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

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

Introduction

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

For close to thirty years, Self-Help has focused on creating ownership opportunities for low-wealth families, primarily through financing home loans to low-income and minority families who otherwise might not have been able to get home loans. In total, Self-Help has provided over $5 billion of financing to 55,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across America.[1]

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

This upselling resulted in a huge percentage of borrowers paying more for their loans than they should have. A study for the Wall Street Journal found that of the subprime loans originated in 2006 that were packaged into securities and sold to investors, 61% "went to people with credit scores high enough to often qualify for conventional [i.e., prime] loans with far better terms."[24] And even those borrowers who did not qualify for prime loans could have received sustainable, thirty-year fixed-rate loans, for at most 50 to 80 basis points above the "teaser rate" on the unsustainable exploding ARM loans they were given.[25] Had these borrowers received the sustainable loans they qualified for, we would not be facing the foreclosure crisis we are in today.

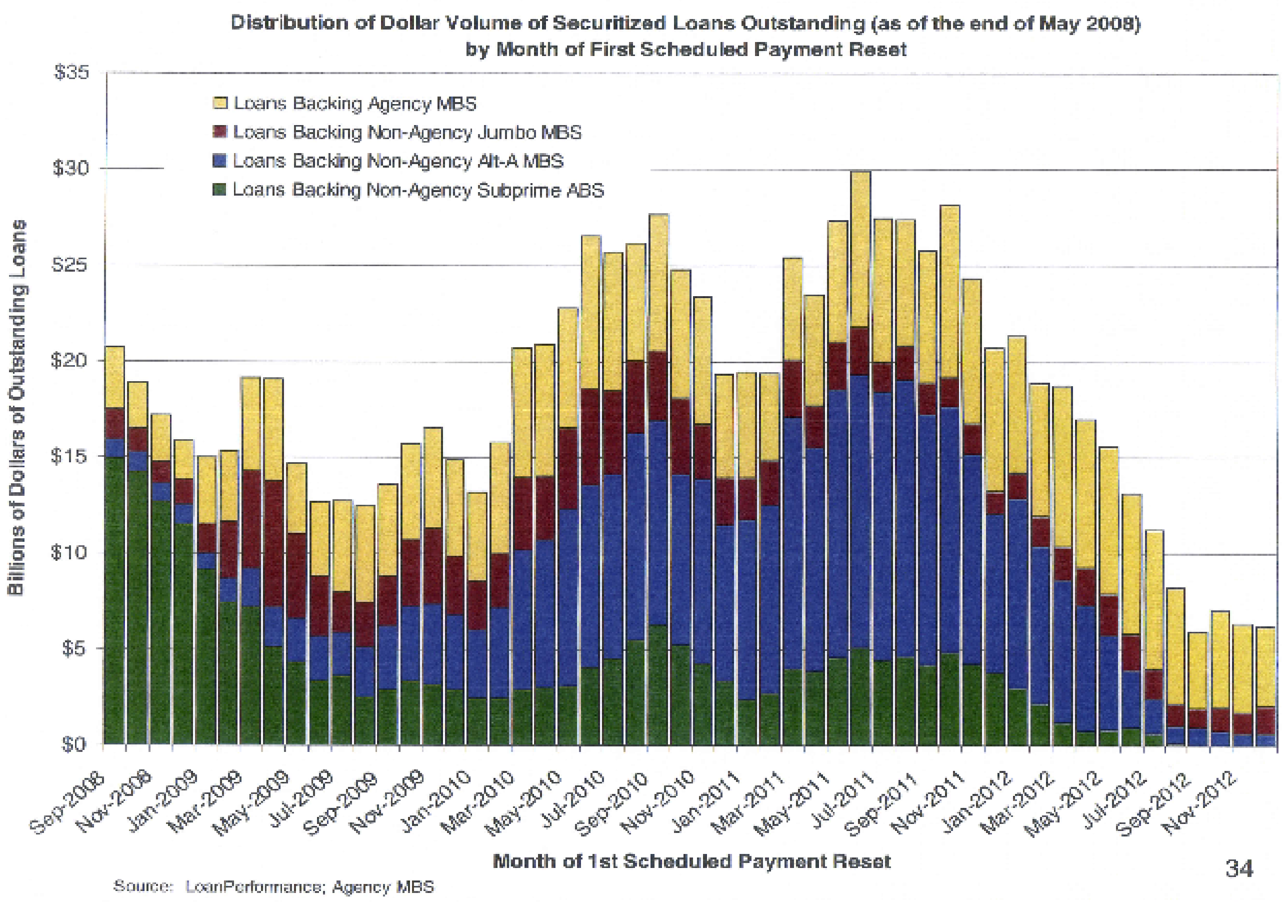
II. Foreclosure figures are mind-boggling, and they're getting worse.

