Reducing Foreclosures without Cost to Taxpayers:

The Helping Families Save Their Homes in Bankruptcy Act of 2009 (S 61 and HR 200)

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The failure to stem the foreclosure crisis will cost the taxpayers hundreds of billions of dollars in lost tax revenues and economic decline.

Recent industry projections are that over 8 million families will lose their home to foreclosure over the next four years. That's 1 in every 6 homeowners with a mortgage. If the economy enters deep recession, the number of homes lost could exceed 10 million. With the housing sector responsible for one in eight US jobs, the flood of new foreclosures will contribute to the growing unemployment rates and further constrict consumer spending.

In addition to the obvious losses imposed on affected families and their communities, these foreclosures will severely reduce tax revenues at all levels of government. They also will diminish the value of the nearly trillion dollar investment the taxpayers have made to rescue our financial institutions and stabilize the financial system. These institutions' excessive leverage (through CDOs and credit default swaps) multiplies the losses from these foreclosures.

Foreclosures are now occurring at the rate of approximately 20,000 per week. The failure to stem these losses imposes a cost to the taxpayers every week, in lost tax revenues, in losses to the taxpayers' investments in the TARP initiative, and in deepening economic decline.

Court-supervised loan modifications will stem these losses, and impose no costs on the taxpayers.

Court-supervised loan modifications can be implemented immediately, through the existing infrastructure of the bankruptcy courts, making use of bankruptcy judges' expertise. The Bankruptcy Code amendments of 2005 resulted in a sharp reduction in the number of bankruptcy cases filed, producing excess capacity in the bankruptcy courts today. This capacity can be immediately deployed to help lenders and homeowners to restructure salvageable mortgages and avoid needless foreclosures.

Court-supervised loan modification imposes no additional costs on investors.

Court-supervised loan modification would be available only where the sole alternative is foreclosure. Foreclosure is a costly prospect for an investor, even in the best of times; today, with housing markets stalled and lenders forced to own and maintain foreclosed properties long after the foreclosure sale, it is even costlier. In normal times, lenders lose on average 28% of the loan balance in a foreclosure; in today's market, losses are roughly 50%. To avoid imposing additional losses, court-supervised loan modification is limited to loans that would otherwise end in foreclosure, and guarantees investors at least as much, and in most cases more, than they would recover in a foreclosure sale.

S 61 and HR 200 limit relief to ensure better outcomes for investors than foreclosure sale:

- Courts cannot reduce lien amount below the home's current value. In contrast, foreclosure sales typically result in a 10% discount off the home's current value. And from the discounted recovery the lender must deduct the costs of foreclosing, of maintaining the property until it is subsequently resold, and the broker fees and other costs of resale.
- Excess of loan balance over current value is recaptured as unsecured debt. Moreover, in contrast to a foreclosure sale, where the lender loses the excess of the loan balance over the foreclosure proceeds, in Chapter 13 bankruptcy, if the loan balance exceeds the home's current value, the homeowner must attempt to pay down this balance during the 3-to-5 years of the bankruptcy plan, along with other unsecured claims.
- Investors are guaranteed a rate of interest at market rate plus a premium for risk.
- Court cannot extend the loan term beyond 40 years (reduced by the number of years the homeowner has already had in the loan).
- Relief is available only for homeowners who can afford to comply with modified terms: Homeowners who cannot afford to repay the loan on the above terms cannot get relief under the Act.

Lenders have expressed concern that "rogue judges" and juries will be unduly lenient with borrowers. The risk of this is nil. These are federal judges, whose approval has generally required bipartisan Senate support and must follow well-established procedures for valuing assets or face reversal on appeal. No juries are involved in bankruptcy cases. Moreover, because it is the creditors, not the borrowers, who have the resources available to hire appraisers to value the property, in the vast majority of cases, the court defers to the creditors' appraisals.

Lenders have expressed concern that scammers could abuse the system to reduce their loan payments when they could otherwise afford to repay their loans. The Act makes this exceedingly unlikely:

- **Rigorous court supervision of all payments for five years.** The Act does *not* apply to Chapter 7 bankruptcy, where borrowers can liquidate their debts and walk away. Instead, it applies only to Chapter 13, where borrowers must <u>live under court supervision for 3 to 5 years</u>, during which time <u>all disposable income</u> is made available for relief of secured and then unsecured creditors. The borrower must comply with a repayment plan over the 3 to 5 year period, and cannot use credit cards or take on any other debt, and must have <u>all payments approved by the court</u>. Speculators would never subject themselves to so much pain in order to keep the house.
- **Credit seriously impaired for 12 years.** Bankruptcy destroys the borrower's credit rating both during the 3 to 5 years of the bankruptcy plan, and for an additional 7 years thereafter. Thus bankruptcy makes credit more

expensive or impossible to get for the next 10 to 15 years. It is not a rational choice for any homeowner who can afford her mortgage payments.

- **Principal reductions repaid with excess income:** Bankruptcy is a particularly irrational choice for high-income borrowers if they can afford to pay their mortgage, because the written-down portion of the mortgage balance still has to be paid back out of income earned over the next 3 to 5 years to the extent available after repaying secured debts.
- **Modifications offer lower payments:** Moreover, some lenders now offer payment terms more favorable than those allowed under the Act, such as interest rates of 3% or less. Any borrower should prefer such modifications to relief in bankruptcy. Court-supervised loan modifications are just a backstop for those borrowers whose lenders cannot or will not offer such terms.
- **Good faith required:** Finally, the law expressly requires that the borrower establish her "good faith" – lenders who believe the borrower is "scamming" can challenge the borrower's right to relief.

For these reasons, it is highly unlikely that anyone who can afford their current mortgage would choose to proceed under the Act. Even among those who cannot afford their current mortgage and are faced with foreclosure, only those who are truly committed to holding onto their home will find relief under the Act preferable to foreclosure, or to walking away. By creating an option for those homeowners who would otherwise walk away or be foreclosed, court-supervised loan modifications will return more to lenders than the likely alternatives.