the various issues before your committee.

However, I do have 19 years experience in secured real estate transactions and I am very familiar with the effect of bankruptcy law and decisions on the real estate and mortgage lending industries.

On behalf of the various associations for which I am appearing today, I should like to request an opportunity for each of them to file technical statements addressing various provisions and aspects of the two bills at a later time for inclusion in the hearing record.

Senator DECONCINI. Without objection, so ordered.

[The prepared statement of Edward Kulik follows:]

PREPARED STATEMENT OF EDWARD J. KULIK

Mr. Chairman, my name is Edward J. Kulik, I am Senior Vice President, Real Estate Division, of the Massachusetts Mutual Life Insurance Company. I appear before you today on behalf of: The Independent Bankers Association of America; The Mortgage Bankers Association of America; The National Association of Mutual Savings Banks; The National Association of Real Estate Investment Trust; and the United States League of Savings Associations.

Appearing with me is Mr. Robert E. O'Malley of the law firm of Covington and Burling of Washington, D.C.

We appreciate the opportunity to testify regarding comprehensive revision of the federal bankruptcy laws, as proposed in S. 2266 and H.R. 8200. We are particularly interested in the impact of any proposed revisions on the secured real estate lender. I should like to make clear at the outset that I am not an expert in the field of bankruptcy and I shall not attempt a detailed technical discussion of the various issues before your committee, However, I do have 19 years experience in secured real estate transactions and I am very familiar with the effect of bankruptcy law and decisions on the real estate and mortgage lending industries.

On the behalf of the various associations for whom I am appearing today, I should like to request an opportunity for each of them to file technical statements addressing various provisions and aspects of the two Bills at a later time for inclusion in the Hearing record.

I should like to call the Subcommittee's attention in a more general way to the areas in the Bills of crucial interest and concern to those of us in the real estate lending industry, as well as to express our appreciation for the careful and comprehensive work which the Senate and House Judiciary Committees have done in bankruptcy area over the last several years. Certainly simplification and streamlining of the bankruptcy laws are long overdue. Consolidation of the present bankruptcy reorganization Chapters would help eliminate time-consuming and costly delays caused by various parties contesting the appropriate reorganization Chapter under which to proceed. The expansion of the "adequate protection" concept, which permeates the two Bills is most welcome.

"CRAM-DOWN" PROVISIONS

As I suggested, however, there are a number of areas dealt with in S. 2266 and H.R. 8200 about which secured real estate lenders are greatly concerned. One of those areas is that of the so-called "cram-down" under Chapters X and XII of the present Bankruptcy Act. Under the "cram-down" provisions, a secured creditor's legal rights can be altered and modified, despite the fact that the creditor has not assented to the proposed plan.

We are particularly concerned about "cram-downs" under Chapter XII of the current Act. For many years, Chapter XII was used infrequently. However, in recent years large numbers of debtors have sought its protection for a number of reasons. First, as a result of changes in the Bankruptcy Rules in 1975, a plan of arrangement in Chapter XII need no longer be filed with a petition. Second, since the 1975 changes, during the bankruptcy proceedings, the debtor is generally allowed to remain in possession although previously a trustee was usually appointed immediately. As a result of the bankrupt remaining in possession, there is a very real possibility that the income earned by the property will be diverted. This could lead to the deterioration of the property and the creation of real estate tax liens. Third, filing a Chapter XII petition is attractive to many large real estate debtors because such filing acts as an automatic stay of foreclosure proceedings, leading to the abuses just mentioned.

In many instances, the automatic stay has been used by syndicated partnerships which originally entered into real estate transactions primarily for the purpose of realizing substantial tax benefits. Foreclosure results in the individual partners becoming subject to recapture of substantial amounts of accelerated depreciation taken earlier as deductions against ordinary income.

These factors encourage Chapter XII filings even though there is often no realistic prospect for recovery. These filings, I should emphasize, are made by large complex commercial real estate enterprises which were organized by supposedly experienced and sophisticated investors. The financial difficulties of such enterprises have caused the explosive growth in the use of Chapter XII. We are most definitely not talking about the small investor or the so-called "man in the street."

Secured real estate lenders are greatly concerned about this sudden large increase in the volume of Chapter XII reorganizations in part as a consequence of the now well-known *Pine Gate* case.[1] In *Pine Gate*, "value" of the non-assenting secured creditor's debt was found to be the appraised value of the security at a time of substantially depressed real estate market conditions. When a plan is "crammed-down" in such a manner, and under Section 461(11)(c) of the present Act the secured creditor is paid only the depressed "appraised value" of the property (even though it is substantially less than the principal balance of the debt), the secured creditor loses any possibility of recovering the full debt if the real estate market returns to more normal conditions. Hence the creditor is in substantial part denied its security and its contract rights.

While the *Pine Gate* case and the other cases which have imposed delays and losses upon lenders are harmful in themselves, the disruption which they have caused has spread throughout the secured lending industry. Managers of loan portfolios secured by real estate have been subjected to the threat of bankruptcy proceedings by debtors wishing to renegotiate loans or otherwise delay the lenders' payments. In view of the recent developments in bankruptcy law, these threats are not empty ones and lending institutions are under great pressure to capitulate. The pervasive threat of bankruptcy proceedings has had a deleterious impact on the real estate lending community. Unless this situation is changed, the flow of funds into new mortgages will be greatly reduced.

Any legislation which codifies the *Pine Gate* results or makes the situation worse, would have the gravest consequences for the real estate lending industry which annually pumps in excess of $86 billion a year into the economy. For example, if "value" of the security is to be determined under a revised Bankruptcy Act in a way which permits use of depressed real estate market appraisals of properties of the security for debts, or permits the "value" to be determined by appraisal of physically abused or mismanaged properties, lenders contemplating new real estate loans would be faced with intolerable uncertainty.

I should like to emphasize that the matter of how secured interests are to be "valued" is of course a crucial one as to any number of proposed amendments to the bankruptcy laws, since it affects the dollar amount of "secured claims," the interest that must be "adequately protected," etc. We hope that the closest attention will be given by the Congress to appropriate valuation methods. We respectfully urge that Congress require that appropriate appraisal methods are used to arrive at "value" and that appraisers appointed by the Courts understand that a secured creditor has the staying power and financial resources to restore distressed properties to their earlier value once the creditor has title.

With respect to "cram-downs," although the "absolute priority" rule of present Chapter X has been partially incorporated in the revised reorganization provisions, this does not cure the problem, since the secured lender has only a "secured claim" for the possibly depressed "appraisal value" of the security.

In addition, at least at present, under Section 461(11)(c), if a plan is "crammed-down," a lender receives the appraised value of the security in cash. Under the two Bills, however, should the normal confirmation procedure not go forward under Section 1129(a) of H.R. 8200 and Section 1130(a) of S. 2266, the secured creditor is subject to a "cram-down" pursuant to Section 1129(b) and Section 1130(b) & (c) and is forced to accept property which might include securities of the debtor in place of cash payment.

We are of course aware of the permissive language regarding "cram-downs" contained in S. 2266 as contrasted to the mandatory language of H.R. 8200. This is a distinct improvement from our perspective. However, if the intent is to limit the situations where "cram-downs" are to be permitted, we think it crucial that such limitations be spelled out carefully in the new legislation.

For example, as indicated above, the type of bankruptcy that is particularly troublesome and unfair to secured lenders involves limited partnerships composed

[1] In Re Pine Gate Associates, Ltd., Debtor, Case No. B75–4345A, U.S.D.Ct., N.D. Ga., Atlanta Div. (1976).

of wealthy individuals seeking tax shelter. These partnerships generally are formed to purchase a single piece of real estate. Typically, the loan documents provide that the lender is only able to look to the asset in satisfaction of the indebtedness and cannot proceed against the partners personally. Therefore, the public policy implicit in the bankruptcy laws favoring reorganization does not apply in this situation.

In our view, all the equities suggest that the secured lender in the single asset, non-recourse loan bankruptcy should be permitted to take physical possession of the security. We recommend that Congress consider most carefully whether the "cram down" and substitution of security provisions of Section 1130 of S. 2266 and Section 1129 of H.R. 8200 should apply at all in such bankruptcies. Should not the secured creditor be able to take back its security, in which no one else, including the debtor, has any equity?

ADEQUATE PROTECTION

With respect to "adequate protection" under Section 361 of the two Bills, which relates to Sections 362–364, dealing with automatic stays, use, sale or lease of property, and obtaining credit, respectively, we greatly prefer the approach contained in S. 2266, which limits the means by which "adequate protection" can be afforded to secured creditors to two: periodic cash payments to a creditor made by a trustee and an additional or replacement lien to protect against decrease in the value of a creditor's interest in property. We believe that the additional alternative "adequate protection" provisions in H.R. 8200 are unnecessary and increase the risk to the secured creditor.

However, we think that a provision should be added to Section 361 requiring that any income from rental properties be reserved to the extent necessary for operation and maintenance of the property and for real estate taxes, and that payment be made into a court supervised account of any remaining amounts available for debt service.

AUTOMATIC STAYS

With regard to Section 362 of the two Bills concerning automatic stays, we believe that in certain respects these provisions would be substantial improvements over current law. Particularly, the provision of Section 362(d) authorizing the court to grant relief from a stay upon a showing of cause, when combined with Section 362(e), providing that a stay shall automatically terminate with respect to the party requesting relief within 30 days of the request, unless the court extends the stay, is an important change. Absent an automatic termination provision, a court can effectively deny relief from a stay merely by delaying decision. Section 362(g), providing that the party supporting the stay bears the burden of proof on the question of whether or not "adequate protection" of a creditor's interest has been provided, is also important.

As for differences between the two Bills, the provision in Section 362(d) in S. 2266, which does not appear in H.R. 8200, that the court shall grant relief from a stay if the court finds that the debtor has no equity in the property in question, is one which we endorse.

However, there are some additional changes in the stay provisions which we strongly urge the Subcommittee to consider. First, there would seem to be no apparent reason why stays should not be limited to enjoin only execution of a secured creditor's judgment, while permitting a creditor, following appropriate notice, to prosecute a claim to judgment in local courts. Such modification of the stay provisions would, without harming the debtor or conflicting with the goals of bankruptcy, significantly aide secured creditors by reducing the substantial overall time necessary to foreclose in the majority of states.

Second, in our opinion stay provisions should not apply with respect to property developed or held for sale or investment where such property is not necessary for continuation of the debtor's primary business. This limitation on stays, by its very nature, would not conflict with the goal of debtor rehabilitation.

Third, stays should be limited in the context of single project real estate entities where experience shows that inept management or a poor market, or a combination of both, is usually the cause of insolvency, making rehabilitation unlikely to succeed. In such cases, the automatic stay should terminate after a fixed period, e.g., 60 days, unless the debtor can successfully show that reorganization is reasonably likely to succeed.

USE, SALE OR LEASE OF PROPERTY

Section 363 in both Bills provides for the use, sale or lease of property of the estate by the trustee. We support the changes from H.R. 8200 in Section 363 which are found in S. 2266. Specifically, the inclusion of "rents" within the definition of "soft collateral" contained in Section 363(a), the addition of language in Section 363(e) regarding bidding by a creditor at a proposed sale of property by the trustee and set off against the purchase price of the property of up to the amount of the creditor's claim, and the addition in Section 363(f) of language concerning sale of an interest in property at no less than a "fair upset price" on at least 30 days' notice to creditors with such interest in the property, are all desirable changes.

We would suggest additional changes in Section 363 as follows:

(a) Adequate protection of the secured creditor should be a precondition to use, sale or lease of property, instead of requiring that a creditor must take the initiative to request protection;

(b) Consideration should be given to tightening procedures for segregating, and perhaps paying to the secured creditor, during the period of trustee use, any rent or other income from real property on which a secured creditor has a lien;

(c) Authorization granted by the bankruptcy judge to use, sell or lease property should be stayed for a period sufficient to permit the filing of an appeal, e.g., 10 days, and for the pendency of any appeal taken; and

(d) There should be more specific protection against use of "soft collateral" that consists of proceeds of sale of "hard collateral."

OBTAINING CREDIT

Section 364 of both Bills provides in subsection (d) that if the trustee cannot obtain unsecured credit, or secured credit which does not affect the priority of existing lien holders, then the court may authorize obtaining of credit, after notice and hearing, secured by a lien on the property of the estate which is senior or equal to existing liens, so long as the existing lien holders' interests are "adequately protected." Here, as in the earlier Sections noted, one of the key considerations is the specificity with which "adequate protection" will be defined and circumscribed. It would also be desirable to add a provision to Section 364 staying the imposition of any equal or senior lien for a period sufficient to permit the filing of an appeal, e.g., 10 days, and for the pendency of any appeals so taken, from an order of the bankruptcy court.

EXECUTORY CONTRACTS AND UNEXPIRED LEASES

Section 365(a) of the two Bills provides that a trustee may either assume or reject an executory contract or unexpired lease of the debtor, subject to the provisions of Section 365(b) to the effect that if there has been a default by the debtor, a trustee may assume a contract or lease only if he (a) cures, or provides "adequate assurance" that he will promptly cure, such default and (b) compensates, or provides "adequate assurance" that he will promptly compensate, the other party to the contract or lease for any actual loss as a result of default and (c) provides adequate assurance of future performance under the contract or lease.

Obviously, the addition of Section 365(b)(3) to S. 2266, which does not appear in H.R. 8200, is of considerable value and importance to lenders, providing as it does for termination of a lease pursuant to provisions in the lease (a) in straight bankruptcy cases, (b) where the lease was entered into before the effective date of the bankruptcy law amendments, (c) where the property leased is not essential to the debtor's business, or (d) where the rent payable pursuant to the lease is substantially less than the "fair rental value" of the property leased. Although obviously enforceability of termination clauses in leases, regardless of when they were entered into, is preferable from the secured lender's point of view to the new language in S. 2266, the importance of the changes already incorporated in the Senate Bill can perhaps be illustrated by the example of shopping centers, which typically involve complex, long-term interrelated leases and are financed under long-term loan agreements.

If the shopping center owner does not have the right to terminate a lease in the event of bankruptcy, there is no effective way in which a shopping center lender can protect against a disruption of tenant mix through undesirable assignments by the trustee in bankruptcy. Also, since percentage rentals are very important in the shopping center business, continuation of the same business by the trustee of a major lessee on a substantially reduced basis would have most adverse consequences for the lessor, greatly lessening his cash flow and perhaps threatening his own financial position vis-a-vis his lenders.

Therefore, to continue the shopping center example, if termination clauses contained in leases are not to be enforceable in all circumstances, in those cases in which a trustee is permitted either to assume or assign a lease, we would recommend that additional language be added to Section 365 on such questions was what would constitute "adequate assurance" (a) as to the source of rental payments due under the lease, (b) that percentage rents would not decline substantially, (c) that assignment or assumption would not valid breach restrictive clauses in other leases or agreements, and (d) that tenant mix will not be disrupted by assumption or assignment. Similar considerations as to what might constitute "adequate assurance" would apply in case of a number of other executory contract or lease situations.

NATIONAL HOUSING ACT EXEMPTION

There are prohibitions in the Bankruptcy Act at present, in Chapter X (Section 263) and Chapter XII (Section 517) which provide that nothing in those Chapters shall be deemed to affect or apply to the creditors of any corporation under a mortgage insured pursuant to the National Housing Act and amendments thereto. The Chapter XII provision also prohibits "extension or impairment of any secured obligation held by Home Owners' Loan Corporation or any Federal Home Loan Bank or member thereof."

These exemptions are not contained in either of the Bills, and there is no reference in the House Judiciary Committee Report on H.R. 8200 to the exemptions in the existing law or the reasons why the exemptions do not survive in the Bills. Insofar as we have been able to determine, the omission of these exemptions in H.R. 8200 and S. 2266 was merely an oversight. In any event, these long-standing exemptions are just as important today as they have been in the past, and we strongly suggest that the exemptions be retained so that the home financing roles performed by the FHA insurance program and the Federal Home Loan Bank system, which have produced over the years shelter for millions of low and moderate income families, will not be diminished.

In the Chapter X contest, this prohibition has been construed to exempt an FHA-insured mortgage issued pursuant to the National Housing Act from even a temporary stay of foreclosure proceedings brought by the lender. No such exemption is contained in either of the Bills. There is no reference in the House Judiciary Committee Report on H.R. 8200 to the exemption in the existing law or the reasons why the exemption does not survive in the Bill. The omission of the exemption in H.R. 8200 may be merely an oversight. We think that it is important that the exemption be retained so that the risk-reducing function of the FHA insurance program not be diminished.

CHAPTER 13 (INDIVIDUAL WITH REGULAR INCOME)

The proposed Chapter 13 in both Bills, providing for the adjustment of debts of an individual with regular income, includes two fairly significant changes, compared to existing law, that may have the unintended effect of restricting the flow of home mortgage money. First, similar to the situation discussed previously in the commercial context, the holder of a mortgage on real estate may be forced to give up its specific security in return for some other property of uncertain value. Second, the stay of actions by the creditor protects not only the individual debtor under Chapter 13 but any guarantor or other codebtor as well. These provisions may cause residential mortgage lenders to be extraordinarily conservative in making loans in cases where the general financial resources of the individual borrower are not particularly strong. Serious consideration should be given to modifying both Bills so that, at the least, (i) a mortgage on the real property other than investment property be modified, and (ii) providing that the stay of actions against a guarantor or other codebtor is applicable only to guarantees executed after the effective date of the new legislation.

INVESTMENT OF FUNDS OF THE ESTATE

Section 345 both Bills is undesirably narrow in the sense that unbonded or unsecured deposits are permitted to be made in banks and savings and loan associations only to the extent that the deposit is federally insured. The current limit on federal insurance is $40,000 per account, which obviously means that deposits in savings and loan associations and certain banks will be seriously discouraged. We respectfully suggest that the Bill contain a provision permitting the unbonded, unsecured deposit of the estate's funds in savings and loan associations, and banks, and providing further that such funds are deemed to be insured as public funds within the meaning of the FSLIC and FDIC statutes.

OTHER PROVISIONS OF THE BILLS

Although a number of the associations on whose behalf I am appearing also have comments and recommendations regarding other provisions of the two Bills, such as those regarding preferences, set-off rights, and the service of secured creditors either on the estate's main creditors' committee or on a separate committee of secured creditors, any such recommendations will be filed with the Subcommittee separately before the record closes. At this time, Mr. Chairman, I should like again to express our appreciation for the opportunity to appear before the Subcommittee on this matter of the greatest interest and concern to the real estate lending industry. Thank you.

Mr. KULIK. I should like to call the subcommittee's attention in a more general way to the areas in the bills of crucial interest and concern to those of us in the real estate lending industry, as well as to express our appreciation for the careful and comprehensive work which the Senate and House Judiciary Committees have done in the bankruptcy area over the last several years.

Certainly, simplification and streamlining of the bankruptcy laws are long overdue. Consolidation of the present bankruptcy reorganization chapters would help eliminate time consuming and costly delays caused by various parties contesting the appropriate reorganization chapter under which to proceed. The expansion of the "adequate protection" concept, which permeates the two bills, is most welcome.

I turn now to the "cram-down" provisions:

As I suggested, however, there are a number of areas dealt with in S. 2266 and H.R. 8200 about which secured real estate lenders are greatly concerned. One of those areas is that of the so-called "cram-down" under chapters X and XII of the present Bankruptcy Act.

Under the "cram-down" provisions, a secured creditor's legal rights can be altered and modified, despite the fact that the creditor has not assented to the proposed plan.

We are particularly concerned about "cram-downs" under chapter XII of the current act. For many years, chapter XII was used infrequently. However, in recent years, large numbers of debtors have sought its protection for a number of reasons.

First, as a result of changes in the bankruptcy rules in 1975, a plan of arrangement in chapter XII need no longer be filed with a petition. Second, since the 1975 changes, during the bankruptcy proceedings, the debtor is generally allowed to remain in possession although previously a trustee was usually appointed immediately.

As a result of the bankrupt remaining in possession, there is a very real possibility that the income earned by the property will be diverted. This could lead to the deterioration of the property and the creation of real estate tax liens.

Third, filing a chapter XII petition is attractive to many large real estate debtors because such filing acts as an automatic stay of foreclosure proceedings, leading to the abuses just mentioned.

In many instances, the automatic stay has been used by syndicated partnerships which originally entered into real estate transactions primarily for the purpose of realizing substantial tax benefits. Foreclosure results in the individual partners becoming subject to recapture of substantial amounts of accelerated depreciation taken earlier as deductions against ordinary income.

These factors encourage chapter XII filings even though there is often no realistic prospect for recovery. These filings, I should emphasize, are made by large complex commercial real estate enterprises which were organized by supposedly experienced and sophisticated investors.

The financial difficulties of such enterprises have caused the explosive growth in the use of chapter XII. We are most definitely not talking about the small investor or the so-called "man in the street."

Secured real estate lenders are greatly concerned about this sudden large increase in the volume of chapter XII reorganizations, in part as a consequence of the now well-known *Pine Gate* case. I refer to *In Re Pine Gate Associates, Ltd., Debtor*, Case No. B75-4345A, U.S. D. Ct., N.D. Ga., Atlanta Div. (1976).

In *Pine Gate*, the "value" of the nonassenting secured creditor's debt was found to be the appraised value of the security, at a time of substantially depressed real estate market conditions.

When a plan is "crammed-down" in such a manner, and under section 461(11)(c) of the present act, the secured creditor is paid only the depressed "appraised value" of the property—even though it is substantially less than the principal balance of the debt—the secured creditor loses any possibility of recovering the full debt if the real estate market returns to more normal conditions. Hence, the creditor is, in substantial part, denied its security and its contract rights.

While the *Pine Gate* case and the other cases which have imposed delays and losses upon lenders are harmful in themselves, the disruption which they have caused has spread throughout the secured lending industry.

Managers of loan portfolios secured by real estate, including myself, have been subjected to the threat of bankruptcy proceedings by debtors wishing to renegotiate loans or otherwise delay the lenders' payments.

In view of the recent developments in bankruptcy law, these threats are not empty ones and lending institutions are under great pressure to capitulate. The pervasive threat of bankruptcy proceedings has had a serious adverse impact on the real estate lending community. Unless this situation is changed, the flow of funds into new mortgages will be greatly reduced.

Any legislation which codifies the *Pine Gate* result, or makes the situation worse, would have the gravest consequences for the real estate lending industry, which annually pumps in excess of $86 billion into the economy.

For example, if "value" of the security is to be determined under a revised Bankruptcy Act in a way which permits use of depressed real eatate market appraisals of properties which are security for debts, or permits the "value" to be determined by appraisal of physically abused or mismanaged properties, lenders contemplating new real estate loans would be faced with intolerable uncertainty.

I should like to emphasize that the matter of how secured interests are to be "valued" is, of course, a crucial one as to any number of proposed amendments to the bankruptcy laws. The determination of "value" affects the dollar amount of "secured claims," the interest that must be "adequately protected," and other issues.

We hope that the closest attention will be given by the Congress to appropriate valuation methods. We respectfully urge that Congress require that appropriate appraisal methods are used to arrive at "value" and that appriasers appointed by the courts understand that a secured creditor has the staying power and financial resources to restore distressed properties to their earlier value once the creditor has title.

With respect to "cram-downs," although the "absolute priority" rule of present chapter X has been partially incorporated in the revised reorganization provisions, this does not cure the problem, since the secured lender has only a "secured claim" for the possibly depressed "appraised value" of the security.

In addition, at least at present, under section 461(11)(c) if a plan is "crammed-down," a lender receives the appraised value of the security in cash. Under the two bills, however, if the normal confirmation procedure does not go forward under section 1129(a) of H.R. 8200 and section 1130(a) of S. 2266, the secured creditor is subject to a "cram-down" pursuant to sections 1129(b) and 1130(b) and (c) and is forced to accept property which might include securities of the debtor in place of cash payment.

We are, of course, aware of the permissive language regarding "cram-downs" contained in S. 2266 as contrasted to the mandatory language of H.R. 8200. This is a distinct improvement from our perspective.

However, if the intent is to limit the situations where "cram-downs" are to be permitted, we think it crucial that such limitations be spelled out carefully in the new legislation.

For example, as indicated above, the type of bankruptcy that is particularly troublesome and unfair to secured lenders involves limited partnerships composed of wealthy individuals seeking tax shelter. These partnerships generally are formed to purchase a single piece of real estate. Typically, the loan documents provide that the lender is only able to look to the asset in satisfaction of the indebtness and cannot proceed against the partners personally.

Therefore, the public policy implicit in the bankruptcy laws favoring reorganization does not apply in this situation.

In all fairness, the secured lender in the single asset, nonrecourse loan bankruptcy should be permitted to enforce fully its contract rights.

We recommend that Congress consider most carefully whether the "cram-down" and substitution of security provisions of section 1130 of S. 2266 and section 1129 of H.R. 8200 should apply at all in such bankruptcies.

With respect to "adequate protection" under section 361 of the two bills, which relates to sections 362–364, dealing with automatic stays use, sale, or lease of property, and obtaining credit, respectively, we greatly prefer the approach contained in S. 2266, which limits the means by which "adequate protection" can be afforded to secured creditors to two: periodic cash payments to a creditor made by a trustee, and an additional or replacement lien to protect against a decrease in the value of a creditor's interest in property.

We believe that the additional alternative "adequate protection" provisions in H.R. 8200 are unnecessary and increase the risk to the secured creditor.

However, we think that a provision should be added to section 361 requiring that any income from rental properties be reserved to the extent necessary for operation and maintenance of the property and for real estate taxes, and that payment be made into a court supervised account of any remaining amounts available for debt service.

