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To the U.S. Senate Judiciary Committee

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

<u>**December 5, 2007**</u>

Chairman Leahy, Presiding Member Durbin, Ranking Member Specter, and members of the Committee, thank you for holding this hearing on how we can avert foreclosures on families in financial distress. I appreciate the opportunity to submit comments.

Every day it appears, the problems in the subprime market have become more evident and have grown even worse. However, one hopeful sign is that we now have an active bipartisan effort to address this situation. I commend Senator Durbin for his current bankruptcy proposal, and I also want to commend Senator Specter for his leadership in recognizing bankruptcy reform as a necessary tool for addressing the massive home losses families are experiencing today. A collaborative approach to this problem is essential, and it is heartening to see consensus on the need for action.

In this statement, I will emphasize these four points:

- There is a serious subprime foreclosure crisis that will get even worse in the future.
- Voluntary modifications by lenders and servicers are not enough. The private sector is stymied by competing financial interests and the sheer magnitude of the problem.
- The most effective solution, both for investors and homeowners, is a small change to the bankruptcy code that would impose no cost on the U.S. Treasury, have no negative impact on home credit, and prevent 600,000 needless foreclosures.
- The failure to prevent a significant proportion of the coming foreclosures will severely impact whole communities – including the millions of homeowners who continue to pay their mortgages on time, but who will suffer the effects of foreclosures in their neighborhoods – and risks pushing the economy into recession.

First, a bit of personal background. I have direct experience as a mortgage lender, since I serve as Chief Operating Officer of Self-Help (www.self-help.org), which consists of a credit union and a non-profit loan fund. I also serve as Senior Vice President of Self-Help's affiliate, the Center for Responsible Lending (www.responsiblelending.org), which is a not-for-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices.

For the past 26 years, Self-Help has focused on creating ownership opportunities for low-wealth families, primarily through financing home loans to low-income and minority families who otherwise might not have been able to get home loans. In other words, we work to provide fair and sensible loans to the people most frequently targeted for predatory and abusive subprime mortgages. Self-Help has provided over $5 billion of financing to 55,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across the country. Our loan losses have been less than one percent per year.

In addition to making direct loans, Self-Help encourages sustainable loans to borrowers with blemished credit through a secondary market operation. We buy these loans from banks, hold on to the credit risk, and resell them to Fannie Mae. We have used the secondary market to provide $4.5 billion of financing to 50,000 families across the country, loans that have performed well and significantly increased these families' wealth.

Through this lending experience, I understand the importance of promoting sustainable homeownership and maintaining access to affordable home loans, and I have an appreciation of how responsible use of the secondary market can contribute to such a result.

I. The Subprime Crisis Worsens and Spreads

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

Homeowners aren't the only ones who are hurting; problems are accelerating for lending institutions and financial markets. Virtually every financial institution with a stake in subprime lending has reported high losses and layoffs. Some notable examples: Countrywide Financial Corp. posted a $1.2 billion loss in the third quarter and has seen its stock lose 60% of its value and 12,000 of its employees lose their jobs so far this year. Merrill Lynch announced it lost $8.4 billion in the 3rd quarter—its worst loss in 93 years—with $7.9 billion of these losses on subprime and CDO assets. Citigroup recently wrote down $1.3 billion in subprime assets, paid $2.6 billion to cover credit losses and increased reserves, and is reportedly considering layoffs for 45,000 employees. Last week, Wells Fargo announced a $1.4 billion hit for mortgage-related charges. Similarly, the Office of Thrift Supervision said third-quarter profits at the nation's 831 savings institutions plunged 84 percent due to increased reserves for losses on housing-related assets.

Overall, banks and brokers may have to write off as much as **$130 billion** in subprime assets this year, according to Deutsche Bank AG, and Lehman Brothers predicts **another $250 billion** in losses over the next five years.

And in yet another twist, subprime's financial tsunami is moving beyond Wall Street and now reaching Main Street in our communities. A significant number of state- and county-run investment pools—used by thousands of school, fire, water and other local districts—hold interests in structured investment vehicles (SIVs) backed by subprime loans. Losses on SIVs will impact many states, include Connecticut, Florida, Maine, Montana and Washington. "Nobody knows how much more pain is coming. State funds could lose hundreds of millions of dollars" says Lynn Turner, chief accountant of the U.S. Securities and Exchange Commission from 1998 to 2001. Similarly, the subprime SIV problems may soon cause losses in money market mutual funds—called "the bedrock investment of ordinary Americans" and currently holding about $3 trillion in assets.

With such widespread repercussions from subprime foreclosures, it's no surprise that consumers have ranked the subprime crisis above global warming and the federal deficit among their most pressing concerns, according to a recent survey by TNS North America.[3] It is notable that subprime lenders—who should have known better in the first place—have yet to act on the widespread public understanding that recent lending is excessively dangerous. As Friedman Billings Ramsey reports in a recent study: "We find scant evidence that the risk characteristics of subprime loans originated in 2007 differ significantly from those of subprime loans originated in 2006 and 2005. Therefore, we cannot conclude that lenders have reversed the liberal underwriting criteria of 2007, limited exceptions to these criteria, and strengthened quality control procedures for newly originated subprime loans."[4]

II. Voluntary Loan Modifications Will Not Solve the Problem

A. Obstacles to Modification

Opponents of this bankruptcy tweak often claim that the mortgage market is "self-correcting" and, therefore, can adequately address the current foreclosure crisis without government interference. However, the magnitude of this problem simply overwhelms the private sector response to it.

First of all, lenders are not modifying loans in any significant numbers.[5] Moody's Investors Service recently surveyed servicers representing 80 percent of the market through July of this year and found that only about one percent of subprime loans experiencing rate resets were being modified.[6] Given up to half of the 450,000 families facing subprime resets in the next three months will lose their homes to foreclosure,[7] even if industry modification efforts increase ten-fold—an extraordinary increase under any circumstances—only 10 percent of subprime loan-holders facing reset would receive modifications.