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

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

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

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



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

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

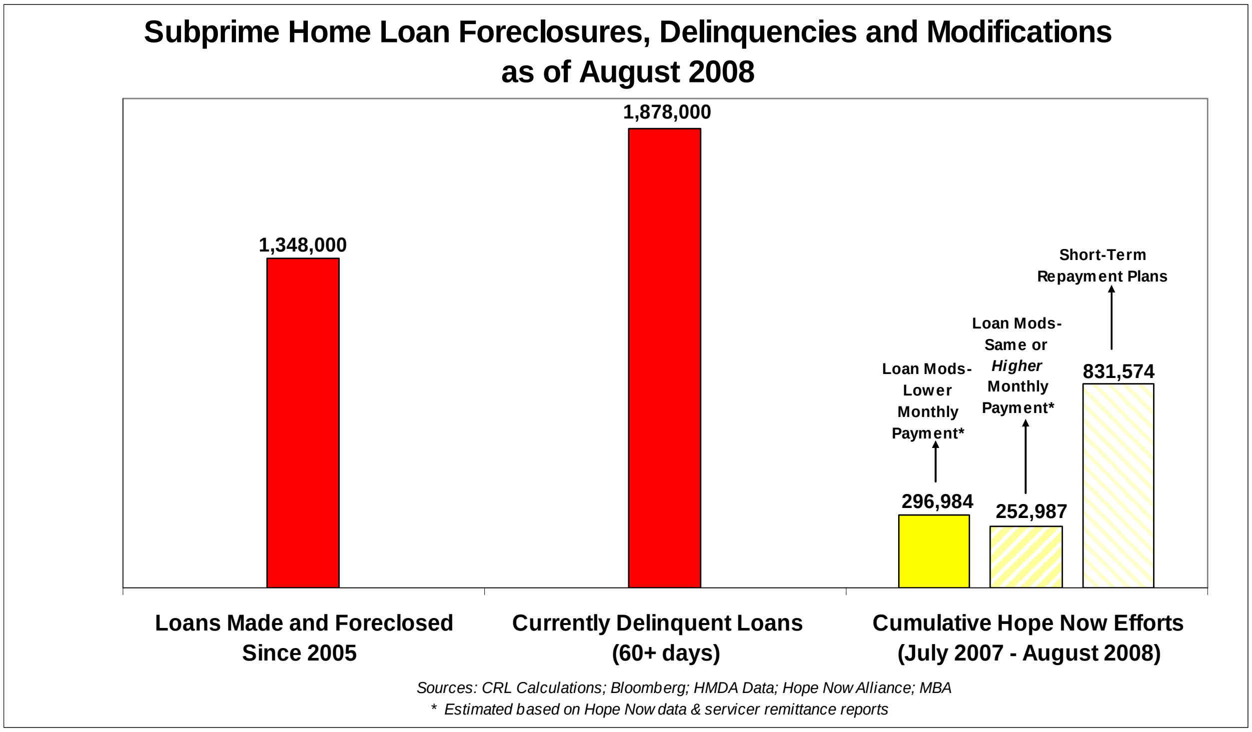
Not surprisingly, this cycle of foreclosures is also having a dramatic impact on homeownership rates and, by extension, the ability to build wealth, for millions of families. Robert Shiller recently noted that the meltdown and resulting crisis has erased any gains in the homeownership rate made since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

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

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

A. *The number of modifications is inadequate.*

Seriously delinquent loans are at a record high for both subprime and prime loans,[38] and all available data have consistently indicated that (1) continuing foreclosures far outpace total loss mitigation efforts, and (2) only a small share of loss mitigation efforts result in true loan modifications that are likely to result in sustainable loans.[39]



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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The Family Farmer Bankruptcy Act of 1986 provides an informative precedent, demonstrating how the availability of bankruptcy would increase voluntary modifications. That legislation enacted what is now Chapter 12 of the Bankruptcy Code for the specific and express purpose of permitting bankruptcy judges to modify mortgages on family farms, including primary residences located on these farms, permitting adjustment of interest rates and the adjustment of secured principal balance to the fair market value of the property. The allowance of court-supervised modifications induced more voluntary modifications outside of bankruptcy because everyone knew the alternative. After being extended several times, the Family Farmer Bankruptcy Act was made a permanent part of the Bankruptcy Code in 2005. In addition, as Richard Levin, Vice Chair of the National Bankruptcy Conference, has said, the success of Chapter 12 has actually led to a *decrease* in its use. As lenders and borrowers have come to understand how the law operates, they are increasingly able to reach agreements on their own, without intervention by the courts.[58]