With regard to section 362 of the two bills concerning automatic stays, we believe that in certain respects these provisions would be substantial improvements over current law. Particularly, the provision of section 362(d) authorizing the court to grant relief from a stay upon a showing of cause, when combined with section 362(e), providing that a stay shall automatically terminate with respect to the party requesting relief within 30 days of the request, unless the court extends the stay, is an important change.

Absent an automatic termination provision, a court can effectively deny relief from a stay merely by delaying decision. Section 362(g), providing that the party supporting the stay bears the burden of proof on the question of whether or not "adequate protection" of a creditor's interest has been provided is also important.

As for differences between the two bills, the provision in section 362(d) in S. 2266, which does not appear in H.R.8200, that the court shall grant relief from a stay if the court finds that the debtor has no equity in the property in question, is one which we endorse.

However, there are some additional changes in the stay provisions which we strongly urge the subcommittee to consider.

First, there would seem to be no apparent reason why stays should not be limited to enjoin only execution of a secured creditor's judgment, while permitting a creditor, following appropriate notice, to prosecute a claim to judgment in local courts.

Such modification of the stay provisions would, without harming the debtor or conflicting with the goals of bankruptcy, significantly aid secured creditors by reducing the substantial overall time necessary to foreclose in the majority of States.

Second, in our opinion, stay provisions should not apply with respect to property developed or held for sale or investment where such property is not necessary for continuation of the debtor's primary business. This limitation on stays, by its very nature, would not conflict with the goal of debtor rehabilitation.

Third, stays should be limited in the context of single project real estate entities where experience shows that inept management or a poor market, or a combination of both, is usually the cause of insolvency, making rehabilitation unlikely to succeed.

In such cases, the automatic stay should terminate after a fixed period, such as 60 days, unless the debtor can successfully show that reorganization is reasonably likely to succeed.

I turn now to use, sale, or lease of property.

Section 363 in both bills provides for the use, sale or lease of property of the estate by the trustee. We support the changes from H.R. 8200 in section 363 which are found in S. 2266.

Specifically, the inclusion of "rents" within the definition of "soft collateral" contained in section 363(a), the addition of language in section 363(e) regarding bidding by a creditor at a proposed sale of property by the trustee and set off against the purchase price of the property of up to the amount of the creditor's claim, and the addition in section 363(f) of language concerning sale of an interest in property at no less then a "fair upset price" on at least 30 days' notice to creditors with an interest in the property, are all desirable changes.

We would suggest additional changes in section 363 as follows:

One: Adequate protection of the secured creditor should be a precondition to use, sale or lease of property, instead of requiring that creditor must take the initiative to request protection;

Two: Consideration should be given to tightening procedures for segregating, and perhaps paying to the secured creditor, during the period of trustee use, any rent or other income from real property on which a secured creditor has a lien;

Three: Authorization granted by the bankruptcy judge to use, sell or lease property should be stayed for a period sufficient to permit the filing of an appeal, for example, 10 days, and for the pendency of any appeal taken; and

Four: There should be more specific protection against use of "soft collateral" that consists of proceeds of sale of "hard collateral."

As for obtaining credit, section 364 of both bills provides in subsection (d) that if the trustee cannot obtain unsecured credit, or secured credit which does not affect the priority of existing lien holders, then the court may authorize obtaining of credit, after notice and hearing, secured by a lien on the property of the estate which is senior or equal to existing liens, so long as the existing lienholders' interests are "adequately protected."

Here, as in the earlier sections noted, one of the key considerations is the specificity with which "adequate protection" will be defined and circumscribed. It would also be desirable to add a provision to section 364 staying the imposition of any equal or senior lien for a period sufficient to permit the filing of an appeal, for example, ten days, and for the pendency of any appeal so taken, from an order of the bankruptcy court.

As for executory contracts and unexpired leases, section 365(a) of the two bills, provides that a trustee may either assume or reject an executory contract or unexpired lease of the debtor, subject to the provisions of section 365(b) to the effect that if there has been a default by the debtor, a trustee may assume a contract or lease only if he: (1) Cures, or provides "adequate assurance" that he will promptly cure, such default and (2) compensates, or provides "adequate assurance" that he will promptly compensate, the other party to the contract or lease for any actual loss as a result of default and (3) provides adequate assurance of future performance under the contract or lease.

Obviously, the addition to section 365(b)(3) to S. 2266, which does not appear in H.R. 8200, is of considerable value and importance to lenders, providing as it does for termination of a lease pursuant to provisions in the lease: (1) In straight bankruptcy cases; (2) where the lease was entered into before the effective date of the bankruptcy law amendments; (3) where the property leased is not essential to the debtor's business; or, (4) where the rent payable pursuant to the lease is substantially less than the "fair rental value" of the property leased.

Although obviously enforceability of termination clauses in leases, regardless of when they were entered into, is preferable from the secured lender's point of view to the new language in S. 2266, the importance of the changes already incorporated in the Senate bill can perhaps be illustrated by the example of shopping centers, which typically involve complex, long-term interrelated leases and are financed under long-term loan agreements.

If the shopping center owner does not have the right to terminate a lease in the event of a tennant's bankruptcy, there is no effective way in which a shopping center lender can protect against a disruption of tenant mix through undesirable assignments by the trustee in bankruptcy.

Also, since percentage rentals are very important in the shopping center business, continuation of the same business by the trustee of a major lessee on a substantially reduced basis would have most adverse consequences for the lessor, greatly lessening his cash flow and perhaps threatening his own financial position vis-a-vis his lenders.

Therefore, to continue the shopping center example, if termination clauses contained in leases are not to be enforceable in all circumstances, in those cases in which a trustee is permitted either to assume or assign a lease, we would recommend that additional language be added to section 365 on such questions as what would constitute "adequate assurance":

One, as to the source of rental payments due under the lease; two, that percentage rents would not decline substantially; three, that assignment or assumption would not breach valid restrictive clauses in other leases or agreements; and four, that tenant mix will not be disrupted by assumption or assignment.

Similar considerations as to what might constitute "adequate assurance" would apply in case of a number of other executory contract or lease situations.

I turn now to the National Housing Act exemption.

There are prohibitions in the Bankruptcy Act at present, in chapter X—section 263, and chapter XII—section 517—which provide that nothing in those chapters shall be deemed to affect or apply to the creditors of any corporation under a mortage insured pursuant to the National Housing Act and amendments thereto.

The chapter XII provision also prohibits "extension or impairment of any secured obligation held by Home Owners' Loan Corporation or any Federal Home Loan Bank or member thereof."

These exemptions are not contained in either of the bills, and there is no reference in the House Judiciary Committee Report on H.R. 8200 to the exemptions in the existing law or the reasons why the exemptions do not survive in the bills.

Insofar as we have been able to determine, the omission of these exemptions in H.R. 8200 and S. 2266 was merely an oversight. In any event, these longstanding exemptions are just as important today as they have been in the past, and we strongly suggest that the exemptions be retained so that the home financing roles performed by the FHA insurance program and the Federal Home Loan Bank system, which have produced, over the years, shelter for millions of low and moderate-income families, will not be diminished.

I turn now to chapter 13, individual with regular income.

The proposed chapter 13 in both bills, providing for the adjustment of debts of an individual with regular income, includes two fairly significant changes, compared to existing law, that may have the unintended effect of restricting the flow of home mortgage money.

First, similar to the situation discussed previously in the commercial context, the holder of a mortgage on real estate may be forced to give up its specific security in return for some other property of uncertain value.

Second, the stay of actions by the creditor protects not only the individual debtor under chapter 13 but any guarantor or other codebtor as well.

These provisions may cause residential mortgage lenders to be extraordinarily conservative in making loans in cases where the general financial resources of the individual borrower are not particularly strong.

Serious consideration should be given to modifying both bills so that, at the least: One, a mortgage on real property other than investment property may not be modified, and two, providing that the stay of actions against a guarantor or other codebtor is applicable only to guarantees executed after the effective date of the new legislation.

As for investment of funds of the estate, section 345 of both bills is undesirably narrow in the sense that unbonded or unsecured deposits are permitted to be made in banks and savings and loan associations only to the extent that the deposit is federally insured. The current limit on Federal insurance is $40,000 per account, which obviously means that deposits in savings and loan associations and certain banks will be seriously discouraged.

We respectfully suggest that the bill contain a provision permitting the unbonded, unsecured deposit of the estate's funds in savings and loan associations, and banks, and providing further that such funds are deemed to be insured as public funds within the meaning of the FSLIC and FDIC statutes.

As for other provisions of the bills, although a number of the associations on whose behalf I am appearing also have comments and recommendations regarding other provisions of the two bills, such as those regarding preferences, setoff rights, and the service of secured creditors, either on the estate's main creditors' committee or on a separate committee of secured creditors, any such recommendations will be filed with the subcommittee separately before the record closes.

At this time, Mr. Chairman, I should like again to express our appreciation for the opportunity to appear before the subcommittee on this matter of the greatest interest and concern to the real estate lending industry which greatly needs relief from the existing bankruptcy laws before it is forced to consider alternative investments with its funds.

Thank you very much.

Senator DECONCINI. Thank you, Mr. Kulik.

Your last statement there interests me a great deal, having been associated with a savings and loan. What other investments would a savings and loan look to?

Mr. KULIK. Mr. Chairman, I would like to reply in this manner. In order to avoid the "cram-down," we have, on occasion, gone back to the executive committee of our Board, which has to approve any

Ms. SÁNCHEZ. Without objection, so ordered.

And since we are still trying to get the microphones working, I will ask unanimous consent to enter into the record a letter from Professor Robert Shiller with the Cowles Foundation for Research in Economics at Yale University; a statement by Eric Stein, on behalf of the Center for Responsible Lending; a *New York Times* article dated October 8, 2007, entitled, "The American Dream in Reverse;" a letter from a diverse group of consumers, civil rights, labor, housing and community organizations; and also, from the Congressional Research Service, a memo regarding the 1978 bankruptcy legislation and secured lending supplement. Without objection, so ordered.

[The information referred to follows:]

LETTER FROM ROBERT SHILLER, THE COWLES FOUNDATION FOR RESEARCH IN ECONOMICS

Cowles Foundation for Research in Economics
International Center for Finance
Yale University
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October 29, 2007

Honorable John Conyers, Jr.
2426 Rayburn Building
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Honorable Lamar S. Smith
2184 Rayburn House Office Building
Washington, DC 20515

Honorable Linda T. Sánchez
1007 Longworth House Office Building
Washington, DC 20515

Honorable Chris Cannon
2436 Rayburn House Office Building
Washington, DC 20515

Honorable Brad Miller
1722 Longworth House Office Building
Washington DC 20515

Honorable Congressmen:

I want to express my qualified support for the proposal of Representative Brad Miller (paralleling a proposal of Senators Richard Durbin and Charles Schumer), to delete the phrase in Section 1322 of the bankruptcy law that prevents bankruptcy judges under Chapter 13 from modifying secured debts on the mortgage on a borrower's principal residence.

I am the Stanley B. Resor Professor of Economics and Professor of Finance at Yale University. I am also Research Associate at the National Bureau of Economic Research, and Chief Economist for a firm that I co-founded, MacroMarkets LLC. On September 19, 2007, I testified before the Joint Economic Committee on the subprime crisis.

I support this change in bankruptcy law because it will enable the courts to adjust mortgage terms to make it possible for homeowners who are experiencing difficulties making mortgage payments so that they can continue to stay in their homes.

My support is qualified only in that I don't consider it an ideal long-run solution to the deficiencies of our mortgage institutions to encourage a much larger role of bankruptcy courts. We need instead to improve our mortgage institutions themselves. But, despite this qualification, I am convinced that we need to give the bankruptcy courts the latitude to deal with crises like the one we are in.

We are facing a mortgage crisis that has the potential to wreak havoc on innocent homeowners and on the national economy in the coming months. There may be millions more defaults and, ultimately, foreclosures, and there may be a recession that will push our economy down below its potential for some years.

We are in a very unusual situation in the mortgage market for two prime reasons: 1. We have just gone through the biggest home price boom that the US has ever experienced, or at least the biggest it has experienced since the boom right after World War II. This boom may be in the process of bursting. 2. We have just gone through the longest period of low short-term interest rates since World War II. While this period of short interest rates has ended, it has left a legacy of adjustable rate mortgages that stand to have unexpectedly large interest rate resets.

The enormous home price boom produced a period of incaution among both borrowers and lenders. Those who presumed that the home price boom will continue, both borrowers and lenders, were more inclined to find high loan-to-value ratios agreeable, and to worry relatively little about the likelihood that it will be difficult to make payments on the mortgage. The boom thus created a situation of risky mortgages whose risks have become apparent once the boom is over.

Home prices have been falling for over a year now. According to the Standard & Poor's Case-Shiller Home Price Index, which I have been involved in producing, national home prices have fell 3.2% between the second quarter of 2006 and the second quarter of 2007. The falls have been much worse in cities. In Detroit, for example, home prices have fallen 12.4% since their peak in December 2005, and in San Diego home prices have fallen 8.0% since their peak in June 2006.

According to the home price index futures markets at the Chicago Mercantile Exchange, further home price declines between 5% and 10% have been predicted for the next year. If such declines transpire, they will put many more homeowners into a negative equity situation, make it impossible for many more of them to sell their homes and pay off their mortgage, and thus force many more into default.

The effect of declining home prices is exacerbated by the large number of adjustable rate mortgages that were issued, disproportionately to subprime borrowers, during the period of abnormally low short term interest rates. Short-term interest rates were kept below 1.5% from November 2002 to September 2004, almost two years. Short rates have never before been kept so low for so long by the Federal Reserve Board in the entire postwar period. This highly unusual period of low short rates, almost within rounding error of zero, spurred some unfamiliar innovations, not only zero-percent financing of auto loans, but also an increase in adjustable rate mortgages issued to subprime borrowers, who could not be expected to understand how unusual and temporary the interest rate situation was.

Our mortgage institutions have also changed in many ways that produced, along with some benefits, unforeseen hazards to individual borrowers as well. The changes in mortgage institutions represent, in many respects, financial progress, but with such progress comes difficulties in managing all the risks of new financial technology.

Mortgage contracts were often written without proper allowances for all kinds of crises that might come, and the securitization of mortgages, and the spread of these securitized mortgages through other layers of portfolios, often hampers the renegotiation of terms between borrower and lender. Even when a renegotiation of mortgage terms is in the interest of both borrower and lender, it often does not happen.

The United States has long recognized that imperfections in the contracting process justify government intervention in the form of bankruptcy proceedings. The government has an established role in helping people in extreme outcomes, when private insurance and hedging vehicles have not provided adequate protection.

In the future, it would be especially advantageous if the federal government somehow encouraged mortgage lenders to write new mortgages whose contracts are redesigned to provide relief from unfortunate contingencies for all homeowners, not just those who are such an extreme situation as to file for bankruptcy. One thing to do, as I described in my 1993 book *Macro Markets: Creating Institutions for Managing Society's Largest Economic Risks*, is to put into the original mortgage contract a provision that automatically reduces the mortgage balance if the value of the home falls, and raises it back if the housing market recovers. Another thing to do is to make the original loan terms contingent on the future income of the borrower, or aggregate indicators of this future income, as I described in my 2003 book *New Financial Order: Risk in the Twentieth Century*. If borrowers' income falls, the mortgage terms are eased. If income rises again, the original terms are restored. Such contracts could be beneficial for both lenders and borrowers, and if the institutions are developed, both sides of the contract may find mutually advantageous terms to participate.

Shared equity mortgages (SEMs) are one way of improving the risk position of homeowners. This cause has been led by Prof. Andrew Caplin of New York University, and was taken up as well by the Fannie Mae Foundation before its unfortunate demise earlier this year. With a shared equity mortgage, the homeowner shares the ownership, and hence the risk of the property value changes, with an investor. A shared equity mortgage is essentially the same as a sort of mortgage terms adjustment agreed upon in advance between a borrower and a lender. (In the context of a Chapter 13 bankruptcy, Caplin proposes that courts be allowed to do debt-equity substitution.)

If we had such improved mortgage institutions there would be fewer filings for bankruptcy, and the bankruptcy courts would have less of a need to make adjustments in mortgage terms.

But, SEMs and other innovations are still not here. In the current situation, we need to make adjustments to mortgages for people who cannot make the mortgage payment.

Ex-post adjustments to mortgage terms are not being done on any significant scale. A September 21, 2007 report by Moody's Investor Services, which reported on a survey of mortgage servicers representing 80% of the subprime market, found that less than 1% of the mortgages that experienced a reset in January, or Aril, or July 2007 have had their terms adjusted by the lender.

This means that the mortgage crisis is not being decisively answered. The sequence of unfortunate events continues to unfold unabated.

We have so far managed to escape any serious consequences to the economy. Consumption demand as well as nonresidential investment expenditure have held up. But if we see the spectacle of a historic increase in defaults and foreclosures, confidence may suddenly turn sour. This could happen very soon, if Congress does not act, and the consequences may be felt for years to come.

Sincerely,

Robert J. Shiller

PREPARED STATEMENT OF ERIC STEIN, CENTER FOR RESPONSIBLE LENDING

Statement of Eric Stein
Center for Responsible Lending

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

"Straightening Out the Mortgage Mess: How Can We Protect Home Ownership and Provide Relief to Consumers in Financial Distress – Part 2"

October 30, 2007

Chairman Sánchez, Ranking Member Cannon, and members of the Subcommittee, thank you for holding this second hearing on how we can protect homeownership and provide relief to consumers in financial distress. I appreciate the opportunity to provide this statement.

In the short month since Part 1 of this hearing, the problems in the subprime market have become more evident and have grown even worse. However, one hopeful sign is that we now have an active bipartisan effort to address this situation. I commend Representatives Miller, Sánchez and others for their current bankruptcy proposal, and I also want to commend Representative Chabot for his leadership in recognizing bankruptcy reform as a necessary tool for addressing the massive home losses families are experiencing today. A collaborative approach to this problem is essential, and it is heartening to see consensus on the need for action.

I. An Update on the Situation

The epidemic of subprime foreclosures keeps growing, and the ripple effects continue to extend wider. For example, First American CoreLogic (CoreLogic), a private firm with expertise in risk management, has highlighted how quickly risks are escalating in the mortgage market.[1] During the past month alone, roughly 150,000 households have experienced interest rate resets on subprime exploding adjustable rate mortgages (ARMs), meaning that these families are facing monthly payment increases ranging from 20% to 40%.[2] According to CoreLogic, up to 75,000 of these families will lose their homes to foreclosure. In fact, every week that passes without Congressional action to tweak to the bankruptcy code, some 18,000 families will lose their homes to foreclosure. And every subsequent day, the neighbors of each of these families will pay the price in the form of reduced property values, vacant houses nearby and a substantially reduced quality of life.

Homeowners aren't the only ones hurting; problems are still accelerating for lending institutions and financial markets. In the past month we've seen many companies with a stake in subprime lending report higher losses and layoffs. Countrywide Financial Corp. posted a $1.2 billion loss in the third quarter and has seen its stock lose 60% of its value and 12,000 of its employees lose their jobs so far this year. Last week, Merrill Lynch announced it lost $8.4 billion in the 3rd quarter—its worst loss in 93 years—with $7.9

billion of these losses on subprime and CDO assets. Citigroup reported at the beginning of this month that it was writing down $1.3 billion in subprime assets and paying $2.6 billion to cover credit losses and increased reserves. UBS AG reported its first quarterly loss in five years, and predicted that banks and securities firms will see more than **$30 billion** in bad loans and trading losses during the July-through-September period.[3]

Mortgage investors continue to suffer as well. ABX indices hit new lows last week, as the trusts that hold the loans backing subprime bonds in the ABX showed an "increase in 30- and 60-plus day delinquencies [that] was both alarming and surprising on deals that are yet approaching reset." In one alarming example, Barclays reported that the rate of 60-plus day delinquencies on loans from the second half of 2006 now stands at 29%. As a result of these reports, Moody's announced last Friday that it was downgrading or placing on review for downgrade a slew of CDO tranches. While the ratings firm did not immediately specify the amount of CDOs affected by the ratings action, an initial count by Dow Jones Newswires put the total at more than $4 billion.[4]

With such widespread repercussions from subprime foreclosures, it's no surprise that consumers have ranked the subprime crisis above global warming and the federal deficit among their most pressing concerns, according to a recent survey by TNS North America.[5] It is notable that subprime lenders—who should have known better in the first place—have yet to act on the widespread public understanding that recent lending is excessively risky. As Friedman Billings Ramsey reports in a recent study: "We find scant evidence that the risk characteristics of subprime loans originated in 2007 differ significantly from those of subprime loans originated in 2006 and 2005. Therefore, we cannot conclude that lenders have reversed the liberal underwriting criteria of 2007, limited exceptions to these criteria, and strengthened quality control procedures for newly originated subprime loans."[6]

Since the hearing last month, a number of prominent, independent housing economists have recognized the massive scale of the foreclosure crisis, the fact that current efforts to address this crisis are wholly insufficient, and that allowing judicial modification under chapter 13 is an essential part of the solution. Three preeminent professors that I spoke with who specialize in real estate economics and finance support the proposal: William Apgar, Senior Scholar at Harvard's Joint Center for Housing Studies, a former FHA Commissioner; Karl E. Case, a highly respected Professor of Economics at Wellesley College; and Roberto Quercia, Director of the Center for Community Capital at UNC-Chapel Hill. In addition, this Subcommittee has received a letter to this effect from Robert Shiller, Professor of Economics and Professor of Finance at Yale University and a principal in creating the Standard & Poor's Case-Shiller® Home Price Index, which is, according to S&P, "the leading indicator on the overall health of the U.S. housing market." Finally, Mark Zandi, Chief Economist and co-founder of Moody's Economy.com, is testifying in support today.

II. Suggested Modifications to the Miller-Sánchez Bill

While discussing this matter with independent experts, I also spoke with a number of industry representatives who raised objections to the change in the bankruptcy code that we support. Some of the points raised, in my view, were good ones, and thus I would suggest modifying the Miller-Sánchez bill in the following ways:

A. Eligibility

Objection: Families with sufficient income to pay their mortgage should not benefit from the provision. People should not file for a chapter 13 modification if their property has lost value but they are able to continue paying their underwater mortgage; they should only use the bankruptcy option if their only alternative is foreclosure. Otherwise, they will be obtaining a windfall; bankruptcy should be the last option, not the first.

Solution: Impose a strict means test to ensure that only people who otherwise face foreclosure are eligible for a loan modification on their principal residence under chapter 13. To qualify for relief under the proposed bankruptcy tweak, a debtor must satisfy a rigid means test, and must live within strict budget limits.[7] In addition, the good faith requirement already applies, so someone who meets the means test but can still afford mortgage, somehow, could be excluded by lender objection. Finally, the existing $1 million loan limit for secured debt still applies as well.

B. Loan Term

Objection: Since there is no limitation on loan term, a borrower could have already been in a loan for 15 years, and a judge could extend the term out for another 30 years, making the total term 45 years. This would be unfair to lenders. Also, the bill does not provide enough guidance to judges.

Solution: Clarify that the modified loan term can only be up to 30 years less the period of time that the loan has been outstanding. Given that most loans are 30 years, this means that the loan term will generally be unchanged. However, if the original loan term was 40 years, the remaining term should be unchanged.

C. Credit counseling

Objection: A borrower should receive the benefit of credit counseling before filing for bankruptcy whenever possible, since, by receiving good advice, he or she may still be able to avoid filing. Since the lender files a foreclosure petition well before the foreclosure sale occurs, there is plenty of time to obtain counseling even after this event.

Solution: Allow a waiver of credit counseling only after the foreclosure sale has been scheduled. By this time, when the borrower is facing the imminent sale of his or her house and eviction, it is much too late for counseling to be able to prevent the debtor from filing for bankruptcy since that is potentially the only way to save the home.

D. Guidance to bankruptcy judges

Objection: The bill does not provide bankruptcy judges enough guidance on how to modify loan terms, which are threefold: remaining term in years, interest rate, and principal balance. The judge could therefore add 30 years to a loan that has already been outstanding for 15 years, reduce interest rates to 1% or 2% to make the loan maximally affordable, and cram down the principal to a 50% loan-to-value ratio. Such terms would be unfair to lenders, and the uncertainty created by lack of guidance will have a chilling effect on the market.

Solution: Provide guidance to bankruptcy judges on loan term to essentially leave it the same (see above) and establish that the benchmark interest rate will be market rate: the prevailing 30-year fixed rate plus a risk premium. Such a rule is consistent with holding in the Till case to use a customary index and require the judge to add a risk premium; the prime rate used in Till is customary for car loans but is not used to set the interest rate on first mortgages. In addition, the principal can only be crammed down to the fair market value of houseThe amount over value would become unsecured debt paid to extent family is able during 3 to 5 years of the plan. If a family fails in completing the chapter 13 plan, the loan returns to its original terms and cramdown is undone.

III. Arguments that Don't Hold Up Under Scrutiny

A. A Realistic Look at Market-Based Arguments

In addition to the concerns discussed above, the two most common points raised opposing the bankruptcy changes are: (1) market corrections will be adequate and therefore the bankruptcy solution is not necessary, and (2) allowing judicial modification would destroy the market. Let me explain why neither is valid.

1. The market through voluntary modifications is not correcting the problem.

Some industry representatives say lenders are modifying loans in such great numbers that the government does not need to do anything about it. On August 31, President Bush announced a White House initiative to help homeowners facing foreclosure. In his press conference, the President said, "I strongly urge lenders to work with homeowners to adjust their mortgages. I believe lenders have a responsibility to help these good people to renegotiate so they can stay in their home." Regulators have urged the same actions for banks they regulate.[8]

While there has been increased activity and a number of initiatives have been announced, the scope of the problem still dwarfs the response. As I mentioned in my previous testimony, Moody's Investor Servicers surveyed 80% of the servicing market through July of this year, and found that most lenders were modifying only 1% of subprime loans experiencing rate reset.[9] As a result, Moody's expected to continue downgrading mortgage-backed securities (MBS) because of rising defaults.