Second, many of the loss mitigation activities that lenders are pursuing are not resulting in loan terms that are sustainable in the long term. For example, most of Countrywide's foreclosure prevention activities consist of simply capitalizing arrearages, or taking the borrower's home before the foreclosure proceedings are completed.[8] Others simply delay the rate reset for six to 24 months.

Third, the interests of loan servicers and investors are misaligned. As reported in *Inside B&C Lending*, "Servicers are generally dis-incented to do loan modifications because they don't get paid for them but they do get paid for foreclosures." In fact, "it costs servicers between $750 and $1,000 to complete a loan modification."[9] And for servicers that have affiliates who receive payments for foreclosure-related services, such as appraisals and foreclosure trustee services, foreclosure is economically beneficial.[10] Since servicers decide whether to modify, the fact that a modification rather than foreclosure would be in the interests of investors as a whole is irrelevant. So, even when a loan modification would better serve investors and homeowners, loan servicers typically have economic incentives to skip solutions and proceed as quickly as possible to foreclosure.

Finally, even those servicers who genuinely wish to help homeowners in distress, or who recognize that investors as a whole would fare better under a modification than through foreclosure, face significant obstacles to modifying loans. The following are three main obstacles:

- Fear of Investor Lawsuits. Servicers have obligations to investors who have purchased mortgage-backed securities. Modifying loans typically affects various tranches of securities differently, which raises the specter of investor lawsuits when one or more tranches lose income.[11] For example, a modification that defers loss rather than immediately writing down principal will favor the residual holder if the excess yield account is released after a certain period of time, generally three years, but will hurt senior bondholders since the residual, or equity, will not be there to absorb losses anymore. Under circumstances where different tranches would be impacted differently by modification, the least risky course for the servicer is to pursue foreclosure – even though this may be the least economically beneficial for investors as a whole.

- Dilemma of Piggyback Seconds. Between one-third and one-half of 2006 subprime borrowers took out so-called "piggyback loans", that is, simultaneous first and second lien mortgages.[12] When there is a second mortgage, the holder of the first mortgage has no incentive to provide modifications that would free up borrower resources to make payments on the second mortgage. At the same time, the holder of the second mortgage has no incentive to support an effective modification, which would likely cause it to face a 100% loss; rather, the holder of the second is better off waiting to see if a borrower can make a few payments before foreclosure. Beyond the inherent economic conflict, negotiating with two servicers is an insurmountable challenge to most borrowers.

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

For the various reasons listed above, servicers are not modifying loans and these loans are proceeding to foreclosure in unprecedented numbers. Thus, Congressional action is needed to enable bankruptcy courts to order loan modifications, thereby removing the threat of investor lawsuit and leading to voluntary modifications on a much larger scale than has occurred to date. This legislation would be in the interest of borrowers and investors alike.

B. The Paulson Plan

Given estimates that there will be 3.5 million defaults over the next three years,[13] the plan announced by President Bush for targeted loan modifications for some subprime borrowers is a positive, but very limited, step. There are two reasons that the plan, on its own, will not be commensurate to the scale of the problem.

First, eligibility for the streamlined modification plan is extremely narrow:

- 2005 loans. The plan does nothing to help hundreds of thousands of subprime borrowers who received "exploding" 2/28 adjustable-rate mortgages in 2005.
- Delinquency due to reset. The plan excludes those who have fallen behind because the interest rates on their loans have already reset to unaffordable levels. Some lenders have told borrowers they cannot get a modification unless they are delinquent.
- Improved credit scores. To qualify, the borrower needs to have had good payment history on the loan, but the plan then excludes those whose credit scores improved significantly. These criteria are mutually exclusive.
- Cannot refinance. Even if the borrower's loan balance exceeds the value of the borrower's house, or their credit score started low but improved by 10%, they would not be eligible for streamlined modification, even though they cannot refinance.
- PO ARMs. The plan will not cover "payment option" ARM loans, which are not typically considered subprime loans but also face significant rate resets in 2008 and beyond.

Second, the plan relies on voluntary decisions by individual mortgage servicers and investors, does not remove the strong financial and legal incentives servicers have to foreclose on loans rather than modify them, and does not address the obstacles caused by the "piggyback" second mortgages. Recent experience shows that the likelihood of widespread modifications is small under this "business as usual" approach. Finally, servicers and lenders have made repeated announcements throughout 2007 that they will modify large numbers of loans, but because of the substantial obstacles, this hasn't happened. The plan lacks a reporting mechanism to provide accountability that, this time, servicers are living up to their commitments.

The plan will help some borrowers, but in light of its limited impact, it is imperative that Congress complement it with this tweak to the bankruptcy code.

III. Bankruptcy Relief is Needed as a Last Resort

Congress can ameliorate the worst of the crisis yet to come, but only through allowing mortgages to be modified through chapter 13. Currently, federal law makes the mortgage on the primary residence the only debt that bankruptcy courts cannot modify—even though courts can modify mortgages on investment properties and vacation homes. This makes no sense. Because the home mortgage exception applies only to primary residences, borrowers wealthy enough to own two homes or speculators whose investments have gone bad can obtain relief from the mortgage on their vacation or investment home, thereby retaining at least one shelter for their family. Judges have the ability to modify loans securing their home for family farmers, whose bankruptcies are governed by chapter 12, and owners of commercial real estate and other businesses, who are subject to chapter 11. Thus, the current bankruptcy law deprives mostly low-wealth and middle-class families of protections available to all other debtors and grants lenders on home mortgages a special protection not available to any other type of lender.

A. <u>Benefits of the Bankruptcy Solution</u>

<u>Bankruptcy targets those who truly need help, without affecting interest rates.</u> Interest rates already reflect the lender's assessment of the risk that some proportion of loans will end in a foreclosure sale. Because bankruptcy modifications under the proposed reforms would occur only for those loans that would otherwise end in foreclosure, and because, such modifications will net the lender at least as much or more than could be recovered in foreclosure, interest rates on new loans should not be affected.