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

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

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

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

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

Following are several key elements of the proposed plan:

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

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

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

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

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

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

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

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

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

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

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

First, decades of experience in which bankruptcy courts have been modifying mortgage loans on family farms in Chapter 12,[61] commercial real estate in Chapter 11,[62] vacation homes and investor properties in Chapter 13,[63] demonstrate there were no ill effects on credit in those submarkets. Debt secured by all of these asset types, in addition to credit cards and car loans, are readily securitizable even though they can be modified in bankruptcy.[64]

Second, from 1978 (when the current Bankruptcy Code was enacted) until 1993 (when the Supreme Court decided *Nobleman v. American Savings Bank*, 508 U.S. 324 (1993)), many courts across the country believed that bankruptcy judges had the authority to modify home mortgages (by treating them as secured up to the value of the property only). Lending experience during this 15-year period showed that those jurisdictions that permitted principal reductions experienced no adverse effects on the cost or availability of credit, either as compared with jurisdictions that did not permit principal reductions, or as compared with the period after 1993, when principal reductions were no longer permitted.[65]

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

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

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

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

Conclusion

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[12] We have estimated that the proposed changes potentially could help 638,000 homeowners stave off foreclosure arising solely from a subprime adjustable-rate mortgage with a large payment shock. This estimate is net of borrowers who are expected to receive loan modifications (10%) and those who are expected to fail in any event (25%). For a complete explanation of our calculation, *see* Eric Stein, Center for Responsible Lending, Testimony Before the U.S. Senate Judiciary Committee, Appendix A, Dec. 5, 2007, *available at* http://www.responsiblelending.org/pdfs/stein-statement-to-senate-judiciary-looming-foreclosure-crisis.pdf.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[36] Bernanke Statement.

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

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

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

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

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

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

[42] *Id.* at 6 .

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[61] *See, e.g.*, Hon. Greg Zerzan, Deputy Assistant Secretary for Financial Institutions Policy, Dep't of the Treasury, Congressional Testimony Before the House Committee on Agriculture (June 2, 2004) ("There are many providers of credit to farmers and ranchers, including commercial banks, insurance companies, the Farm Credit System, and specialized agricultural credit providers. … Farmer Mac is providing a secondary market outlet for lenders to dispose of loans, much the same way that other financial institutions would purchase or participate in agricultural real estate mortgage loans from one another."); Peter J. Barry, Paul N. Ellinger and Bruce J. Sherrick, Valuation of Credit Risk in Agricultural Mortgages, American Journal of Agricultural Economics (Feb. 1, 2000) ("Agricultural mortgage markets in the United States are experiencing a major transition toward greater institutional lending, wider geographic dispersion, larger lending systems, increased standardization of financing arrangements, greater reliance on nondeposit funding, and expanded potential for securitized loan pools.").

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

[63] While interest rates are generally higher on investment properties than on primary residences, this is due to the increased credit risk associated with lending to investors (an owner-occupier has to live somewhere, and the amount that otherwise would have gone to rent can be applied to the mortgage; in contrast, an investor who cannot find a tenant and lacks sufficient resources to cover the mortgage payments from resources other than revenues generated by the property is at greater risk of default). For example, Genworth Mortgage Insurance's "A-Minus Rate Sheet" dated December 1, 2005 shows a 0.5% premium for investor loans for coverage on 90% LTV A minus loan with credit score of 600-619.

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

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

[66] For more on why the proposal will not increase the cost of credit, *see* Mark Zandi, Chief Economist and Co-Founder, Moody's Economy.com, Testimony Before the U.S. Senate Judiciary Committee, Dec. 5, 2007, *available at* http://judiciary.senate.gov/hearings/testimony.cfm?id=3046&wit_id=6807 ("Given that the total cost of foreclosure to lenders is much greater than that associated with a Chapter 13 bankruptcy, there is no reason to believe that the cost of mortgage credit across all mortgage loan products should rise. Simply consider the substantial costs associated with navigating through fifty different state foreclosure processes in contrast to one well-defined bankruptcy proceeding. Indeed, the cost of mortgage credit to prime borrowers may decline.")

[67] *Id.*

[68] *Id.*

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

Some industry representatives have raised objections to the bill introduced by Senator Durbin to lift the ban on judicial modifications for loans on principal residences, claiming that it will harm the market, or harm borrowers, or unfairly impact lenders or investors. **These objections are refuted by the factual record, as discussed below.**

<u>Myth No. 1</u>: Judicial modifications will make credit less available, or more expensive.

<u>Reality</u>: Three compelling data-points refute this claim.