When considering this 1% figure, keep in mind that the chief researcher at First American CoreLogic concluded that up to half of the 450,000 families facing subprime resets in the next three months will lose their homes to foreclosure. Thus, even if industry modification efforts increase ten-fold—an extraordinary increase under any circumstances—that effort would still be far from enough.

Just this month, the California Reinvestment Coalition (CRC) surveyed 33 mortgage counseling agencies that offer assistance to financially strained borrowers, and found that "California's largest lenders are not helping borrowers, who struggle to make their mortgage payments, avoid foreclosure . . . . [M]ost borrowers are pushed to foreclosure or short sale, leaving them without the homes they worked so hard to own. Fifty-seven percent of counselors surveyed reported foreclosure, and 33 percent reported short sale, as the most common outcomes for borrowers who cannot afford to pay their mortgages. Both of these outcomes lead to more people losing their homes."[10]

Moreover, many of those few modifications that are being made do not comply with the objective of long-term sustainability. Indeed, most of Countrywide's foreclosure prevention activities consist of simply capitalizing arrearages, or taking the borrower's home before the foreclosure proceedings are completed.[11] Others simply delay the rate reset for six to 24 months, or worse, I've heard, add the unpaid interest between the teaser and fully adjusted rates to the loan's principal balance, thus delaying the problem and making it worse at the same time.

The fact is that there are several structural obstacles to modifications on a large scale that will prevent voluntary modifications from occurring in sufficient numbers without enacting the change to the bankruptcy code. Even those servicers and lenders who genuinely wish to help homeowners in distress, or who recognize that investors as a whole would fare better under a modification than through foreclosure, face significant obstacles to modifying loans. The following are four main reasons for failing to modify:

- Fear of Investor Lawsuits. The servicer has obligations to investors who have purchased mortgage-backed securities through pooling and servicing contracts. Modifying a loan typically impacts various tranches of a security differently, which raises the specter of investor lawsuits when one or more tranches lose income. For example, a modification that defers loss rather than immediately writing down principal will favor the residual holder if the excess yield account is released after a certain period of time, generally three years, but will hurt senior bondholders since the residual, or equity, will not be there to absorb losses anymore. In an uncertain situation of tranches with different interests, the least risky course for the servicer is to pursue foreclosure – even though this may be the least economically beneficial for investors as a whole.

The Consumer Mortgage Coalition made just this point in a letter to FDIC Chairman Sheila Bair, noting that servicers that modify too aggressively face investor lawsuits. The letter noted that private securitizations typically do not have an active manager to which the servicer can go for approvals.

> While this passive structure may appear to give the servicer more discretion, in fact, because of the lack of an active decision-maker from which the servicer could obtain waivers of the usual requirements, no entity exists with the authority to grant waivers. As a result, a servicer that violates the terms of the [pooling and servicing agreement] faces potential legal action from the securitization trustee and even from the securities holders themselves. When a servicer agrees with a customer to reduce a loan's interest rate or principal balance, the servicer is giving away the investors' money, not its own. As a result, investors limit the servicer's discretion to make significant modifications both through the servicing contract and related guidelines.[12]

- Dilemma of Piggyback Seconds. Somewhere between one-third to one-half of 2006 subprime borrowers took out piggyback second mortgages on their home at the same time as they took out their first mortgage.[13] When there is a second mortgage, the holder of the first mortgage has no incentive to provide modifications that would free up borrower resources to make payments on the second mortgage. At the same time, the holder of the second mortgage has no incentive to support an effective modification, which would likely cause it to face a 100% loss; rather, the holder of the second is better off waiting to see if a borrower can make a few payments before foreclosure. Beyond the inherent economic conflict, dealing with two servicers is a negotiating challenge that most borrowers cannot surmount.

- Servicers Overwhelmed by Demand. The magnitude of the crisis has simply been too much for many servicing operations to effectively respond. Hundreds of thousands of borrowers are asking for relief from organizations that have traditionally had a collections mentality, have been increasingly automated, and whose workers are simply not equipped to handle case-by-case negotiations. Many of these servicers are affiliated with lenders who are going bankrupt or facing severe financial stress, and therefore they are cutting back on staff just as the demands are increasing significantly. In addition, housing counselors and attorneys have observed that even when top management expresses a desire to make voluntary modifications, the word does not filter to the front-line staff.

- Mismatched Incentives between Servicer and Investor. Foreclosures are costly – often costing 40% or more of the outstanding loan balance – but these costs are borne by investors, not servicers. In fact, servicers often charge fees by affiliates for appraisals, foreclosure trustee services and other foreclosure-related services, and so can have economic incentives to proceed to foreclosure since these fees are paid first after sale of the house following foreclosure, even where a loan modification would be better for investors.[14]

Since, for the various reasons listed above, servicers have not modified loans that are proceeding directly to foreclosure in significant numbers, Congressional action is needed to enable bankruptcy courts to order loan modifications. This will remove the threat of investor lawsuit and therefore lead to voluntary modifications on a much larger scale than has occurred to date. This legislation would be in the interest of borrowers and investors alike.

2. Tweaking the bankruptcy code would actually improve the market.

Some industry groups are asserting that judicial modifications will negatively impact the mortgage market.[15] There is irony to this claim given that the current credit squeeze is caused by the *lack* of adequate regulation. Absent such regulation, reckless lending practices flourished, causing lender bankruptcies and investor losses. Investors reacted abruptly (and belatedly) to stem further losses, causing a sudden, unplanned-for, and highly disruptive liquidity crisis.

Be that as it may, the prominent independent economists I mentioned earlier do not believe that the proposal will harm the market, and there is strong evidence that the proposed reform will not adversely affect the availability of credit and, in fact, will help stabilize the housing market. Such evidence includes the following:

- Experience shows that past modifications worked well without adversely affecting the availability of credit. For the fifteen years between the enactment of the 1978 Bankruptcy Code and the Supreme Court's 1993 *Nobleman* decision interpreting the Code to disallow modification of loans on primary residences, numerous bankruptcy courts did allow modifications of mortgages on primary residences by placing the portion above the market value of the house on par with other unsecured debts. There is no evidence that the cost or availability of credit for mortgages on primary residences was negatively impacted in these jurisdictions during this time, either compared to jurisdictions that did not allow modifications or compared to lending patterns after 1993.[16]

- Bankruptcy modifications work fine for other types of assets. The claim that allowing modifications of home mortgages will adversely impact the cost or availability of credit is similarly belied by decades of experience in which bankruptcy courts have been modifying mortgage loans on family farms in chapter 12,[17] commercial real estate in chapter 11,[18] vacation homes and investor properties in chapter 13,[19] with no ill effects on credit in those submarkets. Debt secured by all of these asset types, in addition to credit cards and car loans, are easily securitized even though they can be modified in bankruptcy.[20]

  In its position paper distributed on Capital Hill, "Oppose Proposals to Modify Mortgage Obligations During Bankruptcy Proceedings," the Securities Industry and

Financial Markets Association (SIFMA) argues that allowing bankruptcy judges to modify mortgages on primary residences, would cause "major disruption in the financial markets." It uses two main pieces of evidence to support this claim. First, it claims that loans on investment properties have higher interest rates and higher down payment requirements because they can be modified in bankruptcy. I must say, in over a decade dealing with housing finance, I have never heard this argument before. As Self-Help has recognized through our commercial lending operation and as the Wall Street Journal concludes, these loans are simply riskier than loans on owner occupied houses, since investors are much more likely to walk away than homeowners. Second, SIFMA asserts that because of judicial modification, loans on second homes and investment properties are more difficult to securitize. It then cites an article in the trade publication Inside MBS & ABS to assert that only 9% of mortgages on second homes are securitized. However, the reference cited for this statistic makes this point about *second liens, not second homes.*[21] Most second mortgages are in fact on primary residences, which are not subject to modification in bankruptcy. Since both of SIFMA's pieces of evidence do not withstand scrutiny, their claim of market impact must be viewed with extreme skepticism.

- Bankruptcy reform would impact only a fraction of all mortgages. We estimate that the proposed changes to the bankruptcy law would allow 600,000 families who are facing foreclosure to keep their homes.[22] While this number would significantly reduce the severity of the current foreclosure epidemic, it only represents 1.4% of all homeowner households with outstanding mortgages.

- Investors receive more from loan modifications than foreclosures. For the 600,000 families whom we expect this legislation to help, the alternative to a loan modification is foreclosure. This outcome is worse, not only for borrowers, but for lenders as well. Chapter 13 would guarantee at least the market value of the property that the lender took as collateral and would mandate that the borrower make regular payments over three to five years on the difference between market value and the loan balance. Conversely, under foreclosure, lenders receive only liquidation value, not fair market value, with any remaining balance written off altogether. In addition, there are significant expenses associated with foreclosure that would not arise under judicial modification: lenders face one to two year delays and incur high legal expenses, not to mention the costs related to the maintenance and sale of the property. Thus, subprime lenders or investors lose approximately 40% of the principal balance of a loan that defaults.[23] Finally, foreclosures have significant negative impacts on surrounding property values. Therefore, to the extent a lender holds liens on other properties in the area, loan modifications help protect the value of other collateral

- Preventing foreclosures will preserve home prices and assist the overall housing market. Foreclosures depress housing prices overall. Millions of families *not facing foreclosure*—those who have faithfully paid their mortgages on time—lose equity through property value declines every time there is a foreclosure in their neighborhood. Averting 600,000 foreclosures will save an additional $72.5 billion in wealth lost by American families *not* facing foreclosure.[24] This in turn will save local governments property tax revenues, as well as the significant costs of police and administrative support that foreclosures require.[25] According to the Joint Economic Committee, every new foreclosure can cost all stakeholders $80,000.[26]

- The cost of credit already reflects the risk that some loans will end in the loss of the home to foreclosure. Because the Miller- Sánchez bill revised to include a means test would provide for modifications only in those cases where without it the home will be lost to foreclosure, and because modification is economically preferable to the lender/investor than the cost and loss associated with foreclosure, it imposes no additional risk, and hence, no further cost. Bankruptcy in this situation does not cause default, it merely ameliorates it.

B. Misconceptions About the Proposal

I would like to address several other common misconceptions. One complaint about the bill is that it seeks to reopen the 2005 bankruptcy act, which has not been in place long enough to justify changing. However, the proposal goes back to the 1978 implementation of the current bankruptcy code, when judicial modification was instituted, bypassing the 2005 changes. In fact, the proposal can be looked at to complement the 2005 act, which moved more borrowers from a chapter 7 liquidation plan to a chapter 13 payment plan. However, when the mortgage on a principal residence is not affordable and is the cause of the family's financial distress, chapter 13 is ineffective; this proposal would enable the chapter 13 plan that the 2005 act encouraged to work. The only provision that even touches the 2005 act is the credit counseling provision. However, if modified to waive counseling only when foreclosure sale is scheduled, it can hardly be said to be a repeal of 2005, and the debt management counseling provided before discharge would still be required.

Some who oppose the proposal are attempting to frame it as legislation that would benefit speculators, investors and/or wealthy homeowners. In fact, the opposite is true: The bill will benefit ordinary homeowners only. It will not have any impact at all on speculators or investors; current law—not the proposal – allows mortgage loan modifications by speculators and investors. The bill would apply to ordinary homeowning families only, and would extend to these families the protections that have long existed for all other debtors and for all other debts. In fact, following a chapter 13 plan requires a family to abide by a budget with *severe limitations* on living expenses overseen by a judge for three to five years, hardly an option a wealthy family is likely to subject themselves to.

Another critique I have heard is that it is unreasonable or unfair to expect lenders to modify the interest rate or principal balance of outstanding loans. To the contrary, the proposal is designed so that lenders will recover *more* from the modification than from the lender's available alternative (foreclosure). Moreover, modifications, including reducing and fixing interest rates and reducing the principal balance, are called for both by Senator Dodd's May 2007 Homeownership Preservation Principles (endorsed by industry leaders), as well as all of the federal banking agencies and the Conference of State Banking Supervisors.[27]

In related argument, some in the industry say that lenders and servicers cannot modify troubled loans because of obstacles posed by securitization vehicles and the objections of those who hold second mortgages. First, this is true only some of the time; in most instances, where a borrower has defaulted or default is reasonably imminent, servicers have authority to modify these loans. But those servicers who do not have such authority, or who fear investor lawsuits, are exactly why the proposal is necessary: bankruptcy judges can order modifications where lenders and servicers cannot not make them voluntarily.

Similarly, opponents say that lenders should be given the opportunity to approve (or veto) any proposed cram-down. However, the reality is that this is sometimes not possible, given the legal obstacles that securitization can place on the servicer. Moreover, as noted above, even where lenders or servicers have the authority to approve these changes, many are reluctant to do so out of fear that any discretion they exercise will give investors a basis for suing them. Empowering bankruptcy judges to order these changes will provide lenders and servicers with the "cover" they need. Today we are seeing the results of lenders' inaction; leaving cram-downs to lender discretion would maintain the status quo and allow the foreclosure epidemic and all its negative effects to continue expanding unchecked.

Finally, some argue that only low-income people should be able to take advantage of judicial modification. However, people with incomes higher than their state median income were deceived into taking an exploding ARM, and should therefore also receive the benefit of judicial modification. For an extra 0.65% over the teaser rate, recent exploding ARM borrowers could have received a fixed rate loan and avoided the rate reset.[28] Instead, half of such borrowers in 2006 paid even more -- an extra 1% or so -- to get a "stated income" loan, even though they had W-2s readily available. Also, 75% got their loans from a broker, and most paid a higher interest rate over what they qualified for and often a prepayment penalty to provide the broker with a yield-spread premium.

In addition, people who have higher-than-median incomes live in middle-class neighborhoods that will be devastated by foreclosures resulting from their neighbors' exploding ARMs. This will reduce everyone's property values, including those faithfully paying their mortgages, and reduce everyone's wealth.

IV. Conclusion

Much of my statement addressing arguments against bankruptcy reform, but let me end by reminding you of all the reasons in favor of opening existing protections to homeowners. The benefits and advantages are many:

- There would be no cost to the U.S. Treasury, and experience shows there would be no negative impact on home credit.

- This solution, particularly with the tweaks I have discussed today, narrowly targets families who would otherwise lose their homes.

- This solution also helps families who live in the vicinity of potential foreclosures by minimizing the amount of value lost in surrounding properties.

- And, finally, this solution not only helps homeowners, it is also better for investors as a whole. Chapter 13 loan modifications are less expensive for lenders and investors than the cost of foreclosures, and modifications would guarantee at least the value of the property that the lender took as collateral. Moreover, a loan modification ensures a continued stream of income—the borrower continues to pay—and, to the extent the lender is involved with other properties in the area, it prevents the further decline of overall property values.

By tweaking the bankruptcy code, Congress has an opportunity to help homeowners all over the country, and the ripple effects emanating from that action will have positive implications for families, local governments and the economy as a whole. I urge you to take this crucial step to help homeowners struggling with abusive subprime mortgages and thereby minimize the impact of the subprime crisis that ultimately will affect us all.

[1] *See, eg.,* Christopher L. Cagan, Mortgage Payment Reset: The Issue and the Impact, First American CoreLogic (March 19, 2007), available at http://www.facorelogic.com/uploadedFiles/Newsroom/Studies_and_Briefs/Studies/20070048MortgagePaymentResetStudy_FINAL.pdf; See also First American CoreLogic: Core Mortgage Risk Monitor Q4, 2007 (October, 2007), http://www.facorelogic.com/uploadedFiles/Newsroom/Innovations_Newsletter/Core_Mortgage_Risk_Monitor_Q3_2007.pdf; and First American CoreLogic: Core Mortgage Risk Monitor Q3, 2007 (Sept. 2007), http://www.facorelogic.com/uploadedFiles/Newsroom/Innovations_Newsletter/riskmonitor_Q4-07_3.pdf

[2] *See* Christopher Cagan, cited in Ivry, Bob, "Subprime Borrowers to Lose Homes at Record Pace as Rates Rise" (Sept. 19, 2007), Bloomberg, available at: http://www.bloomberg.com/apps/news?pid=email_en&refer=finance&sid=akOEPec30TR4.

[3] "UBS Says Subprime Contagion May Cause More Writedowns," (October 29, 2007), Bloomberg, available at http://www.bloomberg.com/apps/news?pid=20601085&sid=arFeWPc869rs.

[4] "ABX Index Hits Record Low Of 17.5 Cents Vs 18," Dow Jones Newswires (October 25, 2007), available at http://www.smartmoney.com/news/on/index.cfm?story=ON-20071026-000836-1526.

[5] "Public Perceptions," American Banker (October 11, 2007).

[6] "Changing Credit Performance of Subprime RMBS," FBR Capital Markets Structured Finance Insights, (Sept 27, 2007).

[7] The means test would exclude from relief any debtor whose monthly income exceeds the sum of: (a) monthly living expenses allowable under the chapter 13 means test that incorporates IRS living expense standards, plus (b) amount due on the mortgage. If a borrower has enough income left after living within the IRS's strict expense limitations to pay their mortgage, modification is not available. If there is not enough income left to do so, the family would otherwise lose their home in foreclosure, and relief is available. In addition, if the debtor does not have sufficient income even to pay a reasonable market-rate mortgage on a loan equal to the fair market value of the house, modification would not be available either. Note that the means test is generally met for families if foreclosure proceedings have been initiated already, since bankruptcy would be an alternative to the foreclosure.

[8] White House press release, August 31, 2007. *See also* the Interagency Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages, http://www.federalreserve.gov/newsevents/press/bcreg/20070904a.htm

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

[10] http://www.calreinvest.org/news-room/2007-10-10; http://www.sfgate.com/cgi-bin/article.cgi?file=/c/a/2007/10/11/BUBTSL4IL.DTL&type=business. See generally "Modified Mortgages: Lenders Talking, Then Balking," San Francisco Chronicle, 9/13/07 ("Lenders are uniformly unwilling to make loan modifications for homeowners whose interest rates are resetting higher, said Rick Harper, director of housing at Consumer Credit Counseling Services of San Francisco, which talks to about 1,000 delinquent borrowers a month."); Jim Wasserman, "Foreclosures stack up: Frustrated borrowers who lenders to try to work things out say it's a fruitless ordeal," Sacramento Bee, 9/2/07; "Tangle of Loans Feeds Foreclosure Crisis," The Boston Globe, 7/3107 http://www.boston.com/business/personalfinance/articles/2007/07/31/tangle_of_loans_feeds_foreclosure_crisis/.

[11] Gretchen Morgenson, Can These Mortgages Be Saved?, The New York Times (Sept. 30, 2007), available at http://www.nytimes.com/2007/09/30/business/30country.html.

[12] "Group Warns on Large Scale Modifications: Consumer Mortgage Coalition Sends Letter to FDIC," MortgageDaily, December 9, 2007.

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

[14] Gretchen Morgenson, Can These Mortgages Be Saved?, The New York Times (Sept. 30, 2007), available at http://www.nytimes.com/2007/09/30/business/30country.html.

[15] Sloan, Steven."Bankruptcy Reform 2.0? Subprime Ills Raise Odds." American Banker, October 9, 2007.
(http://qa.cujournal.com/$nocookies$/article.html?id=2007100590M4RK4L)

[16] CRL reviewed data on homeownership rates, for the years 1984 to 2000, from the United States Census Bureau, as well as data on mortgage interest rates for the same period, from the Federal Housing Finance Board's Monthly Interest Rate Survey, comparing both states that permitted modifications in bankruptcy and those that did not, as well as trends in "modification states" before and after the 1993 Nobleman decision. The data revealed no observable connection between the modification of home mortgages by bankruptcy courts and either homeownership rates or the cost of mortgage credit.

[17] *See, e.g.,* Hon. Greg Zerzan, Deputy Assistant Secretary for Financial Institutions Policy, Dep't of the Treasury, Congressional Testimony Before the House Committee on

Agriculture (June 2, 2004) ("There are many providers of credit to farmers and ranchers, including commercial banks, insurance companies, the Farm Credit System, and specialized agricultural credit providers. ... Farmer Mac is providing a secondary market outlet for lenders to dispose of loans, much the same way that other financial institutions would purchase or participate in agricultural real estate mortgage loans from one another."); Peter J. Barry, Paul N. Ellinger and Bruce J. Sherrick, Valuation of Credit Risk in Agricultural Mortgages, American Journal of Agricultural Economics (Feb. 1, 2000) ("Agricultural mortgage markets in the United States are experiencing a major transition toward greater institutional lending, wider geographic dispersion, larger lending systems, increased standardization of financing arrangements, greater reliance on nondeposit funding, and expanded potential for securitized loan pools.").

[18] Stacey M. Berger, Does anyone (other than the borrowers) care about servicing quality?, Mortgage Banking (July 1, 2005) ("The commercial real estate finance industry has been reshaped by the strong influence of global capital markets. ... A high proportion of fixed-rate loans are now securitized."); Kenneth P. Riggs, Jr., A new level of industry maturity: commercial real estate has earned its place in the pantheon of stable and attractive investment classes, Mortgage Banking (Jan. 1, 2005) http://www.encyclopedia.com/doc/1G1-127789084.html; Amos Smith, Lenders are renewing their interest in real estate, Los Angeles Business Journal (Oct. 16, 1995) ("Investors and developers are once again being courted by lenders and mortgage bankers seeking to finance commercial property. ... Real estate lending is also providing attractive yields relative to other investments.")

[19] While interest rates are generally higher on investment properties than on primary residences, this is because "[e]xperts say such properties are higher foreclosure risks than homes lived in by their owners." "The United States of Subprime: Data Show Bad Loans Permeate the Nation; Pain Could Last Years" by Rick Brooks and Constance Mitchell Ford. Wall Street Journal, Page A1. October 11, 2007.

[20] *See* http://www.riskglossary.com/link/securitization.htm (All sorts of assets are securitized: auto loans, mortgages, credit card receivables); http://jobfunctions.bnet.com/whitepaper.aspx?docid=105734 ("credit card ABS market has become the primary vehicle by which the card industry funds unsecured loans to consumers").

[21] "Securitization Rate Slips in Second Quarter Despite Lag in Nonprime MBS Process," Inside MBS & ABS (September 7, 2007).

[22] *See* Appendix A, Testimony of Eric Stein, CRL, House Judiciary Subcommittee on Administrative and Commercial Law, "Straightening Out the Mortgage Mess: How Can We Protect Home Ownership and Provide Relief to Consumers in Financial Distress,"September 25, 2007, http://www.responsiblelending.org/pdfs/stein-testimony-on-subprime.pdf.

[23] Fitch Smartview: 170 U.S. Subprime RMBS Transactions Placed Under Analylsis (Jul. 12, 2007), http://www.marketwatch.com/news/story/fitch-smartview-170-us-subprime/story.aspx?guid=%7b65699D03-9AFB-468F-86D5-D9272BFBEAE4%7d&print=true&dist=printTop -"First lien loan loss severity assumptions reflect the performance to-date, resulting in projected lifetime loss severity averaging approximately 40%, with a range of 30%-65% by transaction."

[24] Families lose 1.14% of their own house's value for every foreclosure that occurs on their block. Woodstock Institute, "There Goes the Neighborhood: The Effect of Single-Family Mortgage Foreclosures on Property Values," June 2005, http://www.woodstockinst.org/content/view/104/47/. Assuming the median house value equals $212,000 (National Association of REALTORS® Median Sales Price of Existing Single-Family Homes for Metropolitan Area, 2007 Q2, http://www.realtor.org/Research.nsf/files/MSAPRICESF.pdf/$FILE/MSAPRICESF.pdf, $212,000 value per home * 1.14% value lost per foreclosure* 50 homes per block = $121,000 value lost per foreclosure * 600,000 foreclosures avoided = $72.5 billion in home value saved.

[25] *See* Jim Rokakis, The Shadow of Debt – Slavic Village Is Fast Becoming a Ghost Town. It's Not Alone, (Sept. 30, 2007) http://www.washingtonpost.com/wp-dyn/content/article/2007/09/28/AR2007092801331.html?hpid=opinionsbox1; Noelle Knox, "Rising foreclosures reshaping communities," USA TODAY, 4/07, A1 http://www.usatoday.com/money/economy/housing/2007-04-12-foreclose-cover-usat_N.htm.

[26] http://www.jec.senate.gov/Documents/Reports/subprime11apr2007revised.pdf

[27] Homeownership Preservation Summit Statement of Principles (May 2, 2007), http://dodd.senate.gov/index.php?q=node/3870/print (The Principles were announced by Senator Dodd, and endorsed by the Mortgage Bankers Association, CitiGroup, Chase, Litton, HSBC, Countrywide, Wells, AFSA, Option One, Freddie Mac, and Fannie Mae); *also* the Interagency Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages, http://www.federalreserve.gov/newsevents/press/bcreg/20070904a.htm (Encouraging lenders to address subprime hybrid ARM resets by pursuing "appropriate loss mitigation strategies designed to preserve homeownership. . . . Appropriate loss mitigation strategies may include, for example, loan modifications, deferral of payments, or a reduction of principal.")

[28] Industry has acknowledged that borrowers placed in subprime hybrid ARMs could have received fixed-rate loans, with a rate difference that is "commonly in the 50 to 80 basis point range." January 25, 2007 letter from CFAL to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner, at 3. A review of rate sheets from eight subprime lenders on file with CRL showed that the fixed rate premium in the spring of 2007 ranged from 40 basis points (available with a 3-year prepayment penalty) to 75 basis points.