<u>Bankruptcy reform would affect only a fraction of all mortgages</u>. We estimate that the proposed changes to the bankruptcy law would allow 600,000 families who are facing foreclosure to keep their homes (see **Appendix A, Homeowner Savings**). While this number would significantly reduce the severity of the current foreclosure epidemic, it only represents 1.4% of all homeowner households with outstanding mortgages.

<u>Investors receive more from loan modifications than foreclosures</u>. For the 600,000 families whom we expect this legislation to help, the alternative to a loan modification is

foreclosure. This outcome is worse, not only for borrowers, but for lenders as well. Chapter 13 would guarantee at least the market value of the property that the lender took as collateral and would mandate that the borrower make regular payments over three to five years on the difference between market value and the loan balance. Conversely, under foreclosure, lenders receive only liquidation value, not fair market value, with any remaining balance written off altogether.

In addition, there are significant expenses associated with foreclosure that would not arise under judicial modification: lenders face one-to-two year delays and incur high legal expenses, not to mention the costs related to the maintenance and sale of the property. Thus, subprime lenders or investors lose approximately 40% of the principal balance of a loan that defaults.[14] Finally, foreclosures have significant negative impacts on surrounding property values. Therefore, to the extent a lender holds liens on other properties in the area, loan modifications help protect the value of other collateral

B. <u>Stabilizing the Market</u>

While it is clear that greater accessibility to bankruptcy relief could provide a boost to the housing market, some industry groups continue to assert that judicial modifications will negatively impact the market.[15] There is irony to this claim given that the current credit squeeze is caused by the *lack* of adequate regulation. Absent such regulation, reckless lending practices flourished, causing lender bankruptcies and investor losses. Investors reacted abruptly (and belatedly) to stem further losses, causing a sudden, unplanned-for, and highly disruptive liquidity crisis.

There is strong evidence that the proposed reform will not adversely affect the availability of credit and, in fact, will help stabilize the housing market. Such evidence includes the following:

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

<u>Bankruptcy modifications work well for other types of assets</u>. The claim that allowing modifications of home mortgages will adversely impact the cost or availability of credit is similarly belied by decades of experience in which bankruptcy courts have been modifying mortgage loans on family farms in chapter 12,[17] commercial real estate in chapter 11,[18] and vacation homes and investor properties in chapter 13,[19] with no ill effects on credit in those submarkets. Debt secured by all of these asset types, plus credit

cards and car loans, are easily securitized even though they can be modified in bankruptcy.[20] In addition, as Richard Levin, Vice Chair of the National Bankruptcy Conference, testified in October, the success of Chapter 12, in which loans on family farms can be modified, has actually led to a *decrease* in its use. As lenders and borrowers have come to understand how the law operates, they are increasingly able to reach agreements on their own, without intervention from the courts.[21]

Some industry groups have argued that allowing bankruptcy judges to modify mortgages on primary residences, would cause "major disruption in the financial markets." Specifically, these groups claim that loans on investment properties have higher interest rates and higher down payment requirements because they can be modified in bankruptcy, and that would be the fate of all mortgages. I must say, in over a decade dealing with housing finance, I have never heard this argument before. As Self-Help has recognized through our commercial lending operation and as the Wall Street Journal concludes,[22] these loans carry higher rates simply because they are riskier than loans on owner-occupied houses, since investors are much more likely to walk away than homeowners.

To review other arguments against the bankruptcy solution and why they are not persuasive, please refer to **Appendix 2, "Myth v. Reality."**

C. <u>The Durbin Bill</u>
The Durbin bill is specifically structured to make bankruptcy modifications available <u>only</u> for those borrowers whose homes would otherwise be lost in foreclosure. Moreover, to qualify for relief, a homeowner must not have sufficient income to pay their mortgage after applying the strict expenditure limits imposed by the 2005 amendments to the Bankruptcy Code. The proposed bill addresses concerns that I've heard about changing chapter 13.

The first set of concerns is that families with sufficient income to pay their mortgage should not benefit. In other words, people should not file for a chapter 13 modification if their property has lost value but they are able to continue paying their underwater mortgage; they should only use the bankruptcy option if their only alternative is foreclosure. Otherwise, they will be obtaining a windfall; bankruptcy should be the last option, not the first.

In fact, the Durbin Bill imposes a strict means test to ensure that only people who otherwise face foreclosure are eligible for a loan modification on their principal residence under chapter 13.[23] In addition, the good faith requirement already applies, so someone who meets the means test but can still afford mortgage, somehow, could be excluded by lender objection. Finally, the existing $1 million loan limit for secured debt still applies as well.

The second concern I heard was that allowing judicial modification would give bankruptcy judges unfettered discretion to modify loan terms so that any loan could be made affordable, even when the borrower has simply purchased too much house for their income. A judge might add 30 years to a loan that has already been outstanding for 15 years, reduce interest rates to one or two percent to make the loan maximally affordable, and strip down the principal to a 50 percent loan-to-value ratio. Such terms would be unfair to lenders, and the uncertainty created by lack of guidance will have a chilling effect on the market.

The Durbin bill actually provides guidance to bankruptcy judges to generally leave the remaining term of the loan the same as it currently is and establishes that the benchmark interest rate will be market rate—i.e., the prevailing 30-year fixed rate plus a risk premium. Such a rule is consistent with a holding in the *Till* case to use a customary index and require the judge to add a risk premium; the prime rate used in *Till* is customary for car loans but is not used to set the interest rate on first mortgages. In addition, the principal can only be stripped down to the fair market value of house. The amount over value would become unsecured debt paid to extent family is able during three-to-five years of the plan. If a family fails in completing the chapter 13 plan, the loan returns to its original terms and cramdown is undone.