First, decades of experience in which bankruptcy courts have been modifying mortgage loans on family farms in Chapter 12,[1] commercial real estate in Chapter 11,[2] vacation homes and investor properties in Chapter 13,[3] demonstrate there were no ill effects on credit in those submarkets. Debt secured by all of these asset types, in addition to credit cards and car loans, are readily securitizable even though they can be modified in bankruptcy.[4]

Second, from 1978 (when the current Bankruptcy Code was enacted) until 1993 (when the Supreme Court decided *Nobleman v. American Savings Bank*, 508 U.S. 324 (1993)), many courts across the country believed that bankruptcy judges had the authority to modify home mortgages (by treating them as secured up to the value of the property only). Lending experience during this 15-year period showed that those jurisdictions that permitted principal writedowns experienced no adverse effects on the cost or availability of credit, either as compared with jurisdictions that did not permit principal writedowns, or as compared with the period after 1993, when principal writedowns were no longer permitted.[5]

Third, and dispositively, the cost of credit and its availability already reflect the risk that some loans will end in the loss of the home to foreclosure. Because the proposal introduced by Senator Durbin provides for modifications <u>only</u> in those cases where without it the home will be lost to foreclosure, and because modification is economically preferable to the lender/investor than the cost and loss associated with foreclosure, the proposal imposes no additional risk, and hence, no further cost. The proposal imposes a strict means test that limits relief to those homeowners whose income is insufficient, after deducting modest living expenses allowed by the IRS, to cover their mortgage obligations, and there is a good faith requirement that allows courts to exclude anyone who wrongly makes it through those hurdles. The result of these requirements is that judicial modification will only be available for those loans that would otherwise end in foreclosure. In foreclosure, the lender cannot recover any more than the market value of the home, and typically recovers far less, in a process that typically takes one to two years. Bankruptcy modification guarantees that the lender will recover the value of the property—without the cost or delays of foreclosure.

<u>Myth No. 2</u>: Judicial modification will cause an increase in the cost of credit by 2% because it will increase the risk of non-payment, or because current credit pricing models do not capture the risk of bankruptcy modifications, according to the MBA.

<u>Reality:</u> The proposal adds no further risk of non-payment and does not add any risk or cost that isn't already captured in the current pricing models.

By making modification available only to loans that would have ended in foreclosure, the proposal ensures that no new risk or cost will be imposed on lenders. Credit pricing models already capture the risk and cost of a loan ending in foreclosure, and the proposal adds no new risk or cost. The loss will be caused *not* by the Chapter 13 provision, but rather by the borrower's inability to repay the debt according to its terms; the alternative to judicial modification isn't full repayment but nonpayment. Because bankruptcy modification under the proposal is *less costly* to the note-holder than foreclosure, the cost of bankruptcy modification is a subset of the total cost of foreclosure already captured by current pricing models. Therefore, existing pricing models already account for all risk and cost associated with the proposal.

A recent academic research study concluded, "As there is significant evidence that mortgage interest rate markets are indifferent to bankruptcy modification risk, we conclude that permitting unlimited strip-down would have no or little effect overall on mortgage interest rates."[6]

<u>Myth No. 3:</u> (According to SIFMA):[7] If mortgages on primary residences are subject to modification just like mortgages on secondary residences (e.g., vacation homes and investment properties), mortgages on primary residences will be harder to securitize. "Roughly only 9 percent of second home mortgage originations are securitized. By comparison, roughly 84 percent of primary home mortgage originations are securitized."

<u>Reality:</u> SIFMA has confused mortgages on second homes with junior (second position) mortgages. The latter stand behind the first mortgage on the property at issue, and, for obvious reasons, are far riskier than the first position mortgage. This has nothing to do with first position mortgages on second homes, the point SIFMA purports to address.

Here is the full quote from a document that SIFMA circulated to members of the House on October 18, 2007:

> "How dramatic would such a change be? Unlike mortgages on primary residences, mortgages on second homes and investment properties can be modified during bankruptcy proceedings. As a result, mortgages on second homes and investment properties generally require greater down payments and have higher interest rates. **Roughly only 9 percent of second home mortgage originations are securitized.[1] By comparison, roughly 84**

percent of primary home mortgage originations are securitized.[2]"

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

[2] Including subprime, prime jumbo, conforming, FHA/VA in the first half of 2007. Inside MBS & ABS (September 7, 2007).

Moreover, most second liens are secured by primary residences, and so are not subject to modification in bankruptcy. SIFMA's data points thus do not say what SIFMA claims they do, and they have absolutely no connection to the points for which they are cited.

SIFMA also claims that mortgages on vacation homes and investment properties have higher interest rates and larger down payments because they are riskier due to their potential for modification in bankruptcy. This also is false. Loans on vacation and investment homes are considered riskier because people are more likely to walk away from their second homes than their primary residence. People need to live somewhere, so they are far more reluctant to lose the home they live in than other properties they may own.[8]

Myth No. 4: Judicial modification will let speculators and investors off the hook for bad investments.