ARTICLE FROM *THE NEW YORK TIMES,* DATED OCTOBER 8, 2007, TITLED "THE AMERICAN DREAM IN REVERSE"

The New York Times

The American Dream in Reverse
October 8, 2007

For the first time since the Carter administration, homeownership in the United States is set to decline over a president's tenure. When President Bush took office in 2001, homeownership stood at 67.6 percent. It rose as the mortgage bubble inflated but is projected to fall to 67 percent by early 2009, which would come to 700,000 fewer homeowners than when Mr. Bush started. The decline, calculated by Moody's Economy.com, is inexorable unless the government launches a heroic effort to help hundreds of thousands of defaulting borrowers stay in their homes.

These days, modest relief efforts are in short supply, let alone heroic ones. Some officials seem to think that assistance would violate the tenet of personal responsibility that borrowers should not take out loans they cannot afford. That is simplistic.

The foreclosure crisis is rooted in reckless - and shamefully underregulated - mortgage lending. Many homeowners - mainly subprime borrowers with low incomes and poor credit - are now stuck in adjustable-rate loans that have become unaffordable as monthly payments have spiked upward. Their predicament is not entirely of their own making, and even if it were they would need to be bailed out because mass foreclosures would wreak unacceptable damage on the economic and social life of the nation.

The relief efforts so far have been too little, too late. In August, the White House established a program to allow an additional 80,000 borrowers to refinance their loans through the Federal Housing Administration - on top of 160,000 who were already eligible. That's not enough. Foreclosure filings soared to nearly 244,000 in August alone.

Federal regulators and Treasury officials are urging mortgage lenders and mortgage servicers to do their utmost to modify loan terms for at-risk borrowers, but saying "please" hasn't worked. To be effective, modifications must reduce a loan's interest rate or balance or extend its term, or some combination of the three. Gretchen Morgenson reported recently in The Times that a survey of 16 top subprime servicers by Moody's Investors Service found that in the first half of the year, modifications were made to an average of only 1 percent of loans on which monthly payments had increased.

What's missing is executive leadership to bring together many players, including lenders, servicers, bankers and various investors. All of them are affected differently depending on whether and how a borrower is rescued, which makes it difficult to agree on a rescue plan. But all of them also made megaprofits during the mortgage bubble. Under firm leadership, they could come up with a way to modify many loans that are now at risk.

Democratic Congressional leaders have called on the Bush administration to appoint one senior official to lead a foreclosure relief effort. The White House dismissed the idea, saying, in effect, that it's doing enough.

Congress should move forward on other remedies. The most important is to mend an egregious flaw in the current bankruptcy law that prohibits the courts from modifying repayment terms of most mortgages on a primary home. Two bills, one in the House and one in the Senate, would treat a mortgage like other secured debt, allowing a bankruptcy court to restructure it so that it's affordable for the borrower. That would give defaulting homeowners and their advocates much needed leverage in dealing with lenders and servicers. Creditors would presumably prefer to cut a deal with a borrower rather than be subject to the decision of a bankruptcy judge.

The administration and Congress should work to avoid mass foreclosures. Meanwhile, bankruptcy reform would give borrowers a shot at keeping their homes.

LETTER TO THE HONORABLE JOHN CONYERS, JR., CHAIRMAN, COMMITTEE ON THE JUDICIARY, AND THE HONORABLE LAMAR SMITH, RANKING MEMBER, COMMITTEE ON THE JUDICIARY

October 22, 2007

The Honorable John Conyers
Chairman
Committee on the Judiciary
2138 Rayburn House Office Bldg.
Washington, DC 20515

The Honorable Lamar Smith
Ranking Member
Committee on the Judiciary
2138 Rayburn House Office Bldg.
Washington, DC 20515

Dear Chairman Conyers and Rep. Smith:

The undersigned represent a diverse group of consumer, civil rights, labor, housing, lending and community organizations. We are writing to express our strong support for the legislative initiative embodied in H.R 3609, the Emergency Home Ownership and Mortgage Equity Protection Act of 2007. Such legislation will bring desperately needed assistance to families on the brink of losing their homes.

Predatory lending practices and declining real estate markets threaten hundreds of thousands of American families with the imminent loss of their homes to foreclosure. For many families, the precipitating event will be a catastrophic rate increase on an inappropriate "exploding" subprime adjustable-rate mortgage loan. As devastating as foreclosures have been to date, they are expected to accelerate dramatically during 2008, when a large number of loans are scheduled for a rate reset.

This is a nationwide crisis that is engulfing not only for individual families, but also for neighborhoods and entire communities. One important solution to this serious problem is to give consumers on the brink of losing their homes more flexibility to restructure their loans in bankruptcy. H.R. 3609 would eliminate an inequity in the law that currently denies borrowers protections for their primary residence that the law has long granted to wealthier borrowers with respect to their vacation homes or investment properties.

The inability of courts to modify loans on primary residences dates to the enactment of bankruptcy legislation in 1978. At that time, mortgage loans were nearly all fixed-interest rate instruments with low loan-to-value ratios and were rarely themselves the source of a family's financial distress. This is no longer the case. Preventing the modification of home loans for primary residences makes no sense in an age of subprime exploding ARMs where the mortgage itself causes financial crisis. Unless bankruptcy courts have the authority to modify such loans at reset, particularly in areas of property depreciation or where there were fraudulent appraisals, hundreds of thousands of families will be unable to keep their homes.

The Emergency Home Ownership and Mortgage Equity Protection Act would help families save their homes, without any cost to the Treasury, and ensure that lenders recover at least what they would in foreclosure. Distressed homeowners deserve effective and meaningful safeguards in bankruptcy that will allow them to strip down their mortgages to the value of their home so that they can "pay and stay."

We congratulate the Committee for addressing this issue with the sense of urgency it deserves. It is our hope that the clear recognition from both sides of the aisle that distressed homeowners need additional tools to save their homes will result in speedy passage of this urgently needed reform.

Respectfully,

ACORN
AFL-CIO
Central Illinois Organizing Project
Center for Responsible Lending
Consumer Action
Consumer Federation of America
Leadership Conference on Civil Rights
National Association of Consumer Bankruptcy Attorneys
National Community Reinvestment Coalition
National Council of La Raza
National NeighborWorks Association
National Women's Law Center
Rainbow PUSH Coalition
Service Employees International Union
The Reinvestment Fund
U.S. PIRG

cc: All Members, House Committee on the Judiciary
Rep. Brad Miller

MEMO FROM THE CONGRESSIONAL RESEARCH SERVICE (CRS)

Congressional Research Service

Memorandum October 18, 2007

TO: Honorable Brad Miller
Attention: Michael Canning

FROM: Mark Jickling
Specialist in Financial Economics
Government and Finance Division

SUBJECT: 1978 Bankruptcy Legislation and Secured Lending

This memorandum responds to your request for information bearing on the question of whether changes to the bankruptcy code in 1978 affected the market for secured debt. The Bankruptcy Reform Act of 1978 (P.L. 95-598), which took effect on October 1, 1979, permitted the bankruptcy court to write down the amount of certain secured debt to the market value of the collateral. This provision did not apply to mortgages for principal residences. Since the changes amount to an increase in credit risk for secured lenders, the question is whether they responded by raising the price or limiting the availability of credit. If so, one ought to observe a divergence in credit conditions between secured debt subject to reduction by the bankruptcy court (e.g., commercial real estate loans) and the single-family residential mortgage market, where the court does not have the same authority to revise the terms of debt contracts.

The table below presents data from the Federal Reserve's Flow of Funds Accounts on the net credit flows[1] into three segments of the mortgage market: single-family homes, multi-family residences, and commercial mortgages. The table shows the dollar value of net lending in each sector and the percentage that each represents of total credit market borrowing by all nonfinancial sectors.

If the change in bankruptcy law had a significant impact on credit markets, we would expect to observe it around 1980, the first full year after the effective date. The data show a sharp decline in residential mortgage lending — both single- and multi-family — between 1979 and 1982. In commercial mortgages, on the other hand, there is a slight decline between

[1] The Fed's flow statistics do not measure total transactions, but rather net transactions with respect to sectors and financial instruments. For example, nonfinancial businesses may write checks causing trillions of dollars of demand deposits to move between banks, but the Flow of Funds statistics will report only the net change in deposit balances for that sector.

1979 and 1980 and strong growth over the next few years. Thus, the hypothesis that the 1978 law acted as a drag on secured lending other than single-family home mortgages finds no support in these data. Of course, market conditions around 1980 were highly unusual: in late 1979, the Federal Reserve severely tightened monetary policy to combat inflation, resulting in very high interest rates and followed by recessions in 1980 and 1981–82. It is possible that the bankruptcy amendments did raise the cost and limit the availability of secured credit (other than for home mortgages) but that this effect was swamped by other market forces. The data simply suggest that if such an effect was present, it was not a major factor in the market.

It is not possible to make the same comparison between mortgage sectors based on the price of credit, because the Federal Reserve does not publish a data series on interest rates for commercial real estate lending (or any other rate that seems to be a suitable proxy).

If more information is needed, please call me on 7-7784.

Table 1. Net Credit Market Borrowing in Selected Mortgage Sectors, 1975–1990

Year	Total Credit Market Borrowing by Nonfinancial Sectors ($ billions)	Credit Flows to Mortgage Lending ($ billions)			Share of Total Nonfinancial Borrowing (Percentage)		
		Single-family Home	Multi-family Residential	Commercial	Single-family Home	Multi-family Residential	Commercial
1975	192.9	38.8	0.0	11.6	20.1	0.0	6.0
1976	244.7	60.7	5.0	12.5	24.8	2.0	5.1
1977	321.1	92.7	8.4	18.9	28.9	2.6	5.9
1978	390.5	110.6	10.8	21.1	28.3	2.8	5.4
1979	391.6	115.9	9.8	24.8	29.6	2.5	6.3
1980	342.9	92.6	7.5	20.5	27.0	2.2	6.0
1981	409.7	67.6	4.8	40.0	16.5	1.2	9.8
1982	439.8	54.5	5.4	36.0	12.4	1.2	8.2
1983	572.9	116.0	15.2	55.7	20.2	2.7	9.7
1984	791.7	135.6	25.1	78.3	17.1	3.2	9.9
1985	953.3	178.6	28.5	65.5	18.7	3.0	6.9
1986	846.3	203.3	33.4	60.8	24.0	3.9	7.2
1987	718.7	240.3	17.2	68.2	33.4	2.4	9.5
1988	784.3	233.7	18.0	85.8	29.8	2.3	10.9
1989	684.2	226.4	10.7	29.7	33.1	1.6	4.3
1990	655.8	206.7	-1.6	21.4	31.5	-0.2	3.3

Source: Federal Reserve, Flow of Funds Accounts, Table F.2.

Ms. SÁNCHEZ. How are we doing with the microphones down there? Okay.

Mr. Drew Brewer, we will try this one more time. We invite to you open your testimony.

TESTIMONY OF WILLIAM E. BREWER, JR., ESQ., THE BREWER LAW FIRM, RALEIGH, NC, ON BEHALF OF THE NATIONAL ASSOCIATION OF CONSUMER BANKRUPTCY ATTORNEYS

Mr. BREWER. Okay. Working good now.

Chairwoman Sánchez, Ranking Member Cannon and Members of the Subcommittee, I am grateful to have the opportunity to offer testimony today that hopefully will facilitate congressional action that will enable many thousands of your constituents to avoid losing their homes to foreclosure. My name is William E. Brewer, Jr., and I am on the Board of Directors of the National Association For Consumer Bankruptcy Attorneys.

From that title, you might conclude that I am an officer in this battle over the proposed amendments of the bankruptcy law, but I am just a foot soldier. I practice law in Raleigh, North Carolina, as a sole practitioner. From my 20 years of representing debtors, I know as much or more as any person in this room about debtors. What they are like, what motivates them, what gets them in financial trouble, the great lengths to which they will go to avoid filing bankruptcy. These things I know, and that is a perspective I bring to this debate today.

I consult every day with clients who face the stark reality of losing their homes to foreclosure. When I look into their faces, I see fear and hope; fear that they are going to lose their homes, but hope that I, through the bankruptcy process, can help them save their home. Unfortunately, with increasing frequency, I am forced to confirm their fears and eliminate their hopes.

Here is a typical dialogue.

I say: If you are going to keep your house, you have to resume making your full house payments.

The client says: But they are too high. That is why I am here.

Me: I know but that is the rule.

Client: Well, I was making them at first, but the payments kept going up. They are $500 more now than when I started. Doesn't the bankruptcy law allow me to reduce the amount of the debt or the interest rate? You said we could do that on my car. My house is more important than my car.

I say: I know. It makes no sense. But calling Congress can change it.

The culprit, as you know, is section 1322(b)2 of the Bankruptcy Code, which prohibits the modification of loans secured solely by a debtor's principal interest. The blanket bar to modification is unique to home loans. For example, a debtor who owns residential rental property can modify a loan secured by property.

The solution is simple, remove the bar to modification. The mortgage industry opposes any change to the anti-modification provision. Others propose that the bar be removed only as to these 2/28 adjustable rate mortgages and that the bar continue to apply only to future loans.

Unquestionably, the bar to modification should be eliminated across the board to existing and future loans. Though ARMs represent the bulk of these troublesome loans, there are a plethora of other subprime loans and other predatory high-interest loans in the market contributing to the foreclosure crisis. The homeowners trapped in these loans are no less deserving than the ARM borrowers of a chance to save their homes from foreclosure. Congressional policy that grants relief to one and not the other has no defensible rationale. The same is true for future loans.

The mortgage industry created a mortgage market predestined for disaster. Through the fragmentation of the various segments of the industry and the securitization of mortgage, it promoted the meteoric rise in the issuance of these ill-advised 2/28 ARMs. The mortgage brokers and the loan originators either didn't pay attention to the fact or perhaps just didn't care that these loans were no good. They made their money and passed the risk of loss up the line through securitization.

Metaphorically, the disaster created by the mortgage industry is a conflagration, putting people out of their homes all over this country. The incendiary device are these exploding ARMs. The fire must be put out.

As more and more homes are foreclosed, property values are driven lower and lower, and neighborhoods are being destroyed. The industry claims it will get the fire under control with its voluntary modification program. Do we really want to turn over that responsibility to the people who started this mess by playing with matches?

In conclusion, you were elected to deal with this kind of problem. I implore each of you, whether you be Democrat, Republican, Blue Dog Democrat to cooperate in a bipartisan way to enact this legislation which is so badly needed by so many homeowners. While these financial fires continue to burn, don't just sit here in Washington playing your fiddles.

[The prepared statement of Mr. Brewer follows:]

PREPARED STATEMENT OF WILLIAM E. BREWER, JR.

Chairman Sanchez, Ranking Member Cannon and member of the Subcommittee, thank you for the opportunity to appear before you today to testify on the need to enact legislation to help homeowners prevent the loss of their homes through foreclosure.

I am William E. Brewer, Jr. I practice law in Raleigh, North Carolina, as a sole practitioner, where I represent debtors in bankruptcy cases. I am a certified specialist in consumer bankruptcy law by the North Carolina State Bar Board of Legal Specialization and serve on the Board of Directors of the National Association of Consumer Bankruptcy Attorneys (NACBA). I appear today on behalf of NACBA, its more than 2700 members, and most importantly, their future clients who face the real prospect of losing their homes to foreclosure. My testimony comes from the perspective of consulting each and every working day with clients who come to me in hopes that I can help them hold on to the key ingredient of the American Dream, home ownership.

First, I want to commend you, this Subcommittee and your colleagues, Representative Miller and Representative Chabot, for recognizing the urgent need for immediate action to help distressed homeowners save their home from foreclosure. We are pleased to see that there now is clear recognition from both sides of the aisle in Congress that distressed homeowners need additional tools to save their homes from foreclosure and that America's long-established bankruptcy safety net should serve as an essential part of that solution. Second, I urge Congress to enact H. R. 3609. I will not repeat the testimony this Subcommittee has already received from other witnesses in prior hearings as to the nature and extent of the crisis in the home mortgage market that created the need for H.R. 3609 and the other similar bills introduced in the House and the Senate. Suffice it to say that home foreclosures are at historical high levels, and many of your constituents are destined to be put out of their homes if you do not take the appropriate remedial action.

Homeowners are trapped in high interest mortgages with payments that adjust upward to the point that they simply cannot afford to make them. Many of these loans are the adjustable rate loans that have original "teaser" rates that the borrowers can afford, but are set to adjust two years after the loan is made and every six months thereafter. The contractual provisions on these loans are such that substantial increases in payments are certain. However, the problem is not limited to adjustable rate loans. Many homeowners facing foreclosure executed fixed-rate, high interest loans with subprime lenders. Whether the looming foreclosure arises out of an adjustable rate or fixed-rate loan, the loss of the home is the same. Both types of borrowers need the help of Congress.

The most effective remedy available to homeowners facing foreclosure is to file a bankruptcy under Chapter 13 of the Bankruptcy Code to stop the foreclosure. Under existing law, for debtors to successfully utilize Chapter 13 to stop a foreclosure and keep their home, they must resume making their contractual mortgage payments upon the filing of the bankruptcy and "cure" (i.e., catch up) arrears in payments existing when the bankruptcy is filed. With respect to these high interest loans, whether adjustable or fixed-rate, existing law prevents a debtor from remedying the financial circumstance that created the problem in the first place, i,e., a mortgage payment that the debtor cannot afford to pay. This is so because section 1322(b)(2) of the Bankruptcy Code prohibits a debtor from modifying a loan secured solely by real property that is the debtor's principal residence. As this Subcommittee knows from the prior testimony, this prohibition on the modification of the terms of the loan is unique to loans on a primary residence. In the face of foreclosures at epidemic levels, the useful life of this provision has ended.

H.R. 3609 would allow a debtor to modify a home mortgage by reducing the amount of the debt to the fair market value of the property, if the property is worth less than the amount of the debt, and to pay that debt at reasonable rates in accordance with existing Supreme Court precedent. Similar bills pending in Congress also amend the anti-modification provision to a lesser degree. From the perspective of someone who must first advise clients as to their options under the law and then attempt to appropriately apply the law for the benefit of clients, I urge Congress to enact legislation that is not only clear in its meaning, but free of cumbersome conditions that create ambiguities in its application or hurdles in its implementation. Neither debtors, nor creditors, nor the courts are served well by legislation that creates needless issues to litigate. For Chapter 13 to function as it should, the process must be efficient and easy to implement.

It is my understanding that the mortgage lenders oppose this legislation. One might assume from that opposition that the enactment of this legislation represents a zero sum game – that is, every dollar saved by a debtor in modifying a home mortgage loan is a dollar lost by the mortgage lender. Such a circumstance would arise only if one assumes that in the absence of the modification, the homeowner would continue to comply with the contractual terms of the loan. From my experience of delving into the financial circumstances of these homeowners on a daily basis, I know that compliance with the terms of the loan is not one of the options. In the absence of the modification of the loan, the homeowner will eventually have to give up the home. Whether this "surrender" of the home occurs in connection with a Chapter 7 or Chapter 13 bankruptcy, or with no bankruptcy, the mortgage lender will eventually have to foreclose on the home. The time frame under North Carolina law in which the property can be foreclosed, with an intervening bankruptcy, is three to six months. The home will sell for no more than its fair market value. In fact, in most cases these homes sell for substantially less than the fair market value. (From my experience, homes sold in foreclosure generally sell for only 70-75 percent of the actual fair market value.) If the lender is the high bidder and purchaser at the foreclosure sale, it must then maintain the home until it can liquidate it and bear the costs of liquidation.

As intended, the homeowners will benefit from a newly-created right to modify home mortgages. They gain an enhanced opportunity to retain their homes. However, not so expectedly, the mortgage lenders will also fare better under these modifications. In the absence of the modifications, the mortgage lenders will suffer the substantial losses arising out of the scenario set out in the previous paragraph. Conversely, with the modifications of these loans the mortgage lenders receive a stream of payments at reasonable market rates for the entire debt or the value of the property, whichever is less.

The mortgage lenders' protestations that the bankruptcy law does not need to be amended to allow the modification of home loans because mortgage lenders are voluntarily working with homeowners to modify these subprime loans are hollow. First, it is far from clear that these "modifications" being offered by the subprime lenders are meaningful in substance. The mortgage lenders convinced the homeowners in the first place that they can afford to pay these subprime loans. It is certainly likely that they can convince these homeowners that they can comply with modification terms that are unrealistic and designed not to prevent, but only delay, the inevitable foreclosure.

Secondly, these voluntary modifications will reach only a small percentage of defaulting homeowners. To save their homes, the vast majority of these homeowners will have to resort to some remedy other than the mortgage industry's voluntary modification programs. The mortgage industry created this financial "Titanic" via the fragmentation of the industry and the "securitization" of the home loans which allowed each segment to make profits and pass the risk up the line. Now that the ship has hit the iceberg, I submit that Congress should view with skepticism the industry's contention that it has enough lifeboats to save the passengers.

Assuming for the sake of argument that my view of the effectiveness of the industry's medication programs is wrong, and some significant portion of the these loans will in fact be meaningfully modified, the need to allow modification of home loans in bankruptcy still exists. Clearly, a significant portion of these homeowners will not successfully modify their loans outside of bankruptcy. They, too, deserve an opportunity to save their homes from foreclosure. If the industry is sincere about the desire to allow homeowners to save their homes through a modification of these subprime loans, it is difficult to understand why it opposes the modification of these loans through bankruptcy. What difference does it make whether the loan is modified through an industry created modification program or through a bankruptcy? In fact, the modification through the bankruptcy process will be the most cost effective and orderly means of modification. The debtors, through their payments of fees and costs for the bankruptcy, will bear the expense of the modification. The lenders will save the administrative costs, which must be significant, associated with evaluating, processing, and documenting modifications outside bankruptcy.

Another argument made by the industry is that to allow the modification of home loans in bankruptcy will create a flood of debtors, who are having no difficulty in meeting their obligations on their debts, who will file bankruptcy for the sole purpose of "refinancing" their home loans. The argument is unfounded. I have been representing debtors in bankruptcy proceedings for over 20 years, and I state without reservation that borrowers who can and who are meeting their financial obligations do not file bankruptcy to take advantage of bankruptcy laws that allow them to eliminate or modify financial obligations. Bankruptcy remains the refuge of last resort for those who can't pay their debts. Today, the bankruptcy law allows people to modify their car loans by reducing the amount of the debt to the value of the vehicle and the interest rate to a reasonable rate. Yet, I have *never* had a car owner come to see me about filing bankruptcy saying, "Mr.Brewer, I am having absolutely no difficulty in paying my car loan and other debts, but I heard that I might be able to reduce my car loan payments if I file bankruptcy. I would like to do that." There is no good reason to believe that homeowners will be induced to file bankruptcy just to obtain lower mortgage payments.

Likewise, the mortgage lenders' argument that the right to modify home mortgages in bankruptcy will increase the costs of home mortgages to everyone and detrimentally "dry up" mortgage loans, appears to be a stretch. First, the percentage of loans that will ever be modified in bankruptcy, as a percentage of the total mortgage loans written, is so small that the effect will be *de minimis*, Secondly, when viewed through the prism of the effect that the right in a bankruptcy to modify loans secured by other types of collateral has had on the cost and availability of such loans, the argument loses any remaining persuasiveness. Loans on investment property can be modified, yet those loans are available. I don't know of anyone ever suggesting that the rates on these loans have been increased because of the fact that they can be modified in a bankruptcy. The same can be said of car loans, which also may be modified.

With every loan there is a risk of default, and through the underwriting process that assessed risk is a component of the interest rate charged for the loan. Sometimes the default results in a bankruptcy, but bankruptcy does not *create* the risk of default or the loss arising out of the default. Bankruptcy laws do have an impact on how the debtor and creditor sort out the effect of the default. As established earlier in my testimony, the ability to modify a defaulted home loan in bankruptcy in most cases decreases rather than increases the mortgage lenders loss. Therefore, the argument that the ability to modify loans increases the risk of loss and the rate of interest does not withstand scrutiny.

Bankruptcy relief, especially relief through Chapter 13, is about second chances and preserving assets essential for debtors and their families to maintain a dignified life. No asset is more essential than the home. In fact, obtaining and retaining a family's home is the American Dream. In the absence of the enactment of this legislation, many of your constituents will be victims of a cruel hoax—a hoax in which home ownership was but a temporary illusion.

Ms. SÁNCHEZ. Thank you, Mr. Brewer. I appreciate your testimony.

And at this time, I would invite Mr. Kittle to begin his testimony.

TESTIMONY OF DAVID G. KITTLE, CMB, CHAIRMAN-ELECT, MORTGAGE BANKERS ASSOCIATION, WASHINGTON, DC

Mr. KITTLE. Thank you, Madam Chairman, Ranking Member Cannon. Thank you for the opportunity to testify before you on this most important issue.

H.R. 3609 is a well-meaning attempt to close what is mistakenly described as a bankruptcy loophole and to ensure that people don't lose their homes to foreclosure with no material effect on the real estate financial system. Unfortunately, this bill will have a devastating impact on current and future homeowners. This legislation would repeal anti-modification protections on home loans that have been in existence since the Bankruptcy Act of 1898 and that were confirmed by the Bankruptcy Code of 1978 and by unanimous Supreme Court in 1993.

These protections are not loopholes. They were created by Congress to ensure the continued lowered cost and free flow of mortgage credit for primary residences. The anti-modification protections are sound public policy and have helped generations of families by keeping mortgage interest rates down. Changing the law will have serious consequences for home buyers, homeowners with existing mortgages. The hardest hit will be people in areas with declining home prices.