Because the Durbin bill is so prescriptive about how a loan otherwise heading into foreclosure can be modified judicially, the parties will have every incentive and sufficient information to come to agreement outside of bankruptcy. Families have no desire to enter bankruptcy, given the stigma, 10-year damage to their credit report, court supervision of every expense for 5 years, and cost. Servicers would have a perfect defense to investor lawsuits, since they can negotiate outside of bankruptcy for more favorable terms than what they would receive in chapter 13. This move toward voluntary modification because of the bankruptcy availability is exactly what occurred for family farms in chapter 12.

IV. The Risks of Failing to Prevent a Substantial Proportion of the Anticipated Foreclosures are Great

While some will point out risks of enacting a change to chapter 13 to allow judicial modification of primary residences, the risks of not making this change are far greater. A family doesn't need to be holding a subprime mortgage to be hurt by it. Recently we at the Center for Responsible Lending found that, for subprime home loans originated in 2005 and 2006, 44.5 million neighboring homes will experience devaluation because of subprime foreclosures that take place nearby. The decline in house values and tax base resulting from these nearby foreclosures will add up to $223 billion—losses that are completely outside the direct losses associated with foreclosures.[24]

As described in Appendix 1, we believe that the Durbin bill would avert 600,000 foreclosures, saving $72.5 billion in wealth lost by American families *not* facing foreclosure.[25] This in turn will save local governments property tax revenues, as well as the significant costs of police and administrative support that foreclosures require.[26] According to the Joint Economic Committee, every new foreclosure can cost all stakeholders $80,000.[27]

Recognizing the massive scale of the foreclosure crisis and the fact that current efforts to address this crisis are insufficient, a number of prominent, independent housing economists have recognized that judicial modification under chapter 13 is an essential part of the solution. Three preeminent professors that I spoke with who specialize in real estate economics and finance support the proposal: William Apgar, Senior Scholar at Harvard's Joint Center for Housing Studies, a former FHA Commissioner; Karl E. Case, a highly respected Professor of Economics at Wellesley College; and Roberto Quercia, Director of the Center for Community Capital at UNC-Chapel Hill. In addition, this Committee has received a letter to this effect from Robert Shiller, Professor of Economics and Professor of Finance at Yale University and a principal in creating the Standard & Poor's Case-Shiller® Home Price Index, which is, according to S&P, "the leading indicator on the overall health of the U.S. housing market." Finally, the written testimony of Mark Zandi, Chief Economist and co-founder of Moody's Economy. com, for the hearing states that "there is no more efficacious way to short-circuit this developing cycle [of foreclosures and falling housing prices] and forestall a recession than by passing this legislation."[28]

The negative cycle that Mark Zandi spoke of—that is, of foreclosures leading to depreciation of home values, which consequently, increase foreclosures—is hard to break. Concentrations of foreclosures can devastate communities in ways that may be irreparable. The impact of the foreclosure epidemic on the economy as a whole could be similarly devastating. We therefore need to use every means at our disposal to stem this crisis. Treasury Secretary Paulson's plan will help some borrowers. But bankruptcy reform could save the homes of hundreds of thousands of the families who will not be helped by that plan.

Conclusion

Let me end by reiterating some of the major benefits of making bankruptcy accessible to homeowners who are struggling with subprime loans:

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

- This solution narrowly targets families who would otherwise lose their homes.

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

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

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

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

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

3 "Public Perceptions," American Banker (October 11, 2007).

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

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

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

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

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

9 Inside Mortgage Finance Reprints, Subprime Debt Outstanding Falls, Servicers Pushed on Loan Mods (Nov. 16, 2007) (Quoting Karen Weaver, a managing director and global head of securitization research at Deutsche Bank Securities).

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

11 Sam Garcia, "Group Warns on Large Scale Modifications: Consumer Mortgage Coalition Sends Letter to FDIC," MortgageDaily.com (October 9, 2007) (servicer doing widespread modifications "faces potential legal action from the securitization trustee and even from the securities holders themselves"); Harris Terry, ARM Workout Calls Trigger Fierce Debate, American Banker (Oct. 9, 2007) ("Servicers are 'scared to death' of being challenged by investors for making too many modifications, [Citigroup

Managing Director Tim] Bolger said. ‘Talking about getting modification rates up, they're probably going to err on the conservative [side] if they think any investor is going to come after them.’”)

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

13 Mark Zandi, “A Step Behind”, Dismal Scientist, Moody’s Eoconomy.com., December 6, 2007.

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

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

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

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

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

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

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

21 http://judiciary.house.gov/media/pdfs/Levin071030.pdf (page 4-5).

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

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

24 "Subprime Spillover: Foreclosures Cost Neighbors $223 Billion; 44.5 Million Homes Lose $5,000 on Average," CRL issue paper (November 13, 2007), available at http://www.responsiblelending.org/pdfs/subprime-spillover.pdf.

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

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

27 http://www.jec.senate.gov/Documents/Reports/subprime11apr2007revised.pdf

28 http://judiciary.senate.gov/testimony.cfm?id=3046&wit_id=6807.

Appendix A – Homeowner Savings

US Estimates

Row	Measurement	2004	2005	2006	1Q-2Q 2007
		Year			
a	Projected Foreclosures	16%	19%	19%	19%
b	Probability of ARM	87%	93%	92%	80%
c	Probability of FRM	13%	7%	8%	20%
d	Probability of Foreclosure Given ARM	16%	20%	20%	20%
e	Probability of ARM Given Foreclosure	91%	95%	94%	85%
f	Probability of Shock	98%	97%	97%	97%
g	Probability of Outstanding	21%	57%	72%	99%
h	Proportion that could be helped (% Original Cohort)	3%	10%	13%	15%
i	Original cohort	2,219,547	3,259,908	3,219,749	1,093,105
j	Estimate of eligible homeowners	64,960	335,260	413,237	169,041
k	Total eligible	982,498			
l	% of outstanding borrowers	14%	18%	18%	16%
m	Total % of outstanding borrowers	17%			
n	Less expected modifications (10%)	6,496	33,526	41,324	16,904
o	Less economically unviable (25%)	16,240	83,815	103,309	42,260
p	Net potential help	42,224	217,919	268,604	109,877
q	**Net total potential help**	**638,624**			
r	Net potential help as % outstanding borrowers	9%	12%	12%	10%
s	Net total potential help as % of outstanding borrowers	11%			