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

Current law – not judicial modification – allows mortgage loan modifications by speculators and investors. The proposal would apply to ordinary homeowning families only and would extend to these families the protections that have long existed for all other debtors and for all other debts.

Myth No. 5: Judicial modification will benefit wealthy homeowners and could provide a windfall to the rich.

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

The only families who are eligible are those whose monthly income is less than the limited monthly living expenses allowable under the existing Chapter 13 means test, plus payments required to cure and pay the mortgage. Thus, relief is available only to debtors who, despite living within the strict expense limitations established by Chapter 13 and IRS rules, still do not have enough income left to save the home.

Moreover, under Chapter 13, a debtor must abide by strict expense guidelines for the life of the plan, which is generally five years, with all income above these minimum provisions being dedicated to repaying debts. In addition, declaring bankruptcy creates an unwanted stigma and harms an individual's credit, making all other debts unavailable or more expensive. As a result, no one who can afford to pay their mortgage would take advantage of this provision.

<u>Myth No. 6</u>: It is unreasonable or unfair to expect lenders to modify the interest rate, amortization or principal balance of outstanding loans.

<u>Reality</u>: 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 have been called for both Senator Dodd's May 2007 Homeownership Preservation Principles (endorsed by industry leaders), President Bush, and all of the federal banking agencies and the Conference of State Banking Supervisors.

The widely endorsed Homeownership Preservation Principles[9] call upon lenders to modify loans to "ensure that the loan is sustainable for the life of the loan, rather than, for example, deferring the reset period," including, as appropriate, one or more of:

- "Switching from an adjustable to a fixed rate loan at an affordable rate"
- "Reducing the interest rate"
- "Reducing the principal in order to ensure affordability"
- "Reamortizing the loan."[10]

Similarly, announcing a White House initiative to help homeowners facing foreclosure, the President said, "I strongly urge lenders to work with homeowners to adjust their mortgages. I believe lenders have a responsibility to help these good people to renegotiate so they can stay in their home." [11] Federal and state regulators have urged the same actions for lenders they regulate.[12]

Moreover, the proposal has two guarantees to ensure that lenders recover at least what they would from their best available alternative to a loan modification—and probably more: *first*, as noted above, the only borrowers eligible are those who otherwise could not afford to save the home from foreclosure; and *second*, the proposal permits the write-down of loan balances to the fair market value of the home. In foreclosure, the lender would recover only liquidation value, not market value, and would incur substantial costs of foreclosing—which, by industry estimates, typically amount to 40% of the principal balance.[13] Finally, in foreclosure, the portion of the loan that exceeds the proceeds of the foreclosure sale is generally lost to the lender forever. Under the proposal, the excess of the loan over the home's fair market value will be treated as unsecured debt, and paid back at the same rate as other unsecured debts during the three to five years of the plan.

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

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

Seriously delinquent loans are at a record high for both subprime and prime loans,[14] and all available data have consistently indicated that (1) continuing foreclosures far outpace total loss mitigation efforts, and (2) only a small share of loss mitigation efforts result in true loan modifications that are likely to result in sustainable loans.[15]

In October, Credit Suisse reported that only 3.5 percent of delinquent subprime loans received modifications in August 2008.[16] Similarly, the most recent report from the State Foreclosure Working Group of Attorneys General and Banking Commissioners (which covers 13 servicers, 57% of the subprime market, and 4.6 million subprime loans) confirms that progress in stopping foreclosures is "profoundly disappointing."[17] Their data indicate that nearly eight out of ten seriously delinquent homeowners are not on track for any loss mitigation outcome, up from seven out of ten from their last report.[18] Even the homeowners who receive some kind of loss mitigation are increasingly losing their house through a short sale or deed-in-lieu rather than keeping the home through a loan modification or workout.[19]

What's more, when modifications and other workouts are made, they are frequently temporary or unsustainable, leading to re-default and placing homeowners and financial institutions in an even worse economic position than when they started. Data through September 2008 indicate that the large majority of HOPE NOW efforts rely on repayment plans,[20] which typically require financially burdened households to add previously unpaid debt to their current mortgage payments. Not surprisingly, we now see very high rates of re-default on loan modifications, primarily because most loan modifications or workouts do not fundamentally change the unsustainable terms of the mortgage to make the loan affordable to borrowers over the long term. According to Credit Suisse, when interest rates or principal are reduced, the re-default rate is less than half of those for these other modifications.[21]

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

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

many homeowners it will help during its first year to 13,300[22]—out of 2.3 million projected foreclosures.