Members of this Committee have discussed their goal of keeping people in their homes. We at the Mortgage Bankers Association share that goal. It pains all of us and me personally to look at the statistics and the real families behind them. None of us wants to see a family pushed out of their home. Current law already provides sufficient protection to keep borrowers in their homes. As soon as a borrower in foreclosure files for bankruptcy, the foreclosure is stayed. The borrower is then allowed 3 to 5 years to repay their delinquency without fear of foreclosure if they pay their bills on time. By reorganizing and ultimately discharging the unsecured debts, money is freed up to pay the mortgage and arrearage.

H.R. 3609 would have a tremendous impact on the mortgage finance system. If this bill becomes law, we believe mortgage rates would jump significantly, going up 1.5 to 2 percent for everyone taking out a loan, holding loan terms, credit, the economy and everything else constant. Our home finance system is based soundly on the idea that mortgage debt is secured lending. If borrowers do not pay their bills, the lender can take possession of the home and partially recover from the bad debt.

The current security and protections in bankruptcy mean that home lenders are not taking as much risk as creditors take with them. For example, credit cards. This is why, at the most basic level, you pay more interest on unsecured debt, such as credit cards, than for a mortgage. If you chip away at the security created on home mortgages—and this bill is not a small chip; it is a sledgehammer attack—you chip away at the entire core of the mortgage finance system.

In order to account for the added risk, you will add significant cost to obtaining a mortgage. What does this mean? Assume you take out a 30-year fixed rate mortgage for $300,000 in today's market. If you are a prime borrower, you will receive a rate of about 6 percent with no points, giving you a principal and interest payment of about $1,800 per month. If you pass this bill, we estimate the same loan at the same terms could cost as much as 8 percent. That increases your payment to about $2,200 per month. This will be an increase of $400 per month, $4,800 per year, for a total over $144,000 over the life of a loan. This is a massive backdoor tax increase on homeowners.

Members of the House can take considerable pride in the steps you have taken already to address the problems in the mortgage market. You have passed legislation giving the Federal Housing Administration a greater ability to help troubled borrowers refinance. You have made it possible for people to exclude discharges of debt on primary residences from gross income, saving borrowers from higher tax bills. The House has passed GSE reform and established an Affordable Housing Trust Fund. The Financial Services Committee is working on a bill to ensure that the problems we have recently seen never happen again. Chairman Frank intends to have that bill on the floor of the House by the end of this year.

I urge you to reconsider your support for the bill and assure you that we will work with the House in addressing the mortgage crisis. This bill is not the answer to the problems, and we urge you to oppose it. Thank you.

[The prepared statement of Mr. Kittle follows:]

PREPARED STATEMENT OF DAVID G. KITTLE

Statement of David G. Kittle, CMB

Chairman-Elect

Mortgage Bankers Association

Before the

Subcommittee on Commercial and Administrative Law

Committee on Judiciary

United States House of Representatives

October 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"

Madam Chairwoman, Ranking Member Cannon and members of the Committee, I am David G. Kittle, CMB, President and Chief Executive Officer of Principle Wholesale Lending, Inc. in Louisville, Kentucky and Chairman-Elect of the Mortgage Bankers Association (MBA).[1] I appreciate the opportunity to appear before you today to testify on behalf of MBA and the mortgage industry concerning legislation that would alter the treatment of home mortgages under Chapter 13 of the Bankruptcy Code and seriously disrupt the U.S. home mortgage market.

The legislation in question is H.R. 3609, the "Emergency Home Ownership and Mortgage Equity Protection Act of 2007," introduced by Representative Brad Miller (D-NC) and Chairwoman Linda Sanchez (D-CA). It makes key changes to Chapter 13 of the Bankruptcy Code including:

- removing anti-modification protections afforded to all mortgages secured by principal residences ("home mortgages");
- permitting modified home loans to be repaid beyond the term of the Chapter 13 plan, which today cannot exceed five years; and
- eliminating the requirement to obtain credit counseling before the debtor can file for bankruptcy.

If these provisions were enacted, it would increase the cost and reduce the availability of mortgage credit for principal residences. For these reasons, MBA opposes the passage of H.R. 3609.

Today, a mortgage secured by the principal residence of a debtor cannot be modified in bankruptcy. This policy has been in existence over 100 years, since the Bankruptcy Act of 1898, and is a cornerstone to an efficient U.S. residential mortgage market. The protection provided to home mortgages was not a loophole or oversight. It was a deliberate act of Congress to ensure the continued low cost and free flow of home mortgage credit. (See Legislative History, Attachment A). A shift in public policy to remove such protections and encourage debtors not to pay their contractual mortgage obligations would dramatically change the residential mortgage market. H.R. 3609 introduces significant new risks for home lenders, investors and loan servicers. These risks include the ability to set aside mortgage contracts and modify interest rates and

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 500,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 3,000 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

other terms. It would also allow liens to be stripped down to the fair market value of the underlying properties, although the bill does not define fair market value.

Impact of H.R. 3609 on Mortgage Financing Costs and Terms

Lenders, securitizers and loan servicers would have to take various precautions to avoid or offset the significant new risks H.R. 3609 would impose. Such precautions would include increasing interest rates and other compensation, tightening credit standards, requiring larger downpayments and restricting credit in declining markets. Failing to take such precautions would be unsound business management.

MBA was asked to estimate the severity of changes borrowers could face if H.R. 3609 were enacted as proposed. In general, we believe based on our preliminary estimates that downpayments would be required in the order of 20 percent or more,[2] as are currently required for mortgages secured by investment properties. Of course, there is some flexibility on this requirement as points are assessed in inverse proportion to the amount of the downpayment. In other words, a borrower can pay an extra point or more to make a 10 percent downpayment instead of a 20 percent or higher downpayment.

Rates and downpayment terms would no doubt vary among lenders, but it is very clear that it would be difficult for borrowers to get high loan-to-value (LTV) loans. The reason for this result is that if a lender is exposed to 95 percent of a property's value and a sizeable amount is forgiven, the lender cannot recoup that money. In addition to higher downpayments, we estimate, based on current pricing for mortgages on investment properties, that a borrower is likely to pay one to three points on the entire loan amount, depending on the size of the downpayment, and an additional 3/8 of a percent in mortgage interest rate. To explain this in terms of pure interest rate (versus a combination of rate and points/fees), we estimate that borrowers would see a 200 basis point jump in interest rates with a 5-10 percent downpayment home mortgage, with no points or fees at closing.

The need for the additional costs and higher downpayment is straightforward. Losses on any foreclosure are high and lenders are always subject to fluctuations in real estate prices for the value of any collateral recovered. For example, if the terms of the debt are subject to an appraisal conducted years after origination and the courts can strip down the lien to the current fair market value, then the security interest in the collateral and the fundamental nature of secured home lending will differ. Bankruptcy filings will no doubt skyrocket as borrowers will seek the incentives H.R. 3609 creates. The severity and velocity of bankruptcy cram downs will be comparable, if not higher, than rates and

[2] It is unclear whether mortgage insurance would be available to offset this requirement. If insurers were willing to accept the risk of strip down, the cost of mortgage insurance would increase. Mortgage insurance is not available on weaker credit borrowers.

losses from foreclosure on investment properties[3] as bankruptcy attorneys will aggressively advertise to borrowers whose homes have declined in value, whether or not the borrower is in default, and when interest rates decline, advertise to all borrowers that bankruptcy provides an inexpensive method to refinance. The cost of defending these bankruptcy cases will be staggering to the industry.

It is important to understand what this bill does, to understand why it will so drastically affect the mortgage market and why MBA opposes its passage. In addition to the risk described above, other risks are introduced that are perhaps unintended, but which have serious consequences for all players in the mortgage market. We would like to discuss the full range of risks in greater detail, which will illustrate why mortgage rates and terms will change so dramatically.

Key Provisions of H.R. 3609 Introduce Substantial New Credit Risk

A. Permits Modifications and Strip Down of Home Mortgages

As stated above, the bill amends section 1322(b)(2) of the Bankruptcy Code, which currently prohibits bankruptcy judges from modifying the terms of mortgages secured by "principal residences" in Chapter 13. The bill would permit bankruptcy courts to change the terms of the mortgage without the lender's consent (often referred to as a "cram down"), including modifying the interest rate, extending the maturity date, capitalizing arrearages and reamortizing the loan. In addition, judges would be granted the authority to "strip down" a secured home mortgage. A strip down (sometimes also known as a "lien strip") is a type of cram down that effectively converts that portion of the secured debt that exceeds the fair market value of the home into unsecured debt. The unsecured portion is treated like other unsecured debt, which is generally paid little or nothing through the Chapter 13 Plan, and is discharged upon successful completion of the plan.

The modification provision in H.R. 3609 applies to all loans secured by principal residences, not just the narrowly defined classes of abusive mortgages that members of Congress claim is the reason for this drastic change in public policy. Needless to say, this broad application of cram downs to the entire spectrum of mortgage products introduces substantial new risks into first mortgage and home equity lending on principal residences.

[3] Unlike foreclosures, borrowers do not lose their assets in a Chapter 13. Rather the borrower receives a key benefit by imposing losses on the lender or investor. Because of this combination, the decision to file bankruptcy becomes significantly driven by economics (since home loss is not a factor). If the decline in property value is significant enough, the homeowner will have an incentive to seek cram down benefits comparable to an investor seeking to dispose of an underwater or financially draining asset.

B. Eliminates Substantial Controls

In addition to permitting cram downs of home mortgages, H.R. 3609 goes farther and removes significant controls that virtually ensure that bankruptcy filings will skyrocket. H.R. 3609 creates a quintessential moral hazard. Today, the Bankruptcy Code generally allows mortgages other than those secured by principal residences of the debtor to be crammed down. However, if such loans are crammed down, the debtor must pay the *entire amount* of the secured claim within the three-to-five-year duration of the Chapter 13 plan.[4] [5] For example, if a mortgage contract of $150,000 gets stripped down to $100,000, the debtor must pay the entire $100,000 within three-to-five years in equal monthly installments. This control limits unbridled runs on the bankruptcy court whenever property values or rates decline. This control, however, is stripped from the rights of creditors by allowing the modified debt to be paid over a term longer than the Chapter 13 plan, which currently cannot exceed five years. H.R. 3609 thereby ensures more borrowers will seek Chapter 13 Bankruptcy.

Of course, consumer groups argue that the bill will *not* substantially increase creditor risk or mortgage costs because cram downs of second homes and investor properties had minimal impact on rates since protections were removed on those property types in 1978. Consumer groups fail to mention the whole truth.

In addition to the restriction mentioned above, vacation homes and investment properties seldom get to the point of cram down because there is generally little reason to cram down these loans. A vacation home clearly is not necessary to provide a roof over the borrower's head and with no equity, and little or no income, is a burden on the estate. Likewise, an investor property that has no equity and a negative cash flow is not necessary for reorganization and is a burden on the estate.[6] Thus, cram down of these types of loans is seldom attempted. Instead, the lender obtains termination of the automatic stay and the property is foreclosed without stripping down the lien. Conversely, a principal residence *is essential* to the reorganization of the borrower and thus if H.R. 3609 is enacted, courts will not release these assets from the stay and judges will be required to impose cram downs.

Because H.R. 3609 also removes the credit counseling requirement when the debtor is in foreclosure, the bill removes the final control against unfettered bankruptcy filings. Congress enacted the pre-filing counseling requirement to assure that debtors in financial difficulty had the benefit of two independent

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[4] 11 USC 1322(d)(2007). See also In re Enewally, 368 F.3d 1165 (9^{th} Cir., 2004).

[5] The unsecured portion of the claim that gets crammed down gets an apportioned payment to the extent there is additional income or cash that can support those payments. If there are no funds remaining to pay unsecured creditors after paying secured and priority claims, the unsecured creditors receive nothing and the unsecured debt is discharged upon termination of the plan.

[6] Investment properties with no equity but with a positive cash flow are still subject to repayment during the 3/5 year term of the plan and thus seldom get crammed down.

sources of information – approved non-profit counselors, and bankruptcy attorneys. Credit counselors are well versed in housing assistance that can help a borrower save his home without filing bankruptcy.

There is no doubt that the impact of the modification provision combined with elimination of all creditor protections will result in increased Chapter 13 filings. The considerable incentive of financial gain to the borrower will ensure that cram downs on home loans will skyrocket over the rate of existing cram downs on second homes and investor loans. Lenders will be forced to control or offset these costs through higher interest rates, points and fees; tighter underwriting restrictions; and bigger down payments. In addition, we believe that lenders and servicers would have a fiduciary duty to their stockholders to take precautions to minimize losses by avoiding declining markets. The bill has the potential to promote legal "red-lining" of distressed regions, such as the Rust Belt states. The result is counter to industry and legislative efforts to help these borrowers.

Impact of Cram Downs on Government Programs

A significant downside of the proposed bankruptcy legislation is the impact on mortgage servicers and ultimately the government housing programs. Today, the Federal Housing Administration (FHA), Department of Veterans Affairs Home Loan Guaranty Program (VA) and Rural Housing Service (RHS) are the prime liquidity vehicles for home purchases and mortgage refinances. FHA, for example, has seen a 15 percent increase in mortgage applications just in the last three months due to the exodus of private investors. VA and RHS programs, while smaller, offer significant benefits, including 100 percent financing, to a specialized segment of consumers.

When these government programs were created, there was no risk of cram down on home mortgages. As a result, authorizing statutes and regulations of the government programs fail to deal appropriately with the risk created by H.R. 3609. Statutes were developed to deal with foreclosures, not bankruptcy modifications and strip downs. As a result, the bankruptcy legislation, when combined with existing investor accounting and claim policies, creates perverse results for mortgage servicers. These results may cause servicers to avoid administering these products. Without servicers, originators cannot offer these products.

For example, the vast majority of FHA, VA, and RHS loans are securitized into Ginnie Mae securities. Ginnie Mae guarantees the timely payment of principal and interest to investors; but, servicers are bound by contract to remit scheduled principal and interest to Ginnie Mae regardless of receipt by the borrower. If a mortgage is modified as to rate, term, capitalization or amortization, the loan must be repurchased from the Ginnie Mae security by the servicer at par (the amount of the principal balance). Servicers often have to borrow the money to buy out the loan. In order to avoid taking principal losses, servicers quickly resecuritize the modified loans into Ginnie Mae II securities. Today, there is no problem resecuritizing voluntary modifications because the borrower is brought current through the process. However, unlike voluntary modifications, it is unclear whether modified mortgages *in bankruptcy* will be eligible for resecuritization. Wall Street has little appetite for bankrupt debtors in securities. If bankruptcy modifications cannot be resecuritized, servicers will have to place these assets on their books, hold capital and loan loss reserves against them and take the risk of principal loss, which they do not typically do today. The servicer would also be paying the debt service on the commercial loan used to buy the loan out of the pool. Given our belief that Chapter 13 modifications will dramatically increase, the cost to the servicing industry would be substantial.

It is also important to note that servicers cannot submit an FHA insurance or a VA guarantee claim for the amount of any lien strip down. The servicer would have to advance the amount that was stripped down to Ginnie Mae security holders and absorb the principal loss. This is a substantial shift in liability that servicers certainly did not contemplate when they agreed to service Ginnie Mae securities. As stated previously, servicers rarely take principal losses today. The severity of losses to which servicers would now be exposed would be comparable to what FHA and VA lose with each foreclosure – more than $30,000 per property. Yet, if those loans went to foreclosure sale, FHA insurance and VA guarantees would kick in to protect the servicer against principal loss.

The risk of uninsured losses and repurchase risk created by H.R. 3609 will cause existing servicing portfolios to decline in value, requiring accounting write downs of servicing assets. The velocity at which loans would enter bankruptcy could cause capital and liquidity problems for servicers. This disruption could also cause significant problems with voluntary workouts as bankruptcy cram downs would consume the servicer's financial and personnel resources. The stated objective of encouraging more voluntary workouts through H.R. 3609 would simply not materialize because the reward in bankruptcy is far more lucrative than what servicers could or should offer.

Going forward, servicers would bid less for servicing assets, which will drive up mortgage rates and costs for borrowers. Also, because servicers do not currently bear the primary risk of principal loss, servicers may shun these products, require significantly greater compensation, or service only loans with protections (such as higher down payments) in the future. All of these options have a direct impact on the success of the government programs and program features that make them attractive today.

Consumer groups argue that lenders will convince these entities to merely change their policies. It is not so simple. FHA, for example, is not permitted *by statute* to pay an insurance claim for the strip down amount. [7] It was simply not

[7] 12 USC 1710a (2007). FHA can only pay a claim when it receives title to the property, the mortgage is foreclosed, the loan gets assigned, there is a pre-foreclosure sale or there is a loss mitigation partial claim.

contemplated. An act of Congress would be required to restore the 100 percent federal insurance that makes the FHA products marketable.

Impact of Cram Downs on Investors and the MBS Market

Securitization increases homeownership. Today, banks and other lenders resell mortgage debt to other investors, or "securitize" it. This frees up capital and allows banks and mortgage companies to invest more into local economies and makes home mortgage credit more widely available. As a result, homeownership has risen significantly since the mid-1990s. The share of Americans who owned homes rose from 64 percent in 1994 to 69 percent by 2005. This is the highest increase in homeownership since the surge that followed World War II.

Securitization of mortgages is based on the underlying value of those mortgage contracts. Granting bankruptcy judges the authority to retroactively modify a mortgage in Chapter 13 proceedings would have a materially adverse impact on the mortgage contract. The resulting uncertainty would mean that securitizers or investors could not assess prices or calculate the risk of how many mortgages could be modified. Such uncertainty would likely drive investment away from mortgage-backed securities (MBS) or result in overcompensating for risk through pricing. Existing MBS values could also decline as losses mount, resulting in additional downgrades of securities.

Investors such as Fannie Mae and Freddie Mac would be required to purchase the vast majority of loans out of the MBS pools if the loans are modified and absorb the principal losses.

It is unclear what would happen to investors. No doubt investors in non-guaranteed mortgages and MBS ultimately would take the principal loss and reduced yields, however, it is possible that if judges modify loans beyond the pool parameters (such as by converting a 15-year mortgage to a 30-year mortgage), the loans would have to be purchased out of the MBS pools. It is unknown if servicers would bear that cost.

Bankruptcy as a Low-Cost Refinance Alternative

H.R. 3609 not only creates an incentive to file bankruptcy in markets with declining property values, but it encourages solvent borrowers who can otherwise pay their mortgages to seek Chapter 13 to get what is essentially a low-cost refinance. It has happened before on non-home mortgage assets[8] and would likely occur with home mortgages if H.R. 3609 gets enacted given the removal of all restraints on cram downs. While interest rates have been at

A partial claim is a specialized loss mitigation tool, which allows arrearages to be subordinated into a junior lien held by HUD.

[8] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") prohibited the cram down of car loans for two and a half years from origination to stop borrower abuse.

historic lows, there is no guaranty that rates will not climb into the double digits as this country experienced in the late 1970s and early 1980s. When rates eventually decline, H.R. 3609 encourages borrowers to seek bankruptcy as a cheap alternative to refinancing.

Lenders Forced to Guarantee Origination Value of Properties Damaged or Destroyed by Natural Disasters or Borrower Misconduct

Another significant concern created by HR 3906 is the windfall borrowers would obtain when the property is either 1) damaged by the borrower or 2) damaged by natural disasters such as Hurricanes Katrina and Rita or the recent wildfires of Southern California.

Borrowers in default often fail to properly maintain their property, and sometimes intentionally damage their property. In some cases, borrowers attempt significant renovations but fail to complete them, leaving the collateral significantly devalued. We do not believe these debtors should be rewarded through loan stripping, but H.R. 3609 would do just that if passed.

Likewise, we do not think borrowers should be able to wipe out the security interests of creditors when their properties are destroyed by natural disasters, but H.R. 3609 would do just that. To illustrate our concern, we would like to focus on properties damaged by Hurricanes Katrina and Rita. As you might be aware, lenders have offered borrowers who were impacted by the Hurricanes over two years of forbearance and/or have also modified their mortgages. Some properties have zero or negative values. Now that community development block grant money is flowing to homeowners to rebuild these properties, Congress is poised to add another devastating blow to investors and servicers: the ability for borrowers to wipe out *all or significant portions* of the debt in Chapter 13 bankruptcy. The impact of lien stripping on insurance proceeds and grant funds as secured assets is also brought into question, leaving creditors with possibly no recourse to recover the value of the debts. H.R. 3609 places lenders, servicers and investors in an inappropriate role of property insurers of last resort and/or guarantors of property values. Mortgage lenders and servicers are not in a position to evaluate these risks.

H.R. 3609 Gives Enormous Windfalls to Borrowers

What is probably one of the most inequitable results of H.R. 3609 is the fact that debtors in depressed real estate markets or with damaged or destroyed properties will reap a windfall at the expense of servicers, investors and borrowers who honor their debts. This windfall occurs when the borrower is permitted to reduce the debt to the depressed value of the property, retain the property, and enjoy the benefits of appreciation in value when market conditions improve (or repairs get made with insurance and government aid), while having no obligation to pay the lender the full contractually agreed upon debt. Executing a strip down based on a snapshot of value ensures borrowers will reap significant profits when the property appreciates later in time. The case in point is illustrated by In re: Enewally 368 F.3d 1165 (9th Cir., 2004).[9] While there are always pockets of declining home values, over the last 30 years home prices nationally have risen six percent per year on average.[10]

The unfair result H.R. 3609 creates does not occur today in Chapter 7 or when the borrower is allowed to foreclose on the property. The creditor in either case would have the right to acquire the property by bidding its claim. The creditor could then, if it chooses, hold the property until market conditions improve (and retain full insurance benefits and security interests in grant proceeds in the case of damaged property), thereby reducing its losses. In the case of a foreclosure, the servicer could in most cases also seek a deficiency judgment for the difference between the value of the property and the contractual obligation. No such remedies are contemplated in H.R. 3906.

Industry Efforts to Assist Distressed Borrowers

Members of this Committee have discussed their goal of keeping people in their homes. We at the Mortgage Bankers Association share that goal. None of us wants a family to lose its home and our members are trying their best to help. Servicers are providing loss mitigation to eligible borrowers in distress. These alternatives to foreclosure include forbearance and repayment plans, modifications, partial claims (FHA), short sales and deed in lieu of foreclosure. There has been a lot of criticism about the lenders' speed at modifying loans, but little recognition is given to the fact that many other workout options are being offered to borrowers in significant volume – most notably forbearance agreements that allow the borrower significant time to repay arrearages. The industry has also made strides in clarifying accounting and tax rules to allow for more modifications. However, wholesale modifications are not possible or advisable.

Another problem that servicers are attempting to resolve is the low contact rate servicers have with borrowers. Historically, 50 percent of borrowers who reached foreclosure had no contact with the servicer despite multiple efforts on the servicer's part to reach out. Contact volume is still low and borrowers often simply don't know where to turn for reliable advice and assistance. Servicers have been working diligently to ensure all borrowers know about alternatives to foreclosure and to coordinate with housing counselors if borrowers are uncomfortable talking to their servicers. To help provide a coordinated and centralized approach to foreclosure prevention, the industry, with the assistance

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[9] At the time of the bankruptcy court's ruling in 2001, the debtor's property had declined in value to $210,000. The mortgage debt was approximately $245,000 and the borrowers sought cram down. However by the time the United States Supreme Court rejected the Writ of Certiorari three years later, that same property was worth $600,000. Had the debtors' cram down not been overturned on appeal, the debtors would have received a significant windfall.
[10] OFHEO House Price Index.

of the Department of Treasury, Department of Housing and Urban Development and the Housing Policy Council of the Financial Services Roundtable, recently launched HOPE NOW.[11] This effort will provide additional outreach attempts to borrowers, provide a centralized approach to managing housing counselors, centralized points of contact, and will track various metrics on housing counseling and loss mitigation activities.

Alternative Congressional and Government Actions

Members of the House can take considerable pride in the steps you have taken to address problems in the mortgage market. The House passed legislation modernizing the FHA, giving it a greater ability to help troubled borrowers refinance their loans. The House has passed legislation that would exclude discharged debt on principal residences from gross income for tax purposes, thereby saving borrowers already in trouble from higher tax bills and encouraging work outs. The House has passed meaningful housing government sponsored enterprise (GSE) reform and has passed legislation establishing an affordable housing trust fund to ensure more high quality housing is available for more low- and moderate-income families.

Moreover, the Financial Services Committee is currently working on legislation, H.R. 3915, that will create a new regulatory regime for the mortgage market. Let me assure you, this is a very serious piece of legislation. While we are not able to offer our support for that bill at this time, we are working with Chairman Frank to improve the bill. We understand that the Chairman intends to have that bill on the floor of the House by the end of this year.

In addition to Congressional actions, FHA recently announced FHASecure,[12] which allows borrowers the opportunity to refinance into FHA insured loans. What is remarkable about this program is that it would allow a borrower who is six months delinquent on an adjustable rate (ARM) loan to refinance into an FHA loan, despite his or her delinquency, provided the borrower had a good payment history prior to the ARM rate reset and he can afford the new payments. The program also allows borrowers who are upside down on their mortgages (i.e., owe more than their property is worth) to refinance a portion of their loan into non-FHA insured subordinate liens. In the past, combined loan-to-value requirements prohibited such activity. Unfortunately, passage of H.R. 3609 would prevent these subordinate loans from being originated, thus depriving borrowers of useful assistance.

While Congress has made strides in assisting borrowers in distress, H.R. 3609 goes too far. It encourages damaging behavior that will only serve to increase the cost and reduce the availability of home financing. It repudiates existing contracts, imposes mandatory buyback options or home price guarantees on all

[11] http://www.hopenow.com/
[12] http://www.fha.gov/about/fhasfact.cfm

mortgages and an option to change rate terms. For proponents to argue that such options and guarantees will not come with a price is simply disingenuous.