	Chart Data	All	All Count	FC only	FC Count
	Loans not projected to foreclose	81.5%	7,979,097		
	Projected foreclosures completed or fixed rate	8.5%	830,714	45.8%	830,714
	Projected foreclosures that cannot be helped	3.5%	343,874	19.0%	343,874
	Population that could be helped	6.5%	638,624	35.2%	638,624

Row	Measurement	Source
a	Projected Foreclosures	CRL, Losing Ground report, 2007 assumed
b	Probability of ARM	Fannie Mae, Bloomberg
c	Probability of FRM	Fannie Mae, Bloomberg
d	Probability of Foreclosure Given ARM	UNC research, calculation
e	Probability of ARM Given Foreclosure	Calculation
f	Probability of Shock	HMDA, Federal Reserve H.15
g	Probability of Outstanding	Bloomberg
h	Proportion that could be helped (% Original Cohort)	Product of rows a, e, f, g
i	Original cohort	CRL, Losing Ground, Net Drain reports, Inside B&C Lending
j	Estimate of eligible homeowners	Calculation
k	Total eligible	Calculation
l	% of outstanding borrowers	Calculation
m	Total % of outstanding borrowers	Calculation
n	Less expected modifications (10%)	10% estimate from Moody's 7/12/07 conference call
o	Less economically unviable (25%)	25% assumption

We estimate that the proposed changes potentially could help 638,000 homeowners stave off foreclosure arising solely from a subprime adjustable-rate mortgage with a large payment shock. This estimate is net of borrowers who are expected to receive loan modifications (10%) and those who are expected to fail in any event (25%). This document details the logic, assumptions, and calculations made to arrive at this estimate.

We begin with our estimate of total projected foreclosures for each subprime loan vintage (i.e., annual cohort) in row a. The projections from 2004-2006 are based on our "Losing Ground" report, issued in December 2006. The 2007 figures reflect an assumption that the projected foreclosure rate for this vintage will follow that for 2006. This assumption is based on (1) observations of securitized loan deals brought to market in 2007 showing that loan origination quality has not improved markedly and (2) continued concerns about the strength of the housing market.

Next, in row e, we calculate the proportion of all projected foreclosures that are expected to be adjustable-rate mortgages (ARMs) based on (1) ARM market share (row b) and (2) elevated risk that ARMs will experience foreclosure, based on published research from the University of North Carolina.

Next, in row f, we analyze Home Mortgage Disclosure Act (HMDA) data to arrive at an expectation for the proportion of ARM loans that will experience significant payment shocks at reset. Here, the test for significant payment shocks are that the new payment will be greater than 50% of the original reported borrower income and will be 10% above the original payment burden. Since HMDA data does not contain key information, to arrive at an "average" expectation, we assume all loans are ARMs with 30 year terms, carry a typical start rate, and a typical margin. Using HMDA-reported borrower incomes and loan amounts, we then reach the reported figures. For 2007, we assume the figure will follow 2006.

Next, in row g, we observe the proportion of securitized loans from each year that are still outstanding through market data on subprime mortgage backed securities on Bloomberg.

We then multiply rows a, e, f, g (foreclose % * % ARM given foreclosure * % outstanding * % with expected payment shock) to arrive at our estimate of borrowers who are "eligible" for help: that is, current borrowers with a subprime ARM projected to end in foreclosure and carrying a large built-in payment shock.

From here, we discount the estimate to take into account expectations for borrowers who will receive loan modifications from lenders (row n) and borrowers who are likely to fail in any event (row o).

Appendix B – Objections to the Durbin/Schumer Bill – Myth v. Reality

Some industry representatives have raised objections to the Durbin/Schumer bill, claiming that it will harm the market, or harm borrowers, or unfairly impact lenders or investors. These objections are refuted by the factual record, as discussed below.

Myth No. 1: The Durbin/Schumer bill will make credit less available, or more expensive.

Reality: Three compelling data-points refute this claim.

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

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

Third, and dispositively, the cost of credit and its availability already reflect the risk that some loans will end in the loss of the home to foreclosure. Because the Durbin/Schumer bill provides for modifications only in those cases where without it the home will be lost to foreclosure, and because modification is economically preferable to the lender/investor than the cost and loss associated with foreclosure, the Durbin/Schumer bill imposes no additional risk, and hence, no further cost.

There is irony to this claim; the current credit squeeze is caused by the *lack* of adequate regulation. Absent such regulation, reckless lending practices flourished, causing lender bankruptcies and investor losses. Investors reacted abruptly (and belatedly) to stem further losses, causing a sudden, unplanned-for, and highly disruptive liquidity crisis.

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

Reality: The Durbin/Schumer bill adds no further risk of non-payment, and does not add any risk or cost that isn't already captured in the current pricing models.

As noted above, credit pricing models already capture the risk and cost of a loan ending in foreclosure. The Durbin/Schumer bill will allow bankruptcy modification only for those loans that would have ended in foreclosure. The loss will be caused not by the chapter 13 provision, but rather by the borrower's inability to repay the debt according to its terms; the alternative to judicial modification isn't full repayment, but nonpayment. **Because bankruptcy modification under the Durbin/Schumer bill is *less costly* to the note-holder than foreclosure, the cost of bankruptcy modification is a subset of the total cost of foreclosure already captured by current pricing models. Therefore, existing pricing models already account for all risk and cost associated with the Durbin/Schumer bill.**

Myth No. 3: (According to SIFMA): [6] If mortgages on primary residences are subject to modification just like mortgages on secondary residences (e.g., vacation homes and investment properties), mortgages on primary residences will be harder to securitize. "Roughly only 9 percent of second home mortgage originations are securitized. By comparison, roughly 84 percent of primary home mortgage originations are securitized."