<u>Myth No. 9:</u> Judicial modifications could slow down loan modifications or otherwise interfere with servicers' efforts to voluntarily modify loans.

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

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

<u>Reality</u>: This is true only some of the time; in many instances, where a borrower has defaulted or default is reasonably imminent, servicers have authority to modify these loans. But those servicers who do not have such authority are exactly why the proposal is necessary. Bankruptcy judges can order modifications where lenders and servicers cannot not make them voluntarily.

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

<u>Reality</u>: This is sometimes not possible, for the reason noted in point 7 above. Moreover, as noted above, even where lenders or servicers have the authority to approve these changes, many are reluctant to do so out of fear that any discretion they exercise will give investors a basis for suing them. Empowering bankruptcy judges to order these changes will provide lenders and servicers with the "cover" they need. Finally, leaving this to lenders' discretion does not alter the status quo—in which so few modifications are being made.

<u>Myth No. 12:</u> Borrowers should have understood the risks involved in the subprime loans they got. They should not have relied upon mortgage brokers' assurances.

<u>Reality:</u> Even the senior management of the world's leading banks and hedge funds found it difficult to properly assess the factors that made subprime exploding ARM loans so destructive—i.e., underwriting that necessitated refinancing prior to rate reset, prepayment penalties that guaranteed a substantial loss of equity with each refinancing, and the consequence that the loans were wealth-destroying while home prices were rising, and were guaranteed to fail once home price appreciation slowed. It is unreasonable to expect the average borrower to have understood the risks better than the banks and Wall Street did.

As reported in *The New York Times*, Klaus-Peter Muller, the CEO of Commerzbank, the major German lender, observed that, "Bankers … did not adequately understand these [subprime MBS] investments and relied too heavily on high-grade credit ratings from agencies that helped put together the products, then rated them. This ignorance of the risks extended to the top echelons of the banks."[23]

These sophisticated bankers, well-versed in interest rate risk, housing market risk, anticipated home price appreciation trends, and underwriting norms, had access to independent economic and trading advice, as well as teams of experienced lawyers, investment bankers, and accountants advising them on every one of these transactions. They also owed fiduciary duties of care to their shareholders, and so presumably exercised care in investing in these loans. Nevertheless, even they misunderstood the risks.

The average subprime borrower is not represented by a lawyer at the closing of the loan transaction, let alone a team of advisors, and so is left to rely on the mortgage broker to explain the significance of any loan terms that seem confusing, and to help assess the significance of the relevant risks. Many borrowers were deliberately misled. Most were offered products that were doomed to fail even though they qualified for better, more sustainable loans. (See point 14 below). For most borrowers, the home purchase or refinancing is the largest financial transaction they have ever entered into. Without significant prior experience or access to independent economic or investment advice, they stood little chance against the market forces that incentivized mortgage brokers and originators to push them into products they could not sustain.

<u>Myth No. 13:</u> Judicial modifications are inappropriate because they would shield borrowers from the impact of their poor decisions, thereby creating a moral hazard.

<u>Reality:</u> Historically, and, of course, currently, regulators, Congress and senior members of the administration have organized assistance to failing lenders, investment banks, and private investors, sometimes with taxpayer funding, sometimes by using governmental influence to raise private funds. Most recently, Congress approved a $700 billion industry bailout. The moral hazard has been deemed outweighed by the need to avoid a broader crisis that would harm innocent victims, even if the solution entails helping those who are responsible for the crisis. Similar reasoning mitigates any concerns about moral hazard associated with helping families save their homes. Widespread foreclosures devastate not only the defaulting borrowers, but their neighbors as well.[24] And individual borrowers' responsibility for the crisis is hardly greater than the responsibility of the brokers, lenders and investors who designed and promoted loan products for sale to borrowers who could not afford them. Moreover, and critically, lifting the ban on judicial modifications would cost the taxpayers zero.

<u>Myth No. 14:</u> The real problem is that borrowers were buying homes they could not afford.

<u>Reality:</u> In most instances, it is not the <u>home</u> but rather the <u>loan</u> that the borrower cannot afford. Mortgage brokers and loan originators pushed subprime borrowers into loans they could not afford and steered them away from the sustainable loans for which they qualified. Had they received the latter, most of the foreclosures in the current crisis would never have happened.