Conclusion

MBA opposes H.R. 3609 because of the harm it will cause to the mortgage market and borrowers who seek home mortgages. While well-intentioned, H.R. 3609 will increase rates, tighten credit standards, and dry up investor interest in mortgage-backed securities. Our preliminary estimates indicate that mortgage interest rates could jump as much as 200 basis points per loan and down payment requirements will increase if proposed amendments to Chapter 13 of the Bankruptcy Code are enacted. Government programs also stand to be negatively impacted due to the increased costs to administer these programs. With investor appetite for U.S. mortgages waning, it is ill-advised to pass legislation that will further disrupt the mortgage market. We urge Members of the House to look deeper into the implications of H.R. 3609. We are convinced that upon further detailed analysis you will agree that further action on this legislation is ill-advised.

Thank you for this opportunity to share our concerns with the Subcommittee.

Attachment

Legislative History on the Enactment of the Bankruptcy Code And the Anti-Modification Provisions For Mortgages Secured by Principal Residences

MBA was asked to provide information on the legislative history associated with the current status of the Bankruptcy Code that prohibits modification of a mortgage secured by the borrower's principal residence, but permits such modifications on other mortgage debt, including mortgages on second homes and investor properties.

Consumer groups argue that the prohibition against modifications and cram downs for home mortgages was first offered in 1978 with the passage of the Bankruptcy Code. This is not accurate. The protection against cram downs and modifications of mortgages secured by principal residences has been in existence since the 1898 Bankruptcy Act. In fact, under the Bankruptcy Act, an individual wage earner's plan could not modify or otherwise affect the rights of a holder of a mortgage on the real property of the wage earner.

When the Bankruptcy Code was first proposed to replace the Bankruptcy Act, in the House, no limitations were set on the ability of an individual wage earner to modify the rights of holders of secured claims or of holders of unsecured claims.[1] The Senate version, on the other hand preserved the expansive protections afforded real estate mortgage creditors in Chapter XIII of the Act.[2] The report accompanying the bill noted that the Senate bill would not permit modification of "claims wholly secured by real estate mortgages."[3]

At the Senate hearing in the 95th Congress on November 29, 1977, MBA and other representatives of mortgage industry voiced concerns that the House version of Section 1322(b)(2) would limit the availability of mortgage funds. In testimony before the Subcommittee on Improvements in the Judicial Machinery of the Committee on the Judiciary, Mr. Edward J. Kulik, Senior Vice President, Real Estate Division, Massachusetts Mutual Life Insurance Co., pointed out that reducing a mortgagee's claim to the actual value of any real estate securing the claim would have a dramatically negative impact on the mortgage industry.

Specifically addressing the proposed provision of Chapter 13, Mr. Kulik emphasized that the House version of Section 1322(b)(2) would have a particularly adverse impact on the availability of home mortgage funds, especially where the financial resources of the individual home buyer were not particularly strong. To avoid this result, he proposed that the legislation be modified to protect holders of residential mortgages. He stated:

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[1] H.R. 82000, 95th Cong., 1st Sess. (1977).
[2] S. 2226, 95th Cong. 2d Sess. (1978)
[3] S. Rep. No. 989, 95th Cong. 2d Sess., 141 (1978).

"Serious consideration should be given to modifying [the legislation] so that at the leas[t] ..., a mortgage on real property other than an investment property may not be modified.[4]

It is against this background that the compromise language embodied in present Section 1322(b)(2) of the Bankruptcy Code was adopted. The language preserves the protections afforded mortgage lenders under Chapter XIII of the Bankruptcy Act then in effect, but restricts that protection (along the lines that Mr. Kulik suggested) to mortgages secured by residential property of the debtor. The intent of this provision is explained in the Joint Explanatory Statement agreed on by the House and the Senate floor managers, following the floor debates on the compromise bill:

"Section 1322(b)(2) of the House amendment represents a compromise agreement between similar provisions in the House bill and Senate amendment. Under the House amendment, the plan may modify the rights of holders of secured claims other than a claim secured by a security interest in real property that is the debtor's principal residence."[5]

Several courts since passage of the Bankruptcy Code have also viewed the anti-modification protections to be as a result of "a congressional reaction to fears that, if debtors were allowed to readjust all types of secured debt, including home mortgage loans, this would severely affect the stability of the home mortgage finance industry and the availability of financing by the industry by consumers."[6]

In *Grubbs v Houston First American Savings Assn*, the Fifth Circuit explained the reason for this exception:

"This limited bar was apparently in response to perceptions, or to suggestions advanced in the legislative hearings . . . that home-mortgage lenders performing a valuable social service through their loans needed special protection against modification thereof (i.e., reducing installment payments, secured valuations, etc.)"[7]

Of considerable importance in understanding the legislative history of the treatment of home mortgages in Chapter 13, is the recognition that the enactment of Section 1322(b)(2) occurred following very serious consideration by policymakers. In a series of Acts over almost six decades, Congress developed programs, institutions, favorable tax treatment and broad legislative intent to encourage homeownership and efficient financing for homeownership for Americans of modest means. The FHA mortgage insurance programs, the VA

[4] Bankruptcy Reform Act of 1978, Hearings before the Subcommittee on Improvements of the Judicial Machinery Committee on the Judiciary, 95th Cong., 1st Sess. 709, 714 (1977).
[5] 124 Cong. Rec. S17424 (October 6, 1978)
[6] Victoria Miles, , *The Bifurcation of Undersecured Residential Mortgages Under §1322(b)(2) of the Bankruptcy Code: The Final Resolution,* 67 Am. Bankr. L.J. 207 (Spring, 1993)
[7] Grubbs v. Houston First American Savings Assn, 730 F. 2d 236, 246 (CA5 1984)

Home Loan Guaranty Program, Fannie Mae, Freddie Mac, Ginnie Mae and the ability to deduct interest payable on home mortgage are each examples of the Congressional intent to foster a robust mortgage credit market and to encourage homeownership.

Ms. SÁNCHEZ. Thank you for your testimony, Mr. Kittle.

At this time, I would invite Mr. Levin to give his testimony.

TESTIMONY OF RICHARD LEVIN, ESQ., CRAVATH, SWAINE & MOORE LLP, NEW YORK, NY, ON BEHALF OF THE NATIONAL BANKRUPTCY CONFERENCE

Mr. LEVIN. Thank you, Ms. Chairman, and Members of the Subcommittee. It is an honor and a pleasure to be here, to be invited back.

I am here on behalf of the National Bankruptcy Conference, which is a voluntary nonprofit, nonpartisan organization committed to the improvements in the bankruptcy law. The National Bankruptcy Conference was formed in the 1930's at the request of this Committee to assist the Congress in deliberations on this complicated and technical area.

I stress that we do not represent any economic interest. We pledge when we meet to leave our clients at the door and focus on what we believe is sound bankruptcy policy.

We believe that a bill along the lines of H.R. 3609 is sound bankruptcy policy. You have my prepared statement. I will not review all of the points in there. I would like to make just a few remarks based on what has been said already. But I cover obviously a lot more territory in the prepared statement.

It is our experience, as Mr. Brewer has said, that bankruptcy is not a first resort. It is a last resort. It is a last, last resort. People tend to head toward the bankruptcy court at 11:59 and 59 seconds. Many of the things that have been proposed by the Mortgage Bankers as ways of alleviating the mortgage crisis are helpful, but they are not a complete solution. I note that, just last Friday, the Joint Economic Committee majority staff produced a report on the subprime lending crisis. It proposes many of the things that the Mortgage Bankers have suggested and more, including an amendment to Chapter 13. And it traces the history and effect of the crisis quite well, and I commend its reading to the Subcommittee.

But the fact is, voluntary measures will not work. We need a backstop, a last resort if lenders are to come to the table and negotiate in good faith with borrowers over restructuring mortgage loans.

H.R. 3609 only recognizes economic facts. It does not impose losses that are not already present on the ground. The real estate has lost value. A foreclosure will cause it to lose even more value, increasing the cost to the lender through foreclosure expenses, taxes, insurance, maintenance and cost of resale. H.R. 3609 provides a better solution that is a win-win, that keeps families in their homes and allows lenders to mitigate their losses.

We must focus on this. This is the very fabric of our neighborhoods that we are trying to protect.

We believe that the bills and the law as it currently exists have adequate safeguards already against abuse. To file a Chapter 13 case, a debtor—the court must find that the debtor acted in good faith in filing the case and in proposing the plan of arrangement.

The debtor must devote all of his or her disposable income to the plan for 3 to 5 years, and the debtor is hampered in filing—or restricted from filing bankruptcy because of the adverse effect it will have on the debtor's credit report, which will stay on I think it is at this point 10 years, but I defer to Mr. Brewer on that.

We have no evidence, reading the cases, talking to the judges, following this area closely, that solvent bankruptcies are running to the bankruptcy court. And the other protections that are present are the two Supreme Court decisions within the last 10 years Rash against Associates Commercial finance, which provided for what we will call fair market value of an asset such as a home where the debt is being adjusted until, which sets forth the Supreme Court's interpretation of a market rate in interest. The bankruptcy courts are bound by both of these restrictions if they are to have the power to approve plans and adjust mortgage interest rates.

Finally, just a word on the effect on rates. Before the Supreme Court decided *Nobelman* in 1993, four Circuits permitted mortgage modifications, and many, many, many bankruptcy courts did as well. We did not see any perceptible effect on credit rates, mortgage rates in those jurisdictions than in the only one circuit that went the other way when the Supreme Court took up the *Nobelman* case, the Fifth Circuit.

Second, what H.R. 3609, by recognizing the economic facts on the ground that are already going on, when lenders go to foreclose, most the lenders get is the value of the property, which is what 3609 proposes. And that—even though that has been the economic fact, if not the law, has not affected mortgage lending. And finally, every time a change in the bankruptcy law is proposed that is adverse to lenders, the statement is made, this will hurt credit rates. The converse also ought to be true. If rates—if bankruptcy law is made more generous to lenders, one might think that rates would come down. Have you looked at your credit card bill recently? Have your rates changed in the 2 years since the adoption of the 2005 amendments?

Thank you, Ms. Chairwoman.

[The prepared statement of Mr. Levin follows:]

PREPARED STATEMENT OF RICHARD LEVIN

Testimony of

Richard Levin[1]

Vice Chair

on behalf of the

National Bankruptcy Conference

before the

Subcommittee on Commercial and Administrative Law

of the

House Judiciary Committee

110th Congress, 1st Session

for Hearings on

Straightening Out the Mortgage Mess: How Can We Protect Homeownership and Provide Relief to Consumers in Financial Distress?

October 30, 2007

The National Bankruptcy Conference appreciates the opportunity to participate in these oversight hearings on protecting homeownership and providing families relief from burdensome home mortgages and thanks the Subcommittee for its invitation. The NBC believes that carefully crafted amendments to the Bankruptcy Code, as well as other approaches,[2] can contribute favorably to the management of the subprime mortgage crisis. We therefore commend the Subcommittee for focusing on this issue.

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[1] Partner, Restructuring Department, Cravath, Swaine & Moore LLP, New York, NY. The views expressed in this testimony are expressed solely on behalf of the National Bankruptcy Conference and do not necessarily represent the views of Mr. Levin, Cravath, Swaine & Moore LLP, or any of its clients.

[2] *See* "The Subprime Lending Crisis," Report and Recommendation by the Majority Staff of the Joint Economic Committee, Oct. 2007, at 23-25. Much of the factual background described in this Testimony is supported by the Joint Economic Committee Report.

As you may be aware, by letter and Report dated July 17, 2007 the NBC provided technical comments on drafts of bills, some of which have since been introduced, and set forth policy positions to which the NBC remains committed. We take this opportunity to explain how targeted modifications to the Bankruptcy Code could provide appropriate relief to some homeowners caught up in the subprime mortgage crisis.

The Conference is a voluntary, non-profit, non-partisan, self-supporting organization of approximately sixty lawyers, law professors and bankruptcy judges who are leading scholars and practitioners in the field of bankruptcy law. Its primary purpose is to advise Congress on the operation of bankruptcy and related laws and any proposed changes to those laws. Attached to this statement is a Fact Sheet about the Conference, including a list of its Conferees.

MODIFICATION OF MORTGAGES

The Problem

This Subcommittee—indeed, nearly everyone—is well aware of the crisis affecting homeowners in this country in the wake of the extraordinary increase in the amount and kind of home mortgage loans made over the past several years. A combination of a rapidly falling housing market and tighter credit markets, coupled with 100% (or more) loan-to-value mortgages, negative amortization, exploding ARM's with interest rate increases far beyond the ability of ordinary homeowners to pay, and more have squeezed homeowners between an inability to make their monthly mortgage payments and an inability to sell or refinance their homes to escape the pressure. The result has been a dramatic increase in mortgage loan defaults and a corresponding increase in foreclosures. In some neighborhoods, foreclosure signs are popping up on every street, and home values are being driven into the ground, hurting neighbors who need to sell or refinance their own homes and creating a downward spiral that threatens to take even more hard working homeowners down with it.[3] The only hope is to get some relief from the terms of the mortgages themselves to allow the debtors to stay where they are until the foreclosures storm clears.

As much as borrowers have over-borrowed, lenders have contributed to the crisis in many ways. "No doc" loans, appraisals based solely on computer data and not a property inspection,[4] separation of lending risk assessment from investment, reliance on rating agencies to rate pools rather than individual mortgages, and the focus on fees, fees, and fees, rather than ability to repay all have blown up the bubble. (What ever happened to traditional, responsible lending?)

More important for our purposes here today, lender behavior in the face of defaults can worsen the crisis. Servicers for securitized mortgage loans are often restricted by the servicing agreements with the securitization investors from consenting to home-saving modifications. Even when they are not restricted, they have little incentive to do anything but to start foreclosure proceedings, in part because of fee structures and in part because they may fear that working with homeowners and waiting too long could put them at a disadvantage in a falling market as against other lenders or servicers who rush to foreclose before the market completely collapses.

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[3] "Lenders Curb New Mortgages in Weaker Areas," *Wall St. Journal*, Oct. 23, 2007, at D1 (lender rejected a refinancing because "the lender didn't feel that it could get an accurate valuation of the property, given the high number of forcelsoure sales in the neighborhood.").

[4] *Id.* ("Bank of America Corp. says … appraisers are being told to drive by the property to get a better estimate of its value instead of just running information about the home through a computer model.").

But rushing to the exits creates a self-fulfilling prophecy that pushes home prices down further. The S&L crisis of 1990 resulted in part from a similar combination of over-lending, followed by extensive foreclosures and excess amounts of unsaleable "REO"—real estate owned by savings and loan associations after foreclosures. But a moratorium on foreclosures, as was attempted by some States in the 1930's, would be far too draconian.

By contrast, amendment to chapter 13 of the Bankruptcy Code to permit both borrowers and lenders to work out a constructive solution under the supervision of the bankruptcy court could go a long way to preserving families' homes, preserving neighborhoods, and preserving home and mortgage values. What's more, leaving families in their homes, rather than evicting them through foreclosures, keeps houses and yards tended and relieves the lender of the burden of taxes, insurance, and maintenance. It's a win-win solution, but it needs legislation to help break the cycle and get the lenders and borrowers to the table.

The Solution

There is, of course, clear precedent for Congress to solve such a mortgage crisis. As in the mortgage crisis today, farm values were falling dramatically in the mid-1980's. As in the mortgage crisis today, lenders could not renegotiate farm mortgages to reflect falling land prices and the changing economics of family farmers. In 1986, the good work of Representative Mike Synar and Senator Charles Grassley created chapter 12 of the Bankruptcy Code to help family farmers. Chapter 12 provided a platform for the rational modification and reamortization of farm loans that became the standard for solving the farm loan crisis.

Chapter 12 has been a great success. Though originally enacted as a temporary measure, its sunset provision was extended several times until it was made a permanent part of the

Bankruptcy Code in 2005. Ironically, its very success has resulted in a substantial decrease in its use. As lenders and borrowers understand its operation, they are often able to get to family farm mortgage modifications on their own, without the bankruptcy court's intercession.

In another irony, the chapter 12 experience provides the model for amending chapter 13 to address the current mortgage crisis. Chapter 12 of the Bankruptcy Code was created on the model of Chapter 13, with the added power for family farmers to modify mortgage debt on their farm land, to reamortize the debt, and to save the family farm over a period of years. Chapter 12 overcame the inability of farm lenders to negotiate terms that reflected the economic realities of family farmers in the 1980's. Many home mortgage lenders today face the same inability to realize the economic reality of today's rapidly falling housing market. Now, chapter 12-style adjustments to Chapter 13 can provide the same sort of relief to homeowners trapped in impossible mortgages.

Such an adjustment to chapter 13 would not be a major departure. In 1978, in a compromise between the House and the Senate bills that was partially undone by the Supreme Court's 1993 decision in *Nobleman v. Am. Sav. Bank*,[5] Congress limited modification in chapter 13 of a mortgage on the debtor's principal residence. No similar limtiations were imposed on mortgages on vacation or second homes, on investment, rental, or business property, or on any other form of collateral. Whatever justification there might have been in 1978 for granting special protections to mortgages on a debtor's principal residence has evaporated as the marketplace has produced a baffling array of loans based more on a lender's ability to sell than on a borrower's ability to repay. Current financial conditions—both the markets that produced

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[5] 508 U.S. 324 (1993).

this baffling array of loans and the resulting rising tide of foreclosures—demand that the Bankruptcy Code be amended to reflect the extraordianry changes in mortgage finance that have occurred in the past 30 years.

The necessary adjustment to chapter 13 would permit reamortization of home mortgage debt to reflect the value of the home and reasonable fixed interest rates. Resetting the length of the loan is necessary to deal with the many new short term mortgage products that now exist in the marketplace. Some adjustments to the discharge provisions in chapter 13 are also necessary to allow entry of discharge at the completion of payments to other creditors and survival of the restructured mortgage loan. Importantly, such a change would do no more to the lender than reflect economic reality: A foreclosure will not realize for the lender more than the current value of the home. Indeed, it will likely net less to the lender, after deduction of foreclosure expenses and carrying expenses such as taxes, insurance, and maintenance. And it will evict a family from its home for no real gain to the lender. It's a lose-lose strategy. By contrast, reamortization benefits both sides.

The Effect on Mortgage Markets and Lending

The NBC believes that fears that allowing home mortgage debt modification in chapter 13 cases will upset mortgage markets or the availability of mortgage funding are completely unwarranted and unsubstantiated. There is no evidence that such a change would have any effect on the market for home mortgage loans. Consider the following:

- Mortgage credit has been widely available for vacation and second homes, as well as for single family homes purchased or financed for investment or rental, despite the absence of lender protection in chapter 13 and despite the greater fluctuation in a recession in values of secondary homes than of principle residences.

- From 1979 until 1993, the proposed legislation was already the law in much of the country. Until the Supreme Court ruled otherwise in *Nobleman v. Am. Sav. Bank*,[6] four federal courts of appeals had ruled that chapter 13 permitted mortgage write downs,[7] yet there is no evidence that mortgage credit was less available or more expensive in those circuits.
- Many states already have the economic effect of writing down mortgages to the value of the property through non-recourse provisions, which prohibit the lender from collecting any deficiency over the property value. The supply of mortgage money has been high in these states, indeed, was higher in some of them, like California, than anywhere else in the country.
- Lenders have always used credit price and availability arguments against any amendment to the bankruptcy laws that protects families and consumers. If their arguments were true, the converse also would be true—tightening bankruptcy laws against families and consumers should reduce the price of credit and increase its availability. Yet there is no evidence that the adoption of the 2005 Amendments did anything to reduce the price or increase the availability of credit. Have you seen interest rates on your credit cards, auto loans or mortgages drop in the past two years? There are simply too many other forces at work in the consumer credit markets for a bankruptcy law change, even one as major as the 2005 Amendments, to have any

[6] 508 U.S. 324 (1993).
[7] In re Bellamy, 962 F.2d 176 (CA2 1992); In re Hart, 923 F.2d 1410 (CA10 1991); Wilson v. Commonwealth Mortgage Corp., 895 F.2d 123 (CA3 1990); In re Hougland, 886 F.2d 1182 (CA9 1989).

noticeable effect.

More important, even if the predictions of less or more expensive credit are accurate, would a little less credit availability in the past two or three years have been such a bad thing? Lenders may argue that availability hurts those who are good credit risks as well as those who aren't. Does that mean that lenders haven't been distinguishing between the two groups and that a chapter 13 amendment would cause them to do so now? Wouldn't that be a good idea? What's more, lenders are already restricting credit now, even though chapter 13 does not currently permit mortgage modification.[8]

<u>Other Mortgage Modification Issues</u>

<u>*Valuation and Interest Rate Standard*</u>

There is little risk that bankruptcy judges will have the ability to adjust mortgages arbitrarily. The Supreme Court has set out strict standards that must be applied by a judge both in valuing property in chapter 13[9] and in determining the appropriate interest rate.[10] It is important for bankruptcy judges to have flexibility to adjust mortgages within those standards in accordance with the circumstances of each case. There are no similar limitations in chapter 12, but bankruptcy judge have not had "free rein" to make arbitrary decisions. In addition, under the proposal, any modification can only be accomplished through a confirmed chapter 13 plan that

[8] "Lenders Curb New Mortgages in Weaker Areas," *Wall St. Journal*, Oct. 23, 2007, at D1 ("Some lenders are now making it tougher for borrowers in softening housing markets to get a mortgage.… Among the areas being hit by the tougher standards are parts of California, Florida and Michigan.… The sharper focus on soft housing markets comes after mortgage lenders have tightened their standards for all borrowers amid a slowing housing market, a widespread credit crunch and rising delinquencies.")

[9] *Assocs. Comm'l Corp. v. Rash*, 520 U.S. 953, 117 S. Ct. 1879 (1997). The NBC supports a liquidation value test for valuation of mortgaged property, although *Rash* requires use of fair market value. Unlike for a truck in use in a business, however, there is not likely to be a substantial difference between liquidation and fair market value of a family's home in chapter 13.

meets the chapter 13 confirmation requirements including a good faith test and a disposable income test.

Lender Consent

Some have suggested lender consent should be required as a condition to home mortgage modification. The currrent Bankruptcy Code already allows for home mortgage modification with the consent of the lender,[11] but that has not alleviated the foreclosure crisis. As noted above, lenders often race to the courthouse to get an advantage in a declining market. More important, in a world with securitized mortgage pools and contract mortgage servicers, it isn't always clear who can negotiate on behalf of the lender and whether the servicer that agrees to renegotiate terms runs some legal risk in the exercise of its fiduciary duty. A generation ago, when the 1978 Code enacted the lender consent requirement, lenders held their own paper, and they could make rational decisions to deal with a borrower in trouble. Diverse ownership makes that much more difficult today.

The NBC therefore believes that any use of the Bankrupty Code to address the mortgage crisis must include some form of mortgage debt modification that does not depend on lender consent.

"Entry Ticket"

Chapter 12 was carefully targeted at family farmers of a certain size, with a maximum permissible amount of debt. Chapter 13 offers the same sort of vehicle and limitations. Chapter 13 has strict eligibility limitations that will act as a natural barrier to any flood of

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[10] *Till v. SCS Credit Corp.*, 541 U.S. 465, 124 S. Ct. 1951 (2004).

[11] 11 U.S.C. § 1325(a)(5)(A).

debtors seeking to modify their mortgages.[12] The current debt limitations admit only debtors and families with small economies for whom a modest home mortgage is the largest and most important debt they will ever see.

And debtors who can qualify for chapter 13 then face substantial tests and obstacles that will prevent abuse of home mortgage modification. Bankruptcy courts will supervise the valuation of property. Every chapter 13 debtor must satisfy a "good faith" test, both in filing the petition[13] and in confirming a plan.[14] There is a demanding disposable income test that mandates that every chapter 13 debtor pay creditors all disposable income over a period of three to five years.[15] Every chapter 13 debtor must devote the value of all unencumbered assets to payment of unsecured creditors.[16] Chapter 13 already provides substantial gatekeepers to any new power to modify home mortgage debt.

The NBC believes, therefore, that no additional entry requirements should be imposed for home mortgage modification. However, if an additional barrier is required, a condition based on current monthly income (CMI) along the lines of H.R. 3778 seems more workable than some of the alternatives. CMI is a new and complex concept introduced by the 2005 Amendments. Generally speaking it is an average of a debtor's income over the six months before the month in which a bankruptcy case is filed.[17] It is a number that must be calculated and supplied by every

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[12] *See* 11 U.S.C. § 109(e) ($1,010,650 in secured debt and $336,900 in unsecured debt).

[13] Marrama v. Citizens Bank of Mass., 127 S. Ct. 1105 (2007)

[14] 11 U.S.C. § 1325(a)(3).

[15] 11 U.S.C. § 1325(b).

[16] 11 U.S.C. § 1325(a)(4).

[17] *See* 11 U.S.C. §101(10A).

individual filing a chapter 13 case. Limiting the availability of mortgage modification to chapter 13 debtors with CMI less than 150% of applicable median family income could be implemented without substantial new calculations or issues for litigation. A spouse's CMI is included in this calculation in a joint case but should not be included in a single case. The use of other limitations—such as a budget-based formula—will require new forms, new calculations and new costly litigation over eligibility.

OTHER NECESSARY PROTECTIONS FOR HOMEOWNERS IN CHAPTER 13

Fees And Charges During A Chapter 13 Case

A recurring problem with home mortgages in chapter 13 cases is the hidden accrual of fees and charges by mortgage lenders during the chapter 13 case. Home mortgage instruments typically include many provisions that allow the lender to charge fees for such things as attorneys, inspections, appraisals, late payments and the like. Chapter 13 debtors who want to keep their homes during the three to five years of a chapter 13 case need to know what charges are being added by the mortgage holder and need an opportunity both to challenge charges that may be improper and to pay the proper charges during the case.