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

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

> **"How dramatic would such a change be? Unlike mortgages on primary residences, mortgages on second homes and investment properties can be modified during bankruptcy proceedings. As a result, mortgages on second homes and investment properties generally require greater down payments and have higher interest rates.** Roughly only 9 percent of second home mortgage originations are securitized.[1] By comparison, roughly 84 percent of primary home mortgage originations are securitized.**[2]"**
>
> **[1] Seconds include home-equity lines of credit and closed-end seconds; some second mortgages are also securitized in subprime and other MBS products. "Securitization Rate Slips in Second Quarter Despite Lag in Nonprime MBS Process," Inside MBS & ABS (September 7, 2007)**
>
> **[2] Including subprime, prime jumbo, conforming, FHA/VA in the first half of 2007. Inside MBS & ABS (September 7, 2007)**

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

SIFMA also claims that mortgages on vacation homes and investment properties have higher interest rates and larger down-payments because they are riskier due to their potential for modification in bankruptcy. This also is false. Loans on vacation and investment homes are considered riskier because people are more likely to walk away from their second homes than their primary residence. People need to live somewhere, so they are far more reluctant to lose the home they live in than other properties they may own.[7]

Myth No. 4: The Durbin/Schumer bill will let speculators and investors off the hook for bad investments.

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

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

Myth No. 5: The Durbin/Schumer bill will benefit wealthy homeowners, and could provide a windfall to the rich.

Reality: The Durbin/Schumer bill is drafted so as to prevent this: It applies *only* to debtors who meet a *strict means test* and adhere to a budget with *severe limitations* on living expenses.

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

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

<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 Durbin/Schumer bill is designed so that lenders will recover *more* from the modification than from the lender's available alternative (foreclosure). Moreover, these modifications are called for both by Senator Dodd's May 2007 Homeownership Preservation Principles (endorsed by industry leaders), and by President Bush, as well as all of the federal banking agencies and the Conference of State Banking Supervisors.

The widely endorsed Homeownership Preservation Principles[8] call upon lenders to modify loans to "ensure that the loan is sustainable for the life of the loan, rather than, for example, deferring the reset period," including, as appropriate, one or more of:

- "Switching from an adjustable to a fixed rate loan at an affordable rate"
- "Reducing the interest rate"
- "Reducing the principal in order to ensure affordability"
- "Reamortizing the loan."[9]

Similarly, announcing a White House initiative to help homeowners facing foreclosure, the President said, "I strongly urge lenders to work with homeowners to adjust their mortgages. I believe lenders have a responsibility to help these good people to renegotiate so they can stay in their home." [10] Federal and state regulators have urged the same actions for lenders they regulate.[11]

Moreover, the Durbin/Schumer bill has two guarantees to ensure that lenders recover at least what they would from their best available alternative to a loan modification – and probably more: *first*, as noted above, the only borrowers eligible are those who otherwise could not afford to save the home from foreclosure; and *second*, the bill permits the write-down of loan balances to the fair market value of the home. In foreclosure, the lender would recover only liquidation value, not market value, and would incur substantial costs of foreclosing – which, by industry estimates, typically amount to 40% of the principal balance.[12] Finally, in foreclosure, the portion of the loan that exceeds the proceeds of the foreclosure sale is generally lost to the lender forever. Under the Durbin/Schumer bill, the excess of the loan over the home's fair market value will be treated as unsecured debt, and paid back at the same rate as other unsecured debts during the three to five years of the plan.

<u>Myth No. 7</u>: The bill 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.

A recent Moody's survey of the modification practices of subprime servicers constituting 80% of the total market revealed that, "most servicers had only modified *approximately 1%* of their serviced loans that experienced a reset in the months of January, April and July 2007."[13] Moreover, many of those few modifications that are being made do not comply with the objective of long-term sustainability. Indeed, most of Countrywide's foreclosure prevention activities consist of simply capitalizing arrearages, or taking the borrower's home before the foreclosure proceedings are completed.[14]

There appear to be several reasons for industry's failure to modify loans to any meaningful extent: One relates to the interplay between first and second lien holders.[15] When there is a second mortgage, the holder of the first mortgage has no incentive to provide modifications that would free up borrower resources to make payments on the second mortgage. At the same time, the holder of the second mortgage has no incentive to support an effective modification, which would likely cause it to face a 100% loss; rather, the holder of the second is better off waiting to see if a borrower can make a few payments before foreclosure.

A second concerns a mismatch of incentives between servicers and investors. As noted above, foreclosures are costly. But these costs are borne by investors, not servicers. As reported in Inside B&C Lending, "Servicers are generally dis-incented to do loan modifications because they don't get paid for them but they do get paid for foreclosures." Further, "it costs servicers between $750 and $1,000 to complete a loan modification.[16] In addition, servicers often charge fees by affiliates for appraisals and other foreclosure-related services, and so can be economically incentivized to proceed to foreclosure, even where a loan modification would be better for investors.[17]

Finally, many servicers have said that they want to modify these loans, but are afraid that this exercise of discretion will lead them to be sued by investors. [18] Thus, even where foreclosure is a worse outcome for the investors, it is the least risky for servicers.

Empowering bankruptcy judges to order these modifications will address the problems that may make it harder for servicers and lenders to modify these loans.

Myth No. 8: The bill is unnecessary because Secretary Paulson's loan modification plan will accomplish the same things that the bill would do.

Reality: The Paulson plan is entirely voluntary, and will have an impact only to the extent lenders and servicers agree to modify the loans. The Paulson plan does not address or alleviate any of the problems that have prevented lenders and servicers from modifying loans to date (see point 7 above). Moreover, it expressly excludes borrowers who have already defaulted on their loans, and so would exclude from relief several hundred thousand borrowers now on track to lose their homes in foreclosure. It also excludes all borrowers whose rates reset prior to January 1, 2008, and so excludes most loans originated prior to 2006.