The industry itself has stated that borrowers placed in subprime hybrid ARMs could have received sustainable, thirty-year <u>fixed-rate</u> loans, for at most 50 to 80 basis points above the <u>teaser rate</u> on the unsustainable exploding ARM loan they were given.[25] Worse, borrowers who were needlessly placed into "no doc" loans typically paid at least 50 to 80 basis points for the privilege. This means that borrowers placed into a no doc exploding ARM loan could have received a thirty-year fixed rate loan <u>for less than the teaser rate</u> on the no doc 2/28 exploding ARM loan they were given. Moreover, a recent study for the Wall Street Journal found that of the subprime loans originated in 2005 that were packaged into securities and sold to investors, fully 55% "went to people with credit scores high enough to often qualify for conventional [i.e., prime] loans with far better terms." That number rose to 61% by the end of 2006.[26]

In addition, a majority of families in unaffordable subprime loans already owned their homes before they were convinced to trade in a conventional, sustainable loan for a dangerous subprime loan they could not sustain.[27] The subprime loan was usually a refinance of a home that many families, particularly elderly borrowers, previously owned outright.

Had these borrowers received the sustainable loans they qualified for, the foreclosure crisis we now face would not have occurred. The crisis can be mitigated if the terms of these loans are modified to make them reasonably sustainable—like the loans these borrowers qualified for and should have received. Finally, the borrower would need to be able to afford the modified loan under Chapter 13, which would be a market-rate interest loan on a loan at the full value of the house; if this is more house than the family could afford, Chapter 13 would not be able to help them.

<u>Myth No. 15:</u> It would be unconstitutional (according to SIFMA) to apply Bankruptcy Code changes to existing loans.

<u>Reality:</u> To the contrary, throughout this country's history, and continuing to the present, bankruptcy law changes have been applied to existing loans. Supreme Court authority is clear that this is constitutional.

The application of newly enacted bankruptcy legislation to existing debts has been the norm both historically, in the case of the Depression era statutes, and with modern bankruptcy laws. The Family Farmer Bankruptcy Act of 1986 is useful precedent. There, in response to the farm financial downturn of the early 1980s, Congress did for family farmers precisely what judicial modification would do for ordinary homeowners today: it empowered bankruptcy courts to modify farmers' secured and unsecured debts—including all mortgage debts.[28] The Family Farmer Bankruptcy Act was applied to existing loans without any constitutional impediment.

The proposal avoids constitutional challenge because it would permit loan balances to be written down only to the value of the mortgaged property, but not below that value. As the Supreme Court unequivocally held in *Wright v. Union Central Life Ins. Co.*, 311 U.S. 273, 278 (1940), a creditor has a constitutionally protected property right up to the value of the mortgaged property. However, <u>"[t]here is no constitutional claim of the creditor to more than that."</u>[29] SIFMA's claim ignores this authority, and relies instead on the earlier case of *Louisville Joint Stock Land Bank v. Radford*.[30] *Radford* has no bearing here, because in *Radford*, the relevant statute provided the lender with "<u>*much less* than the appraised value</u>" of the property.[31] The proposal avoids this impediment entirely, and so *Radford* has no bearing here.[32]

The constitutionality of the judicial modifications proposal is not subject to serious dispute.[33]

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1 *See, e.g.*, Hon. Greg Zerzan, Deputy Assistant Secretary for Financial Institutions Policy, Dep't of the Treasury, Congressional Testimony Before the House Committee on Agriculture (June 2, 2004) ("There are many providers of credit to farmers and ranchers, including commercial banks, insurance companies, the Farm Credit System, and specialized agricultural credit providers. … Farmer Mac is providing a secondary market outlet for lenders to dispose of loans, much the same way that other financial institutions would purchase or participate in agricultural real estate mortgage loans from one another."); Peter J. Barry, Paul N. Ellinger and Bruce J. Sherrick, Valuation of Credit Risk in Agricultural Mortgages, American Journal of Agricultural Economics (Feb. 1, 2000) ("Agricultural mortgage markets in the United States are experiencing a major transition toward greater institutional lending, wider geographic dispersion, larger lending systems, increased standardization of financing arrangements, greater reliance on nondeposit funding, and expanded potential for securitized loan pools.").

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

3 While interest rates are generally higher on investment properties than on primary residences, this is due to the increased credit risk associated with lending to investors (an owner-occupier has to live somewhere, and the amount that otherwise would have gone to rent can be applied to the mortgage; in contrast, an investor who cannot find a tenant and lacks sufficient resources to cover the mortgage payments from resources other than revenues generated by the property is at greater risk of default). For example, Genworth Mortgage Insurance's "A-Minus Rate Sheet" dated December 1, 2005 shows a 0.5% premium for investor loans for coverage on 90% LTV A minus loan with credit score of 600-619.

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

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

6 Adam J. Levitin and Joshua Goodman, "The Effect of Bankruptcy Strip-down on Mortgage Markets," Business, Economics and Regulatory Policy Working Paper Series, Research Paper No. 1087816, *available at* http://ssrn.com/abstract=1087816 (Feb. 6, 2008).