What often happens now is that the lender accumulates fees and charges during the chapter 13 case without notice to the debtor, the trustee or the court. The debtor completes payments under the plan and receives a discharge, only to receive an immediate demand and foreclosure notice based on thousands of dollars of unpaid accrued fees, charges and expenses of which the debtor never had notice. Some of those charges may be prohibited by the Bankruptcy Code, but there has been no opportunity to review them during the bankruptcy case. Although it has been held that a lender does not violate the automatic stay by accumulating postpetition fees on its internal records,[18] lenders fear that they will violate the automatic stay by asserting post petition fees and charges *during* the chapter 13 case, creating a perverse incentive to accrue those charges secretly without notice and to assert them only after bankruptcy. Some courts have even questioned the authority of the bankruptcy court to police the imposition of such fees, charges and expenses by mortgage holders after confirmation in chapter 13 cases.[19] The fees can be quite substantial, putting a family's home at risk even after they have done everything they can to pay the original mortgage. If family can't understand the terms, it can't review them to see if they are accurate, and it can't budget for them to get them paid.

The NBC therefore supports a statutory amendment to require timely notice to the debtor and trustee of all postpetition fees, charges and expenses by mortgage holders during chapter 13 cases, together with a procedure for detrmining their validity and satisfying them during the case.

Prefiling Briefing

The Bankruptcy Code currently imposes an eligibility limitation on all individual debtors. They must receive a prepetition briefing from a certified nonprofit budget and credit counseling agency that outlines the availability of credit counseling services and provides related budget analysis.[20] Without such a prepetition briefing, the individual debtor is not eligibile for any kind of bankruptcy relief.

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[18] Mann v. Chase Manhattan Corp., 316 F.3d. 1 (1st Cir. 2003).

[19] *See* In re Telfair v. First Union Mortgage Corp., 216 F.3d 1333 (11th Cir. 2000), *cert. denied,* 531 U.S. 1073, 121 S. Ct. 765 (2001).

[20] *See* 11 U.S.C. §109(h).

Homeowners in trouble with their mortgages often do not seek bankruptcy relief until the eve (or day!) of a foreclosure, sometimes because the borrower and the lender are trying to work things out and just can't, sometimes because the borrower really sees bankruptcy as the last and least desireable alternative, sometimes because of simple human emotion such as fear or denial. For many reasons, individual debtors often can't obtain the briefing before a foreclosure sale would render bankruptcy relief useless for saving a home.

Since the service available through the credit briefing (consensual debt management plan with creditors) cannot address the problem caused by a pending foreclosure, the requirement for a prepetition briefing should be eliminated for a debtor with a home in foreclosure.

Arbitration Clauses

Clauses requiring arbitration are increasingly common in consumer debt documents such as home mortgages and car notes. These clauses are asserted by lenders in consumer bankruptcy cases typically in response to a debtor's or trustee's claim objection or when the lender is sued by a debtor or trustee in the bankruptcy court under a consumer protection statute such as the Truth in Lending Act. Some courts have permitted arbitration, but the law in this area is both confused and confusing, driving up costs and increasing litigation for everyone.

Claims objections and some lawsuits by debtors and trustees clearly fall with the "core" bankruptcy jurisdiction that is essential to the orderly administration of bankruptcy cases. Arbitration clauses in consumer debt contracts therefore create a problem in consumer bankruptcy cases. The confirmation of plans and the payment of creditors in chapter 13 cases is impossible when the claims resolution process in the bankrutpcy court is interrupted by an arbitration clause.

For these reasons, the NBC believes the statute should be clarified, making clear that any arbitration clause in a consumer debt instrument in a consumer bankruptcy case is unenforceable in a core proceeding. Care must be taken, however, to avoid any negative inferences with respect to the enforceability of arbitration clauses in other bankruptcy contexts.

Judicial Estoppel

After a 1999 decision by the Georgia Court of Appeals,[21] some courts concluded that a trustee in bankruptcy can be "judicially estopped" from asserting a cause of action on behalf of creditors in a bankruptcy estate, based on the *debtor's* failure to schedule that cause of action as an asset in a bankruptcy case. Even if the debtor has misbehaved, the trustee and the creditors did not, and they should not lose the benefit that the law otherwise makes available to them if one creditor (like the mortgage lender) has over-reached.

The NBC therefore believes that it is inappropriate to bar recovery on behalf of creditors based on a debtor's failure to schedule a cause of action properly as an asset. Because judicial estoppel is a judge-made rule of decision, and because the NBC believes judicial estoppel is sometimes used inappropriately to reduce the reasonable expectations of creditors in bankruptcy cases, the NBC supports a provision that would preclude the use of judicial estoppel to prevent liability to a bankruptcy trustee based on the failure of a debtor to schedule a cause of action in a bankruptcy case.

Sunset Provision

Finally, the NBC does not support any sunset provision for mortgage modification legislation. The NBC believes that the idea reflects sound policy and will not have any adverse

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[21] Wolfork v. Tackett, 273 Ga. 328, 540 S.E.2d 611 (2001).

affect on mortgage markets. It therefore believes that legislation along the lines that the NBC supports should be adopted as a permanent amendment to the Bankruptcy Code.

CONCLUSION

Once again, I would like to thank the Chair and the rest of the Subcommittee for inviting the National Bankruptcy Conference to testify in these important hearings. The Conference would be pleased to formulate drafting proposals and assist in technical matters if the Subcommittee would find that helpful.

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

We are now ready to begin questioning, and I will begin by recognizing myself for 5 minutes.

Mr. Brewer, Steve Bartlett, on behalf of the Financial Services Roundtable, stated in his prepared testimony for last month's hearing that mortgagees are reaching out to help consumers in trouble on an unprecedented scale. And I am interested in getting your response to that statement.

Mr. BREWER. I would like Mr. Bartlett's phone number because I have got some clients that I need to call him about. Because whether they are reaching out in record numbers, I don't know. Are they reaching out enough? The answer is, it is just a tiny little bit of help based on what the problem is.

And I think you have got to look at two issues. One is, just how many people are they reaching, which is small. And then, what are they doing when they reach them? I think that is where the key is. If you look at the testimony here by Mr. Kittle, it talks about, well, these mortgage servicers are not going to modify the loans to the extent that this bankruptcy will. They are talking about maybe letting folks skip two or three payments, capitalize, put the loan at the end. The modifications are not real. They are not meaningful as far as dealing with the underlying problem, which is property that is worth a whole lot less than what the debt is and interest rates that, when these ARMs reset, hit, you know, get up to 13, 14, 15 percent. And they are one-way ARMs. They are ARMs in which they, you know, they never—they were adjustable rate but only adjustable upwards, never could go beyond that initial teaser rate. So the answer is, in the real world where I practice—I only know about Raleigh, North Carolina—it is not happening.

Ms. SÁNCHEZ. Okay.

In your prepared statement, you note that homes sold in foreclosure generally sell for only 70 to 75 percent of the actual fair market value. I want you to please explain your basis for that statement.

Mr. BREWER. Well, that is just a rule of thumb that I have—I mean, obviously I have filed many bankruptcies for folks who have, perhaps, didn't try to save their home from foreclosure, so it foreclosed before they came to see me. I looked at what the value is, based on what appraisal they had, what tax values were, they have told me it was worth. I see what the deficiency is. North Carolina is one of those States that allows a deficiency judgment. When it sells at foreclosure, the difference the debtor owns. And that is my own unscientific numbers. You can actually find some cases back in history—at one point, that was an issue about bankruptcies, about whether the property brought a fair value at foreclosure sale. And that was a pretty fairly accepted number. If you have seen the TV shows where folks are sitting at home and they are going to make lots of money sitting at home, normally they are talking about buying these homes at foreclosures at these bargain basement prices and flipping them and making money off of them.

Ms. SÁNCHEZ. Thank you.

Mr. Levin, what is your recollection of why the exception or carve out for home mortgages was included in section 1322(b)2 when you helped draft the 1978 bankruptcy amendments? Because we have heard them described as loopholes but to me are more appropriate as a carve out.

Mr. LEVIN. It is not a loophole. Mr. Kittle is correct. It was a policy decision made at the time. This Committee had a different view. This Committee thought that the mortgage, mortgages should be permitted to be modified.

I heard Mr. Feeney say earlier that this was a provision in the law since 1978. In one sense, that is correct. But the difference in 1978 was that, before 1978, no secured debt could be modified, homes, cars, vacation homes, investment property, nothing. The 1978 law moved a long way in permitting modification of secured debt but excepted out mortgage debt because that was the Senate's view. It was not the House's view. It was not this Committee's view. This Committee thought it was sound policy at the time to permit it. But as part of a compromise to get the legislation enacted, which did a tremendous amount of good for many people for many years, the House receded on that point.

Ms. SÁNCHEZ. Okay. I have here a quote. The Fifth Circuit in 1984 wrote that the section 1322(b)2, the exception for home mortgages was included—and I am quoting here from them—"apparently in response to perceptions or to suggestions advanced in the legislative hearings that home mortgage lenders performing a valuable service through their loans needed special protection against modification thereof." And I am interested in getting your response to that.

Mr. LEVIN. A couple of responses to that. The first, that came from I think the statement of the organization represented by the gentleman sitting on my right. And it is nice to know that their position has not changed over 30 years.

Second and more important, the home mortgage lending was very different in 1978 than in 2007, 2006, 2005; 80 percent loan to value, 20 percent down payment, fixed rates, no exploding ARMs, no negative amortization, no securitization. The local bank held your mortgage. These were people you knew and who supported the community. That is not the market we are in today anymore.

If anything, the progress of bankruptcy law should keep up with the changes in the economy, not go back to 1978, unless, of course, the mortgage industry would like to go back to 1978, and maybe that would—maybe that would solve this crisis in a lot of respects.

Mr. KITTLE. Madam Chairman, can I comment on that?

Ms. SÁNCHEZ. Thank you, Mr. Levin.

My time has expired. If I can get unanimous consent for 30 seconds, we will allow you to respond. Without objection.

Mr. KITTLE. Thank you, Mr. Chairman.

It was nice to know Mr. Levin was there in 1977. I am not sure I was born in 1977.

Ms. SÁNCHEZ. We are going to check your driverss license after that statement.

Mr. KITTLE. The Senate at that time held for all protections as far as the bankruptcy went. The House held for no protections, and a compromise was gained. And I am sure he would concur with that.

There was a witness, Mr. Edward Kulik, senior vice president of Mutual Life Insurance. His views were captured and actually put into law. And he pointed out that reducing a mortgagees's claims to the actual value of any real estate securing the claim would have a dramatically negative impact on the mortgage industry. That is what he said. That was embraced by the Committee, and it became part of the statute.

I will close by saying, Supreme Court Justice Stevens said also in the 1993 decision: At first blush, it seems somewhat strange. The anomaly is, however, explained by the legislative history, indicating that favorable treatment of residential mortgagees was intended to encourage the flow of capital into the home lending market. It was there for a purpose.

Ms. SÁNCHEZ. Thank you. My time has expired.

At this time, I will recognize the Ranking Member of the Subcommittee, Mr. Cannon, for 5 minutes.

Mr. CANNON. I am always pleased to take my time. And by the way, thank you for letting the gentleman respond without taking my time.

I would also like to thank Mr. Levin for being here today. You know, I have worked very closely with the National Bankruptcy Conference and appreciate the expertise and the tremendous work that was done, especially on the passage of the bankruptcy bill a couple of years ago, which took great effort.

I think that quote, by the way, was Senator DeConcini, not the National Mortgage Bankers Association, and he was a Democratic Senator. Just I think that might play interestingly in the record. We will have to look a little more on that. I think that is the quote that we had before us.

For the record, Mr. Conyers is going to do the research on that. And if it turns out it was Mr. DeConcini, the Democratic Party may disown him, although that may not be relevant at this stage of his life.

Mr. Levin, you talked about—I think you said something to the effect, voluntary measures might get—won't get the job done or won't get lenders to the table; the problem is more urgent. But they are the guys who have the most to lose, are they not?

Mr. LEVIN. I am sorry for interrupting you.

Mr. CANNON. Go ahead.

Mr. LEVIN. They are not actually the guys to lose. In 1978, they were the guys with most to lose because the local banker was making the loan and keeping it on his books. Now these loans are securitized in pools into mortgage-backed securities which are purchased by collateralized debt——

Mr. CANNON. Let me say, rather than the lenders, let me say, the owners of the paper are the ones who have the most to lose. People who ought to be getting there and solving the problem and by minimizing their losses if it costs so much to go through a foreclosure process, they ought to be the ones in there that are driving that forward.

Mr. LEVIN. You would think so. However, they are not the ones who are at the table. The ones who are at the table are the mortgage loan servicers, and the servicers get a fee for the work they do. And they get a bigger fee when they foreclose because that is a big process.

Mr. CANNON. Right. The guys that are going to have to pay that fee, whoever that—that may be a mutual fund. It may be all kinds of folks out there that own this kind of paper. There ought to be terrific pressure on those folks to solve the problem.

Mr. LEVIN. There ought to be. But what happens is, there is a certain assembly line mentality to this. It i simpler and easier to work through the process than to try to custom tailor a solution to every single problem.

Mr. CANNON. Well, Mr. Brewer talked about that he is not seeing much—and he noted, it was anecdotal—with the industry's attempt to rework these issues, and maybe Mr. Kittle would like to speak about this. But I think—was it Mr. Brewer we had here or Mr. Bartlett—was talking about something in the neighborhood of 1,500 renegotiations per week. So over a couple-year period between now and the end of 2009, you are talking about 150,000. We heard on the last panel, there may be as many as 500,000 of these such houses that will go into some kind of crisis mode. One would expect that as the word gets out—and by the way Mr. Brewer, I suspect that you can find the phone number online. And I think there is a pretty strong——

Mr. BREWER. I have called it. I have called it. It is a black hole.

Mr. CANNON. Well, I guess my point is, what is the best thing for America to have a black hole that gets light over time because you have huge incentives by the owners of this paper to solve the problem short of blowing the market apart with foreclosures, or a bill that would fundamentally transform how we securitize the biggest segment of wealth in America? And you obviously have something to say, Mr. Brewer.

Mr. BREWER. Well, if that question is put to me, the answer is, I don't see why we can't do both. I mean, if these folks are going to fix the problem or fix—I think your numbers will make—I think that might represent—if those numbers are real—I doubt they are—but that may be 30 percent of the problem.

Mr. CANNON. Pardon me. I am about out of time, and I would like Mr. Kittle to have the opportunity to respond to those issues.

Mr. KITTLE. Thank you, Congressman Cannon.

Our Members are reaching out, but communication is a two-way street, which I think Mr. Brewer would agree. We call the consumer on a regular basis, can provide the data to show that, many times, many times, the calls are not returned. We are joined with NeighborWorks; our Home Loan Learning Center Web Site has gone from getting hits as low as 200,000 per month up to 1.6 million hits in August alone. We spent over——

Mr. CANNON. Those numbers—you are talking about numbers that are big enough to solve the problem and would indicate that—I mean, this is a complicated world with different people owning paper. This is not like 1978. But if I understand what you are saying right, there is a massive outreach by your industry to help proactively solve the problem.

Mr. KITTLE. There absolutely is a massive outreach. Are we reaching everybody? No. Because, again, sir, communication is a two-way street.

Ms. SÁNCHEZ. The time of the gentleman has expired. I would request unanimous consent for 30 seconds for Mr. Brewer to continue his thoughts since we allowed Mr. Kittle during my round of questioning to do the same.

Mr. BREWER. Thank you. My point is that the idea of voluntary modifications to the extent that the real—to the extent they actually help people save their homes is good. Folks will turn to that first. But I am telling you from that, down there in the trenches, it is not enough. It is not even anywhere close to enough. So this Congress needs to do something for those people that those voluntary modifications are not reaching. And, again, I think that the real issue is the fact that what they are offering folks in a way of modifications do not fix the problem. We are talking—they are negotiating with the same people who sold them on the idea of these exploding ARMs in the first place.

Mr. KITTLE. That is not accurate.

Mr. CANNON. Madam Chair, may I ask 15 seconds to say something conciliatory here?

Ms. SÁNCHEZ. Fifteen seconds, Mr. Cannon, and then we are going to move on to Mr. Conyers.

Mr. CANNON. The Chairman of the full Committee is laughing because he knows I can do it in 15 seconds.

Ms. SÁNCHEZ. Your time starts now.

Mr. CANNON. This is a matter of where the thumb goes on the scale. And I suggest that the overwhelming weight that we are talking about putting on the scale here may distort it to the great detriment of your clients in the future and hope that we can find something that will balance the problem.

Thank you, Madam Chair.

Mr. KITTLE. Can I correct the inaccurate statement?

Ms. SÁNCHEZ. I apologize. We do want to ensure that everybody gets an opportunity to ask questions. And we have gone a little long.

So I will at this time like to recognize Mr. Conyers for 5 minutes of questioning. And before we begin, Mr. Conyers' time, I want to recognize Mr. Chabot, the gentleman from Ohio, who has been sitting in for the last 30 minutes or so on this hearing. I know he has a keen interest in this issue, and we welcome you to the Subcommittee and thank you for your interest.

And now I will recognize Mr. Conyers for 5 minutes.

Mr. CONYERS. Thank you, Madam Chairman. The Detroit area has the fourth largest number of foreclosures of anyone. Atlanta comes in number seven. It is a serious problem. And most of our experts agree that it is going to get worse before it gets better. How did a nice guy like Kittle get involved in this stuff, representing the mortgage people? I mean, what happened in your life that created this——

Mr. KITTLE. Well, I chose to be here, Congressman. And mortgage bankers are nice people, just like I am. So I am pleased to be here to represent them today.

Mr. CONYERS. Well, that is very reassuring. And if anyone could do it, it would be you that make us feel reassured.

But you know, this Committee is quite collegial with Chris Cannon and Tom Feeney and Mr. Chabot from Cincinnati; Brad Miller is over here. We have got a real political situation here. And that is that we can talk all we want. But this bill is going to be tough to get through the House and the Senate, gentlemen. It is not going to be an easy thing to do, and unless we can get Mr. Chabot and Mr. Miller and this Committee together, that to me is my goal. We have sensational discussions and exchanges on this Committee. But you see, there are a lot of people that are now—I will be putting out a press release later on, and so will a lot of others—but the problem, Chris, is that we have got people who will be listening and looking at this and say, good night, the Sánchez Committee is really getting us taken care of. We are talking upward of 500,000 people or families now. And help is on the way.

The Members, the witnesses that have been invited here today, is there anything you can recommend out of your vast experience? I know Mr. Brewer and Attorney Ted Kalo from North Carolina know of each other. But tell me, knowing the difficulties of getting both Houses of the Congress together, what I am beginning to get worried about is what is going to really happen? I mean, it will be a noble effort and all these people are saying, ah, boy, Chairman Conyers, I know he would do it. And I knew Chabot would do it. I knew Brad Miller could come through. Sánchez has got more work than any other Subcommittee in the Judiciary. Where are we? Mr. Brewer.

Mr. BREWER. If you are asking me how you get this bill passed, that is way above my pay grade, but I mean——

Mr. CONYERS. So tell me anyway.

Mr. BREWER. Well, I think you either do it sooner or you do it later because I—if I am right, if what I am hearing is these modification—these voluntary modifications are going to fix the problems, I will come back here and admit I was wrong. But I will bet anybody here any amount of money that we will come here—you wait until next spring and you don't do something and this foreclosure crisis, this fire I am talking about, is going to be burning out of control, and you will have to do something, you know, because people will ultimately demand it.

Ms. SÁNCHEZ. Attorney Levin, what say you?

Mr. LEVIN. I don't know where the middle ground is to answer your question directly. But the answer is not, do nothing. The answer is not, let the lenders decide when they want to give up value.

To Mr. Cannon's thumb-on-the-scale point, it is a very important consideration in all bankruptcy legislation. At this point, my experience tells me that homeowners with homes with values that have fallen and cannot afford the payments do not have anything on their side of the scale. I think passing something along these lines would give them a little bit of negotiating leverage. Now they have none. And it would be cabined and regulated by the bankruptcy judges under the Supreme Court's decision. But I don't think doing nothing is the answer.

Mr. CONYERS. Madam Chairwoman, could I ask Mr. Kittle for his advice?

Ms. SÁNCHEZ. I will grant you an additional 30 seconds because your time has expired so that Mr. Kittle may respond.

Mr. KITTLE. Thank you, Madam Chairman. First of all, to correct what he said earlier, that the people are not dealing with the same people that originated the loans. The servicers, in many cases, bought those loans from brokers who had no fiduciary responsibility in the transaction. So they are talking with a servicer who is there who wants to help them work the loan out.

Congressman, if could I give you a quick example of how this cram down bill will harm the people that you want to protect, and the quick example is: On an FHA loan, there is a statute in FHA loans that says they cannot insure when you do the cram down. Therefore, the part you would cram down—and I will use an example of a $150,000 loan, and it gets crammed down to $100,000. The FHA insurance can't pay on that $50,000. It goes back to the servicer. The servicer has to eat that money. It has to pay that money to Ginnie Mae, and the servicer takes the cost. That is a statute.

Therefore, those loans, because of higher risk, in many cases, will not be made unless interest rates are raised or points or fees to mitigate the risk going forward.

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

Mr. CANNON. Madam Chair, may I ask unanimous consent for 30 seconds to compliment—that is not compliment Mr. Conyers, but complement—make a statement that is complementary to the statement that he had just made.

Ms. SÁNCHEZ. You can compliment Mr. Conyers, too.

Mr. CANNON. I do that at almost every opportunity I get, and I will do that right now.

Ms. SÁNCHEZ. If you will be brief, I do want to give everybody an opportunity to ask questions, Mr. Cannon. But go ahead.

Mr. CANNON. The gentleman has talked about the people watching this Committee hearing today. And I think many people in America may actually be watching it. Therefore, I think it is extraordinarily important that they begin taking responsibility for their own lives because the likelihood that this bill will get passed in a way that will actually affect them is I think fairly minor. And so let me point out that the global flow of capital is dramatically important here. If we want capital in America to continue making loans, we are going to need to deal with this.

And I would love to have Mr. Kittle say for the record how people can get in touch with the association that is dealing with these mortgages so people can start calling up and screaming at bankers and telling them what they can do and what the value of their house is.

Ms. SÁNCHEZ. I will allow Mr. Kittle to do that, but I would like to get through our round of questions first.

At this time, I will recognize the very patient Mr. Feeney for 5 minutes of questions.

Mr. FEENEY. Thank you.

And again, I want to thank the Chairman for having a second hearing on this very important issue.

I think all of us sympathize with people who have to come see you, Mr. Brewer. Nobody wants to be in that position. And I will tell you that I serve on the Financial Services Committee. And you know, for 30 years, Congressmen and Congresswomen have been beating up, begging, brow beating the credit industry to make credit more available to nontraditional borrowers. We are now up to 70 percent home ownership. America is the first country in the history of the planet where 70 percent of families could actually live in a home that they own. That is a miraculous thing.

But let's acknowledge that much of the bubble that has been created in real estate is because of credit that was too loose. Loans that just simply didn't make sense unless market prices were going to dramatically increase forever.

The market has already overreacted. It has overreacted so severely that policymakers in this building, as we are trying to make credit more risky and therefore tighten credit availability, the Financial Services Committee is actually encouraging Fannie Mae and Ginnie Mae to loosen credit availability. We have the Fed that just dropped interest rates by half a point in order to make sure that we don't dry up credit markets and literally turn a partial recession in one market of our economy into a deep depression in all areas of the economy.

So the question here is not whether the patient is sick. I happen to agree with your proposed analysis and the gentleman from Moody's, too, that the situation is likely to get worse in the next 6 to 12 months, not get better. I happen to agree with that. But like medieval blood letting by doctors, my question is, are we making the situation worse by being sympathetic? My question is, what happens going forward to credit markets? Because, ultimately, the way to relieve yourself of a problem of debt on a piece of property is to have a rising—unless you can get a job that pays you twice as much—is having rising property values. That only happens if there are buyers available. The problem in today's market across the country and especially in the States that have had double-digit declines is that there are just no buyers to sell to at the price that the owner needs to cover the cost of his mortgage.

Now I think there may be things that we can do to get the holders of these mortgages and the folks that actually service the loans in better contact with. That is what this Committee and the Financial Services Committee ought to be doing. I talked to a local judge because at our last panel we had a bankruptcy judge testify that almost none of the servicers or securitized holders of mortgages were available to assist the individual that needed help. And just as Mr. Levin said, you can't deal with this on a case-by-case basis when it is happening across the country.

I talked to an Orlando judge who happens to be a friend of mine, and he does foreclosure, not bankruptcy, admittedly a different animal, but similar. He said that, on a regular basis, he can dial up a phone at 2 in the afternoon and tell the servicer of a loan that the property is going to be sold the next day. One thing all of the witnesses both in this panel and the previous panels have agreed, in this market, especially with declining real estate values, holders of mortgages do not want that property back. It cost them months of interest rate payments, of paying attorneys, of paying realtors to remarket and fix-up costs. So it is in the interest of the holders of securitized mortgages across the country to find a way to negotiate these loans.

But what you do in this piece of legislation that the two of the three of you have endorsed is you have said to all future lenders that you are adding uncertainty into the credit markets. All creditors, all lenders abhor risk. They abhor uncertainty, and you are adding to the uncertainty. And what you are doing is to say that a judge arbitrarily can modify the terms of the mortgage despite what is in the best interest of the long-term economy. And you are taking that decision out of the hands of the people that now are at risk.