Myth No. 9: Lenders and servicers are prevented from modifying these loans by securitization vehicles, and the objections of the holders of second liens.

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

<u>Myth No. 10</u>: Lenders should be given the opportunity to approve (or veto) any proposed cram-down.

<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 hardly any modifications are being made.

<u>Myth No. 11:</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 did the banks and Wall Street.

As recently reported in *The New York Times*, Klaus-Peter Muller, the CEO of Commerzbank, the major German lender, observed that, "Bankers … did not adequately understand these [subprime MBS] investments and relied too heavily on high-grade credit ratings from agencies that helped put together the products, then rated them. This ignorance of the risks extended to the top echelons of the banks." [19]

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

The average subprime borrower is not represented by a lawyer at the closing of the loan transaction, let alone a team of advisors, and so is left to rely on the mortgage broker to explain the significance of any loan terms that seem confusing, and to help assess the significance of the relevant risks. Many borrowers were deliberately misled. Most were offered products that were doomed to fail even though they qualified for better, more sustainable loans. (See point 13 below). For most borrowers, the home purchase or refinancing is the largest financial transaction they have ever entered into. Without significant prior experience or access to independent economic or investment advice, they stood little chance against the market forces that incentivized mortgage brokers and originators to push them into products they could not sustain.

<u>Myth No. 12:</u> Bankruptcy 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 currently, regulators, Congress and senior members of the administration have organized assistance to failing lenders, investment banks, and private investors, sometimes with taxpayer funding, sometimes by using governmental influence to raise private funds. The moral hazard is deemed outweighed by the need to avoid a broader crisis that would harm innocent victims, even if the solution entails helping those who are responsible for the crisis. Similar reasoning mitigates any concerns about moral hazard associated with helping families save their homes. Widespread foreclosures devastate not only the defaulting borrowers, but their innocent neighbors as well.[20] And individual borrowers' responsibility for the crisis is hardly greater than the responsibility of the brokers, lenders and investors who designed and promoted loan products for sale to borrowers who could not afford them.

For example, Treasury Secretary Paulson has encouraged the creation of a $100 billion fund to support the value of Wall Street's investment in subprime mortgage backed securities. The administration is pursuing this course notwithstanding subprime lenders having indicated that the subprime lending practices most responsible for the current crisis were largely investor-driven. This was frankly acknowledged by the chief executive of Ownit Mortgage Solutions, a state-licensed non-bank mortgage lender that filed for bankruptcy protection after investors asked it to buy back well over one hundred million dollars worth of bad loans. Ownit's chief executive, William D. Dallas "acknowledges that standards were lowered, but he placed the blame at the feet of investors and Wall Street, saying they encouraged Ownit and other supbrime lenders to make riskier loans to keep the pipeline of mortgage securities well supplied. 'The market is paying me to do a no-income-verification [i.e., "no doc"] loan more than it is paying me to do the full documentation loans,' he said. 'What would you do?'"[21]

One final irony: Bankruptcy courts have the authority to assist lenders like Ownit by modifying the debts that Ownit cannot repay. Opponents of the Durbin/Schumer bill would deny this relief to the hundreds of thousands of borrowers who are losing their homes because of investor-driven, inappropriate loans they received from Ownit and lenders like it.

Myth No. 13: The real problem is that borrowers were buying homes they could not afford.

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

The industry itself has stated that borrowers placed in subprime hybrid ARMs could have received sustainable, thirty-year fixed-rate loans, for at most 50 to 80 basis points above the teaser rate on the unsustainable exploding ARM loan they were given.[22] Worse, borrowers who were needlessly placed into "no doc" loans typically paid at least 50 to 80 basis points for the privilege. This means that borrowers placed into a no doc exploding ARM loan could have received a thirty-year fixed rate loan for less than the teaser rate on the no doc 2/28 exploding ARM loan they were given. Moreover, a recent study for the Wall Street Journal found that of the subprime loans originated in 2005 that were packaged into securities and sold to investors, fully 55% "went to people with credit scores high enough to often qualify for conventional [i.e., prime] loans with far better terms." That number rose to 61% by the end of 2006.[23] Had these borrowers received the sustainable loans they qualified for, the foreclosure crisis we now face would not have occurred. The crisis can be mitigated if the terms of these loans are modified to make them reasonably sustainable – like the loans these borrowers qualified for and should have received. Finally, the borrower would need to be able to afford the modified loan under chapter 13, which would be a market-rate interest loan, at the same term, on a loan at the full value of the house; if this is more house that the family could afford, chapter 13 would not be able to help them.

Myth No. 14: It would be unconstitutional (according to SIFMA) to apply Bankruptcy Code changes to existing loans.

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

The application of newly enacted bankruptcy legislation to existing debts has been the norm both historically, in the case of the Depression era statutes, and with modern bankruptcy laws. The Family Farmer Bankruptcy Act of 1986 is useful precedent. There, in response to the farm financial downturn of the early 1980s, Congress did for family farmers precisely what the Durbin bill would do for ordinary homeowners today: it empowered bankruptcy courts to modify farmers' secured and unsecured debts – including all mortgage debts.[24] (In fact, the Family Farmer Bankruptcy Act provided much broader relief than would the Durbin bill; it allowed for modification of mortgage loans for *all* family farmers; the Durbin bill applies only to those who satisfy a strict means test.) The Family Farmer Bankruptcy Act was applied to existing loans without any constitutional impediment.

The Durbin/Schumer bill avoids constitutional challenge because it would permit loan balances to be written down only to the value of the mortgaged property, but not below that value. As the Supreme Court unequivocally held in *Wright v. Union Central Life Ins. Co.*, 311 U.S. 273, 278 (1940), a creditor has a constitutionally protected property right up to the value of the mortgaged property. However, "[t]here is no constitutional claim of the creditor to more than that."[25] SIFMA's claim ignores this authority, and relies instead on the earlier case of *Louisville Joint Stock Land Bank v. Radford*.[26] *Radford* has no bearing here, because in *Radford*, the relevant statute provided the lender with "*much less* than the appraised value" of the property.[27] The Durbin/Schumer bill avoids this impediment entirely, and so *Radford* has no bearing here.[28] The constitutionality of the Durbin/Schumer bill is not subject to serious dispute.[29]

December 5, 2007
For further information call Eric Stein or Ellen Harnick (919-956-4400).