7 Securities Industry and Financial Markets Association.

8 *See* Rick Brooks and Constance Mitchell Ford, The United States of Subprime - Data Show Bad Loans Permeate the Nation; Pain Could Last Years, Wall Street Journal (Oct. 11, 2007) ("Experts say such properties [i.e., those not occupied by the owner] are higher foreclosure risks than homes lived in by their owners."

9 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).

10 *Id.*

11 White House press release, August 31, 2007. *See also* the Interagency Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages, http://www.federalreserve.gov/newsevents/press/bcreg/20070904a.htm (Encouraging lenders to address subprime hybrid ARM resets by pursuing "appropriate loss mitigation strategies designed to preserve homeownership. . . . Appropriate loss mitigation strategies may include, for example, loan modifications, deferral of payments, or a reduction of principal.")

12 Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages, http://www.federalreserve.gov/boarddocs/srletters/2007/SR0716.htm

13 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.

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

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

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

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

18 *Id.* at 6 .

19 *Id.* at 7-9.

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

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

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

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

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

25 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.

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

27 Statement by Martin J. Gruenberg, Vice Chairman, FDIC, Speech at 11th Annual Wall Street Project Economic Summit, New York, NY (Jan. 8, 2008): "But it is important to understand that the majority of subprime mortgages were refinancings of existing homes. In other words, these were homes in which the homeowner was living, with mortgages that the homeowner was paying and could afford." Even in 2007, 64% of subprime loans were refinancings. Subprime Guidance Did Little To Diminish ARM Share, Inside B&C Lending at 3 (Feb. 15, 2008).

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

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

30 295 U.S. 555 (1935).

31 Radford , 295 U.S. at 591 (under the Frazier-Lemke Act, "a sale at much less than the appraised value is prescribed") (emphasis supplied). This critical aspect of the Radford decision was highlighted by the Supreme Court in the 1982 case of *U.S. v. Security Industrial Bank*, 459 U.S. 70, 76 n. 7 and text (1982) (emphasis supplied). ("The Frazier-Lemke Act, which by its terms applied only retrospectively, permitted the debtor to purchase the property for less than its fair market value." (emphasis supplied)). The Court explained that, as originally enacted, the Frazier-Lemke Act (48 Stat. 1289, 73d Cong., Sess. II., Chs. 868-69 (June 27-28, 1934)

(s)(3)) gave the debtor the right to purchase the property through deferred payments made in installments over five years, paying only one percent interest. "Given the interest rate of 1%, the present value of the deferred payments was much less than the value of the property." *Security Industrial Bank*, 459 U.S. at 76 n.7. *Security Industrial Bank* involved a creditor's challenge to the retroactive application of the lien avoidance provision of the 1978 Bankruptcy Act (Bankruptcy Code section 522(f)(2)), which permitted debtors to avoid the liens on certain types of property. Although the Court decided the question on statutory, rather than constitutional grounds, it stated in dicta that because the provision would void the entire lien – not just the creditor's right to recover the excess over the value of the mortgaged property – thereby resulting in "a complete destruction of the property right of the secured party," the constitutionality of its retroactive application was in "substantial doubt."459 U.S. at 75, 78 (emphasis supplied).

32 Moreover, whatever Radford's continued viability for propositions not in issue here, in light of SIFMA's reliance on the case, it merits noting that, while never expressly overturned, the Supreme Court itself later cited Radford as an example of Supreme Court error. *See* Rogers, 96 Harv. L. Rev. at 981 n. 33 (noting "the Supreme Court itself once admitted that it may have fallen into error in Radford and corrected itself in Vinton Branch," and citing Helvering v. Griffiths, 318 U.S. 371, 400-01 & n.52 (1943), in which the court observed that, "this Court may fall into error," citing Radford as an example of error, and Wright v. Vinton Branch (in which the Court upheld the amended Frazier-Lemke Act), as the correction of that error. Both decisions were authored by Justice Louis D. Brandeis)).

33 For further details on the analysis of the constitutional law question, *see* http://www.responsiblelending.org/pdfs/constitutionality-of-applying-bankruptcy-changes-to-existing-debts.pdf.

APPENDIX B: Experts Support Judicial Loan Modification

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

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

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

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

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

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

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

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

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

- <u>Other experts supported lifting the ban on judicial modifications</u>. Also supporting the change in the bankruptcy law are William Apgar, Senior Scholar at Harvard's Joint Center for Housing Studies, a former FHA Commissioner; Karl E. Case, a highly respected Professor of Economics at Wellesley College; and Robert Reich, former Secretary of Labor. The New York Times, USA Today and other editorial boards support it as well.

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

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

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

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

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

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

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

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

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