So I understand that none of the three of you—maybe Mr. Levin, maybe you have an economics degree. I think Mr. Kittle has referred—I don't know whether you are an economist. But I am worried about the long-term economic impacts. And I am afraid, like medieval doctors, we are taking a sick patient, and we are letting blood all over the place so that we can argue, as Mr. Levin said, we are doing something. And admittedly, the American people want us to do something. But I am afraid for the patient in the future.

With that, if the Chairman would allow, I would be happy to invite comments.

Mr. BREWER. Do you want my comment on that? Because this is my thought. I was with you because what you were describing was a situation in which doing nothing is bad because we are going to have all these foreclosures. There are going to be losses in the community. There is not going to be enough people buying these houses. Why don't we let the people who are in the houses now, who could make these payments at a reasonable rate and who could pay for the house at its current fair market value? In my area, the market is not that depressed. I understand, in other places, it is terrible. But wherever that level is—and this is not arbitrary. The court—you know, you determine the fair market value. They pay that lender a reasonable interest rate. If you want to let it be like the till rate that is done on car loans, fine. If this Congress wants to set what that rate is——

Mr. FEENEY. Well, respectfully, this bill contains no constraints whatsoever on the bankruptcy judge, and it takes out—there are no constraints whatsoever in this bill.

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

And I would also just like to comment briefly on that last point that bankruptcy judges tend to be experts in assessing the value of assets. I am going to ask—pardon me—unanimous consent to enter into the record a letter from Richard Cordray, the Ohio Treasurer of State, who sent a letter in support of H.R. 3609, and also I would ask unanimous consent to enter into the record—Moody's did a subprime mortgager survey on loan modifications with the finding that less than 1 percent of serviced loans that experienced a reset in the months of January, April and July of 2007 were actually modified by the mortgagees. Without objection, those will be entered into the record.

And at this time, I would like to recognize the gentleman from Georgia, Mr. Johnson, for his 5 minutes of questions.

[The information referred to follows:]

LETTER FROM THE HONORABLE RICHARD CORDRAY, OHIO TREASURER OF STATE

RICHARD CORDRAY
OHIO TREASURER of STATE

(614) 466-2160 • 30 E. Broad Street, 9th Floor • Columbus, Ohio 43215-3461

October 12, 2007

The Honorable Brad Miller
United States House of Representatives
1722 Longworth Building
Washington, DC 20515

Re: Support for H.R. 3609

Dear Congressman Miller:

HR 3609 is entitled the "Emergency Home Ownership and Mortgage Equity Protection Act of 2007." This legislation would remove obstacles that currently prevent bankruptcy courts from restructuring home mortgages, thus helping borrowers save their homes from foreclosure.

The mortgage foreclosure crisis is taking an immense toll on individuals and the neighborhoods they call home. The burden that is falling to the remaining residents as they cope with plummeting home prices and rising crime is clear. Unfortunately for Ohio this problem is widespread. A study released in March of this year by Policy Matters Ohio found that during 2006, 78 of the 88 counties in Ohio saw increases in the number of foreclosure filings. In 46 counties, this number jumped by twenty percent or more.

Ohio Governor Strickland convened a task force in April to delve into this issue and identify recommendations to help those who are in trouble. The group, of which I was a member, recommended 27 action steps, many of which focused the need for loan servicers to offer workout agreements. It was determined that servicers must have the ability to utilize six essential strategies when restructuring loans. These are: changing interest rates from adjustable to fixed, including escrow for tax and insurance costs in affordability calculations, reducing principal in cases of excess valuation, waiving penalties and late fees, waiving prepayment penalties, and requiring borrowers to work with credit counselors. The same flexibility and focus is needed from the bankruptcy courts, which is what this legislation would accomplish.

With the spike in the number of resetting adjustable rate mortgages that is already occurring and that is likely to continue through the end of 2008, I am glad to see the quick timetable that has been set for the consideration of HR 3609. By offering an avenue for more mortgage loans to be modified, more Ohioans will be able to stay in their homes and more neighborhoods will remain attractive places to live and raise a family. I urge you to act quickly in approving this legislation. If you have any questions or would like to discuss this further, please feel free to call me anytime at (614) 466-3639.

Sincerely,

Richard Cordray

Richard Cordray
Ohio Treasurer

www.ohiotreasurer.gov

STRUCTURED FINANCE | Special Report

Moody's Subprime Mortgage Servicer Survey on Loan Modifications

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Over the past several weeks, Moody's performed a survey of the modification practices of subprime mortgage servicers regarding borrowers that have or will experience an interest rate reset on their loans in either 2007 or 2008. Sixteen subprime servicers with a total servicing volume of approximately $950 billion provided data to Moody's concerning modifications performed from January 2007 to July 2007. These servicers constitute roughly 80% of the total subprime servicing market.

SURVEY RESULTS

Despite much industry dialogue and heavy press attention on the topic of loan modifications as a mitigation technique to avoid foreclosure and reduce losses on defaulted loans, the survey results suggest that on average subprime servicers have only recently begun to materially increase the number of modifications as it relates to interest rate resets. Specifically, the survey showed that most servicers had only modified approximately 1% of their serviced loans that experienced a reset in the months of January, April and July 2007.

In addition, although some subprime servicers have recently begun to make outbound calls to borrowers that will experience reset in the near future, the majority of large servicers continue to rely on more passive letter-based contact with borrowers. This is of particular concern given the potential size of the problem - some servicers reported that they could experience in a given quarter interest rate resets on loans which constitute up to 15% of their portfolio during the period from late 2007 to early 2008. In addition, data from a limited subset of servicers indicated that for loans that were current prior to reset and were not modified, the average delinquency rate after reset was in the 5% to 15% range. However, these results are for loans that were made in early 2005. Those loans were of generally higher quality than loans that were issued later in 2005 and in 2006 and had greater refinancing opportunities as they were not as impacted by the negative home price environment. Moody's expects delinquencies will be higher for subprime loans backing securitizations issued in late 2005 and in 2006 and that reset without modification.

EXAMPLES OF PROACTIVE SERVICER PRACTICES

Those servicers that have been proactively addressing the issue of interest rate resets on subprime mortgages have instituted a number of practices, including:

- Frequent outbound calls to borrowers with a pending reset, typically attempted from the 90^{th} to the 30^{th} day prior to reset;
- A proactive review and analysis of the number of loans in their portfolios that are anticipated to reset and their potential to default;

- Increased frequency of letter-based contacts with borrowers;
- Outreach via third-parties such as credit counseling agencies and governmental assistance programs to facilitate contact with borrowers; and,
- Encouraging the use of the servicer's website to give borrowers an opportunity to provide financial information to assess the potential for a modification.

CONCLUSION

Based on the survey results, Moody's is concerned that the number of modifications that will be performed in the future by subprime servicers on loans facing reset may be lower than what will be needed to significantly mitigate losses in subprime pools backing rated securitizations. In light of this risk and the current performance of the collateral, Moody's expects further negative rating activity on subprime residential mortgage backed securities issued in late 2005 and in 2006.

Doc ID# SF110445

Mr. JOHNSON. Thank you, Madam Chair. In our background material, it recites that, in 2006, there were 1.2 million foreclosures in the United States, representing an increase of 42 percent over the prior year, an explosion in foreclosures. And economists estimate that 5 percent of all mortgage holders are expected to default on their mortgage loans this year and next, resulting in a whopping $400 billion worth of defaults and $100 billion in losses to investors in mortgage securities.

And that being the projection, and it being foreseeable that this would have a tremendously negative impact on the economy of this Nation, I want to ask Mr. Kittle, what would be worse, for that situation to unfold, or would it be better for a bankruptcy court to be able to ensure that many of those loans, instead of going into default and becoming nonconforming, would be continuing, would be allowing loans to continue to perform but only partial performance? Which would be better, nonperformance or partial performance, to the lending industry in this country?

Mr. KITTLE. Thank you, Congressman. I am happy to address that.

I think it would be better for the market to let it correct itself——

Mr. JOHNSON. Well, now, that is a different question.

Mr. KITTLE. But I will finish and answer your question the way you put it.

—and I think it would be better for it to play out and not to have this legislation go through.

And here is why: There are a couple of points and statistics that have not been given today. We keep talking about the mortgage products putting these people into foreclosure.

Mr. JOHNSON. Well, you haven't answered my question.

Mr. KITTLE. I am going to.

The three main reasons for foreclosure, Congressman, are unemployment, divorce and illness, not the mortgage products. So that needs to be said.

Mr. JOHNSON. If you have got a mortgage, if you have got an adjustable rate mortgage which is getting ready to adjust upward, and it will cause the—and the value of your property is going down because of foreclosures around it——

Mr. KITTLE. But it is not the mortgage products all the time that are causing the foreclosures around the property.

Mr. JOHNSON. Whatever the cause might be, wouldn't it be better to enable the debtors to continue to pay something on those loans as opposed to ensure that they go into default?

Mr. KITTLE. No, and for this reason.

Because if you enact this legislation, the future interest rates will be up by 2 percent. Borrowers will not be able to obtain credit because the risk will be so high some investors will pull out of the market. You will hurt future purchases.

Mr. JOHNSON. I heard you say that. But now you have got a market of lending as to debtors' principal residences. Then you have got a number of loans that are made for investment property in real estate. You have got commercial property loans. The residential lending industry that is consumed or that portion of the residential lending industry consumed by debtor-occupied homes is probably not as great as that overall market, but yet the overall market allows for a bankruptcy judge to come in and modify the loans.

Mr. KITTLE. Are you speaking on the investment loans?

Mr. JOHNSON. Any other kind of property, other than a debtor's primary residence.

Mr. KITTLE. Well, there is equity in those properties, that's correct.

Mr. JOHNSON. Let me ask Mr. Brewer.

Do you understand the question?

Mr. BREWER. Yeah, I do.

Mr. JOHNSON. We are only talking about a portion of the whole market.

Mr. BREWER. It is obviously the industry—I mean, it is like you are trying to force them to do what is in their best interest. And the most efficient way to modify these loans is not through this cumbersome jump through all these hoops counselor's process, but for those people who cannot make their loan payments, to modify them through a bankruptcy; and it is the most efficient way to do it.

Mr. JOHNSON. Let me add that according to Moody's back in August, a study by Moody's, only 1 percent of the loans that qualified for a workout were actually being voluntarily worked out by the industry.

Mr. Levin, what can you add to that?

Mr. LEVIN. On that specific question, as I said earlier, sometimes lenders need—let me put it this way.

If I am going to negotiate with you about something and you get to make the final decision, you don't have to take my views into account at all, and you invite me to the negotiating table, take it or leave it. What negotiation is there? Whenever one party to a negotiation has all of the decision-making authority, there is no real negotiation; it is a unilateral decision.

What this law would do would be to try to put some negotiating leverage on both sides, regulated by a bankruptcy judge, regulated by Supreme Court decisions, constraints on the process where the Supreme Court has said, a valuation has to be done according to this standard, interest rates have to be done according to that standard.

There is nothing in these bills that talks about valuation and interest rate. It is already in the law. These bills would hitch onto that. That is what I think about voluntary negotiation.

Sure it can be done, but why would it be?

Mr. JOHNSON. And it works very well in circumstances other than debtors' primary residences, which is what is causing the big problem that we are faced with today and which this legislation, H.R. 3609—which was introduced by Representative Miller, who is seated to my right, along with Representative Sánchez and others—seeks to address.

And so, with that, I will yield back my time.

Ms. SÁNCHEZ. The time of the gentleman has expired. I want to thank all of our——

Mr. KITTLE. Madam Chairman, may I make one 15-second comment, please?

Ms. SÁNCHEZ. I will allow you 15 additional seconds and nobody else gets additional time.

Mr. CANNON. I ask to give him 20 seconds so he can announce a phone number and we page.

Ms. SÁNCHEZ. I will allow you 15 seconds for that purpose, and we are watching the clock.

You are on, Mr. Kittle.

Mr. KITTLE. Okay.

I wish Mr. Zandi were here—and he is not—because the 1 percent figure you just allude to is misleading and inaccurate. He says 1 percent of all ARMs, 50 percent of the subprime ARMs, almost 50 percent, have already refinanced. There is a high percentage of those subprime ARMs that are paying on time. Therefore, his using 1 percent of all ARMs is totally inaccurate.

I would encourage you to ask Mr. Zandi to verify his statistics. And also ask him if his own company, Moody's, even supports the bill.

Ms. SÁNCHEZ. The gentleman's time has expired.

And we appreciate again the patience of all the witnesses. We have had a number of scheduling difficulties with this hearing.

Without objection, Members will have 5 legislative days to submit any additional written questions, which we will forward to the witnesses and ask that they answer as promptly as they can so that we can make them a part of the record. Without objection, the record will remain open for five legislative days for the submission of any additional materials.

Again, I want to thank everybody for their time and their patience. I want to thank Representatives Miller and Chabot, who joined us. Back in the old days they would have had an opportunity to participate in the asking of questions of our panelists, and I am sorry that that was not the case today. But I do appreciate your presence here and your interest in this issue.

And this hearing of the Subcommittee on Commercial and Administrative Law is adjourned.

[Whereupon, at 3:30 p.m., the Subcommittee was adjourned.]

APPENDIX

Material Submitted for the Hearing Record

LETTER TO THE HONORABLE LINDA T. SÁNCHEZ, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA, AND CHAIRWOMAN, SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW, FROM J. RICH LEONARD, JUDGE, UNITED STATES BANKRUPTCY COURT, EASTERN DISTRICT OF NORTH CAROLINA

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF NORTH CAROLINA

J. Rich Leonard
Judge

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November 12, 2007

Ms. Linda Sánchez
Chairwoman, Subcommittee on Commercial and Administrative Law
U.S. House Judiciary Committee
1222 Longworth Building
Washington, DC 20515

Dear Chairwoman Sánchez:

Thank you for your important work to protect families from foreclosure by holding hearings and sponsoring legislation about changing the bankruptcy code to allow judges to modify mortgages on primary residences under chapter 13. My name is Rich Leonard, and for the last fifteen years I have been a bankruptcy judge in the eastern district of North Carolina. Our district runs from Raleigh to the Outer Banks, receiving cases both from the thriving metropolitan area around Raleigh, and the largely rural and less prosperous remainder of eastern North Carolina. Because I derive my docket primarily from these rural areas, my particular expertise is mobile home valuation and hog farm operations.

Bankruptcy courts are often the canaries in the mineshaft, noticing changes in the economy before they become readily apparent to others. And thus it has been with subprime mortgages. The problems have manifested themselves in two ways. First, in any number of cases, we began to see mortgages with extremely high interest rates, large transactional costs, and more importantly, payments far in excess of what the debtor could afford under any reasonable underwriting standards. And second, often no one can tell us who the current holder of the mortgage is, not even the servicer, so it is virtually impossible for counsel or the chapter 13 trustee to suggest a reasonable modification.

As you know, the ability of the bankruptcy court currently to provide much relief to distressed homeowners is restricted. Our authority is limited to stopping the foreclosure proceeding while the debtor is provided an opportunity to both resume the regular payments in whatever amount they may be, and to pay the arrearage through the plan under the supervision of the trustee. Like other judges, I frequently decline to confirm reorganization plans that offer this

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treatment because they are simply not feasible. If the homeowner did not have the resources to make the mortgage payments before bankruptcy, it is unlikely they will be able to resume those payments plus pay the delinquent amounts. And in cases where the plan is confirmed, upward adjustments in the mortgage payment during the plan often doom it to failure.

The human face of this is real. The hardest cases for me are the elderly people who often owned their homes outright, but were lured into an unfavorable refinancing, often by an unscrupulous mortgage broker who has long disappeared. Last week I dismissed the case of an elderly African-American widow, thus allowing the foreclosure action to proceed, who had lived in her home for forty years and owned it outright, at least until she was persuaded to do a bad subprime refinancing to enclose her carport.

In looking at the issues surrounding the current proposal, there are six points that I would like to make.

First, the proposal that bankruptcy judges should be able to modify home mortgages in no way suggests that these debts are being singled out for special and unfair treatment. Quite the contrary, they would now be given the treatment given all secured claims in bankruptcy; their current exemption from modification would simply be removed. Reamortizing and restructuring secured debt is the heart and soul of the bankruptcy process. I do it daily with factories, grocery stores, farms, boats, motor vehicles, mobile homes, and investment property – any debt but that secured solely by the principal residence.

Second, this has been tried before in response to an economic crisis and worked well. In the 1980s, devaluation in the farm economy threatened virtually every small farmer in America. No provision of the bankruptcy code provided much relief, in part because the family home was always part of the collateral. Chapter 12, which allowed bankruptcy courts to modify all farm loans, was passed as a response, and has been such a success it is now a permanent part of the Bankruptcy Code. Rather than destroying the farm market, it interposed some rationality and discipline.

Third, the bankruptcy courts are equipped to deal with these cases with their current staffing. In response to what were overwhelming caseloads in the 1990s, the bankruptcy courts of this country have become the most technologically advanced in the world, able to deal with cases and claims electronically and often remotely. There would be an initial flurry of filings, each court would then work out its predictable response to these issues, and the market would respond. For example, the secured debt on motor vehicles is restructured in hundreds of my cases each year, but I rarely have a contested hearing. Debtors' counsel, the trustee, and the car company lawyers know about what my court will do with a certain set of facts and agree to it, and this happens in every jurisdiction.

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November 12, 2007

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Fourth, our discretion in this area is sharply curtailed already by existing caselaw. The idea that we would (or could) somehow willy-nilly give everyone a 40-year mortgage at 2% interest is ludicrous. The Supreme Court has already told us how to value property and compute interest in this situation. Property to be retained by a debtor in Chapter 13 must be valued at its market rate, with interest set at prime plus an upward adjustment reflecting an appropriate risk factor. Any judge who deviated far from that rule would be quickly reversed.

Fifth, I am skeptical from my own experience that out-of-court consensual modifications can be much of a solution here. As I mentioned earlier, these mortgages in no way resemble the conventional mortgage held by the local bank that was fairly protected from modification 30 years ago. Even in hotly litigated cases under threat of contempt, often no one can identify who the actual current holder of the mortgage note is. Yet servicing agents have fiduciary obligations to these unknown investors, and are obviously hesitant to engage in unilateral modifications and risk future liability themselves. The beauty of the bankruptcy solution is that, in a sense, we don't care. We enter in rem orders binding as to the property, the debtor, the servicer, and whoever the noteholder is, and have plenary and nationwide jurisdiction to enforce them.

And finally, it is important to note that this has nothing to do with BAPCPA, except with the one minor matter of relaxing the debt counseling requirement when foreclosure is imminent. I fully understand everyone's fatigue with bankruptcy reform, and the desire not to take the lid off that kettle right now. Whatever your views of the deals struck in the passage of BAPCPA, this proposal in no way challenges or undercuts them. This deals with a provision that preceded BAPCPA by many years.

It is not my job as a judge to suggest what to do in terms of substantive policy. But I would like to say that, whether because they dreamed too large or were lured into bad deals they did not understand, millions of average Americans who have worked hard to have a home are at risk of losing them. This is one policy solution among many worthy of careful consideration to keep that from happening.

Sincerely,

Judge Rich Leonard
Bankruptcy Judge
U.S. Bankruptcy Court, E.D.N.C.

LETTER TO THE HONORABLE JOHN CONYERS, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN, CHAIRMAN, COMMITTEE ON THE JUDICIARY, AND MEMBER, SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW, AND THE HONORABLE LINDA T. SÁNCHEZ, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA, AND CHAIRWOMAN, SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

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October 30, 2007

Honorable John Conyers, Jr.
2426 Rayburn Building
Washington, DC 20515

Honorable Linda T. Sanchez
1007 Longworth House Office Building
Washington, DC 20515

Re: Mortgage relief in bankruptcy

Dear Mr Conyers and Ms. Sanchez:

I am writing to urge you to continue to play an important role in exploring ways that the bankruptcy laws can be used to save the homes of the many hundreds of thousands of families facing foreclosure. With your leadership, communities around the country can be spared the worst of the crisis they now face, in which vacant properties will proliferate, with home values and tax bases plummeting.

As someone who has represented bankruptcy debtors for over thirty years, including many with high rate mortgages, I am quite familiar with these issues. I am also Co-Editor in Chief of Collier on Bankruptcy, I have had the honor of testifying many times before the House Judiciary Committee over the past 25 years, and I am a former member of the Judicial Conference's Advisory Committee on Bankruptcy Rules and the Federal Reserve Board's Consumer Advisory Council.

I know one of the challenging issues is the idea of stripping liens from properties to the extent they exceed the value of the properties, popularly known as "cramdown" (even though the technical bankruptcy meaning of that term is more expansive.) The concept is one of longstanding use and importance in bankruptcy law, and has applied for decades to almost every other kind of asset in chapter 11(commercial real estate and all other assets), chapter 12 (all assets, real and personal), and chapter 13(almost all assets, including second homes, except primary residence). Essentially, it simply permits the debtor to "buy back" an asset from a creditor's lien at the current market value anyone else would pay for it, and pay that amount over time with a fair rate of interest. Moreover, the unsecured portion of the debt remains as an unsecured claim in the bankruptcy case.

I understand that industry lobbyists have been making the argument that permitting cramdown would drive up the cost of credit due to uncertainty in the secondary market, along with its corollary that "you would be hurting the people you are trying to help." The same argument has been made in opposition to every piece of pro-consumer legislation ever proposed.

This argument has never proved to be true. Looking just to bankruptcy law changes, the 1978 Bankruptcy Reform Act effected dramatic changes, such as permitting the cramdown of all other assets for chapter 13 debtors, the voiding of various types of liens held by consumer creditors, the right to cure mortgage defaults, and significantly larger property exemptions in many states, including Pennsylvania. No perceptible reduction in the availability of consumer credit resulted. Indeed, it continued to increase substantially.

More recently, the 2005 bankruptcy legislation was promoted on the basis that it would reduce credit costs, with some of the same creditor lobbyists arguing that every household would save $400 to $500 per year. Of course, that has not happened. The 2005 law protected many car loans (also bundled and sold in the secondary market) from cramdown and greatly increased the rights of car lenders in other ways, yet no one has detected any change in the price or availability of car loans.

These results were predictable for two fundamental reasons:

First, bankruptcy laws simply reflect economic reality and provide an orderly system for resolving the rights of debtors and creditors. Making bankruptcy more difficult for debtors does not mean they will pay debts they cannot afford to pay. If cramdown is not permitted for debtors who cannot pay their mortgages, debtors and creditors have several other alternatives, none of which is more favorable to the creditor:

(1) foreclosure, in which the creditor would receive liquidation value which is less than current market value;

(2) short sale, in which the debtor sells the home privately and pays the creditor what it would receive in cramdown;

(3) deed in lieu of foreclosure, in which creditor receives the home, worth only the cramdown amount;

(4) voluntary modification,which lenders rarely agree to, in which an arrangement similar to cramdown results.

Thus, it is not surprising that the price and availability of mortgages were not affected over the years when four circuits permitted cramdown of home mortgages in chapter 13 prior to the Supreme Court ruling otherwise.[1] Indeed, prior to the Supreme Court's Dewsnup decision, many courts permitted cramdown of undersecured liens in chapter 7.[2] And chapter 13 debtors still have the ability to cram down mortgages on investment properties, commercial real estate, vacation homes, and two and three family homes,[3] with no resulting difference in credit cost or availability of such loans.

The industry's claims that mortgage rates would rise by 2% (for example, from 6% to 8%), a 33% increase in rates, defy credulity. Assuming that the conventional mortgage rate is approximately one percent above the lender's cost of funds, and includes costs of servicing, etc. in addition to a factor for risk, such an increase would be warranted only if the risk for all mortgages more than tripled. While the foreclosure crisis is large, the estimate of 600,000 homeowners who might benefit from the proposed legislation is approximately 1% of the market. And, of course, the cramdown would not be a total loss, but only, at most, a 10% to 20% loss. Combining these numbers, the reduction in total outstanding balances would be a small fraction of 1%. And, again, even that reduction would simply reflect already existing economic reality and produce less of a loss than foreclosure. Thus, even on the unlikely assumption that the risk of default on such loans is not already built into existing rates, and the even more unlikely assumption that lenders would not lose at least as much in foreclosure without enactment of the bill, an increase of 2% in interest rates would be enough to collect, *every year, about 20 times the amount that would be lost to cramdown!*

Second, in our experience people do not file bankruptcy unless they have no alternative (and some will not do so even then.) The cramdown has not been used, and would not be used, where it is not needed. And it will be used only for a small percentage of mortgages, simply reducing them to their true economic value. By providing resolution in such cases, it is more likely to rationalize and stabilize the market, rather than destabilize it.

Indeed, the secondary market seems to be remarkably insensitive to risk in general. It is ironic that the creditors now making the argument about increased risk are the same ones who permitted loans to be made and sold without even verifying whether borrowers could pay them, resulting in enormous market instability. In comparison, the risk created by bankruptcy cramdown is minuscule.

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[1] *See* In re Bellamy, 962 F.2d 176 (3d Cir. 1992); In re Hart, 923 F.2d 1410 (10th Cir. 1991); Wilson v. Commonwealth Mortgage Corp., 895 F.2d 123 (CA3 1990); In re Hougland, 886 F.2d 1182 (CA9 1989).

[2] *E.g.*, Gaglia v. First Federal Savings & Loan Assn., 889 F.2d 1304, 1306-1311 (1989).

[3] *E.g.,* In re Scarborough, 461 F.3d 406 (3d Cir. 2006).

I am available to work with you and your staff and to answer any questions about the feasibility or impact of changes in chapter 13 to deal with the mortgage crisis. Please let me know if I can be of assistance in any way.

Respectfully yours,

s/ Henry J. Sommer