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

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

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

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

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

6 Securities Industry and Financial Markets Association.

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

8 Homeownership Preservation Summit Statement of Principles (May 2, 2007), http://dodd.senate.gov/index.php?q=node/3870/print (The Principles were announced by Senator Dodd, and endorsed by the Mortgage Bankers Association, CitiGroup, Chase, Litton, HSBC, Countrywide, Wells, AFSA, Option One, Freddie Mac, and Fannie Mae).

9 Id.

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

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

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

13 See also, "Modified Mortgages: Lenders Talking, Then Balking," San Francisco Chronicle, 9/13/07 ("Lenders are uniformly unwilling to make loan modifications for homeowners whose interest rates are resetting higher, said Rick Harper, director of housing at Consumer Credit Counseling Services of San Francisco, which talks to about 1,000 delinquent borrowers a month."); Jim Wasserman, "Foreclosures stack up: Frustrated borrowers who lenders to try to work things out say it's a fruitless ordeal," Sacramento Bee, 9/2/07; "Tangle of Loans Feeds Foreclosure Crisis," The Boston Globe, 7/3107 http://www.boston.com/business/personalfinance/articles/2007/07/31/tangle_of_loans_feeds_foreclosure_crisis/. Michael P. Drucker and William Fricke , Moody's Investors Service, Moody's Subprime Mortgage Servicer Survey on Loan Modifications, September 21, 2007 ("Based on the survey results, Moody's is concerned that the number of modifications that will be performed in the future by subprime servicers on loans facing reset may be lower than what will be needed to significantly mitigate losses in subprime pools backing rated securitizations.").

14 Gretchen Morgenson, Can These Mortgages Be Saved?, The New York Times (Sept. 30, 2007).

15 Somewhere between one-third to one-half of 2006 subprime borrowers took out “piggyback second” mortgages on their home at the same time as they took out their first mortgage. See Credit Suisse, Mortgage Liquidity du Jour: Underestimated No More, March 12, 2007, p. 5.

16 Inside Mortgage Finance Reprints, Subprime Debt Outstanding Falls, Servicers Pushed on Loan Mods (Nov. 16, 2007).

17 Gretchen Morgenson, Can These Mortgages Be Saved?, The New York Times (Sept. 30, 2007).

18 Harris Terry, ARM Workout Calls Trigger Fierce Debate, American Banker (Oct. 9, 2007) (“Servicers are ‘scared to death’ of being challenged by investors for making too many modifications, [Citigroup Managing Director Tim] Bolger said. ‘Talking about getting modification rates up, they're probably going to err on the conservative [side] if they think any investor is going to come after them.’”)

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

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

21 Vikas Bajaj and Christine Haughney, Tremors At the Door -- More People with Weak Credit Are Defaulting on Mortgages," The New York Times (Fri. Jan. 26, 2007) C1, C4.

22 January 25, 2007 letter from CFAL to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner, at 3.

23 David Cho and Neil Irwin , “Bush Unveils Mortgage-Relief Plan,” Washington Post (Dec. 6, 2007).
24 Jim Monke, Agricultural Credit, Congressional Research Service Agricultural Policy Briefing Book, http://www.cnie.org/nle/crsreports/briefingbooks/Agriculture/Agricultural%20Credit.htm

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

26 295 U.S. 555 (1935).

27 Radford , 295 U.S. at 591 (under the Frazier-Lemke Act, “a sale at much less than the appraised value is prescribed”) (emphasis supplied). This critical aspect of the Radford decision was highlighted by the Supreme Court in the 1982 case of U.S. v. Security Industrial Bank, 459 U.S. 70, 76 n. 7 and text (1982) (emphasis supplied). (“The Frazier-Lemke Act, which by its terms applied only retrospectively, permitted the debtor to purchase the property for less than its fair market value.” (emphasis supplied)). The Court explained that, as originally enacted, the Frazier-Lemke Act (48 Stat. 1289, 73d Cong., Sess. II., Chs. 868-69 (June 27-28, 1934) (s)(3)) gave the debtor the right to purchase the property through deferred payments made in installments over five years, paying only one percent interest. “Given the interest rate of 1%, the present value of the deferred payments was much less than the value of the property.” Security Industrial Bank, 459 U.S. at 76 n.7. Security Industrial Bank involved a creditor’s challenge to the retroactive application of the lien avoidance provision of the 1978 Bankruptcy Act (Bankruptcy Code section 522(f)(2)), which permitted debtors to avoid the liens on certain types of property. Although the Court decided the question on statutory, rather than constitutional grounds, it stated in dicta that because the provision would void the entire lien – not just the creditor's right to recover the excess over the value of the mortgaged property – thereby resulting in “a complete destruction of the property right of the secured party,” the constitutionality of its retroactive application was in “substantial doubt.”459 U.S. at 75, 78 (emphasis supplied).

28 Moreover, whatever Radford’s continued viability for propositions not in issue here, in light of SIFMA’s reliance on the case, it merits note that, while never expressly overturned, the Supreme Court itself later cited Radford as an example of Supreme Court error.

See Rogers, 96 Harv. L. Rev. at 981 n. 33 (noting "the Supreme Court itself once admitted that it may have fallen into error in Radford and corrected itself in Vinton Branch," and citing Helvering v. Griffiths, 318 U.S. 371, 400-01 & n.52 (1943), in which the court observed that, "this Court may fall into error," citing Radford as an example of error, and Wright v. Vinton Branch (in which the Court upheld the amended Frazier-Lemke Act), as the correction of that error. Both decisions were authored by Justice Louis D. Brandeis)).

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