

THE 12TH ANNUAL GREAT DEBATES

**RESOLVED: CONGRESS SHOULD AMEND THE
BANKRUPTCY CODE TO ALLOW
MODIFICATION VIA A CHAPTER 13 PLAN OF
THE FIRST MORTGAGE ON THE CONSUMER
DEBTOR'S PRIMARY RESIDENCE**

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BEFORE THE SUBCOMMITTEE ON ADMINISTRATIVE AND COMMERCIAL
LAW HOUSE OF REPRESENTATIVES JUDICIARY COMMITTEE

“Straightening Out the Mortgage Mess: How Can We Protect Home Ownership and
Provide Relief to Consumers in Financial Distress”

SEPTEMBER 25, 2007

Chairwoman Sanchez, Ranking Member Cannon, and members of the Subcommittee, we thank you for holding this hearing and for inviting us to testify today regarding ways in which Chapter 13 can be improved to help homeowners avoid foreclosure. I testify here today on behalf of the low income clients of the National Consumer Law Center,¹ as well as on behalf of the National Association of Consumer Bankruptcy Attorneys.² The clients and constituencies of these groups collectively encompass a broad range of families and households who have been affected by the current foreclosure crisis.

A fundamental goal of chapter 13 has always been to provide an opportunity for consumers to repay their obligations. Unfortunately this has become exceedingly

¹ The National Consumer Law Center, Inc. (NCLC) is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of sixteen practice treatises and annual supplements on consumer credit laws and bankruptcy, including Consumer Bankruptcy Law and Practice (8th ed. 2006) Truth In Lending, (5th ed. 2003) and Cost of Credit: Regulation, Preemption, and Industry Abuses (3d ed. 2005) and Foreclosures (2d ed. 2007), as well as bimonthly newsletters on a range of topics related to consumer credit and bankruptcy issues. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low income people, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to deal predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of the all federal laws affecting consumer credit since the 1970s, and regularly provide extensive comments to the federal agencies on the regulations under these laws.

² The National Association of Consumer Bankruptcy Attorneys (NACBA) is the only national organization dedicated to serving the needs of consumer bankruptcy attorneys and protecting the rights of consumer debtors in bankruptcy. NACBA has more than 2,500 members located in all 50 states and Puerto Rico. NACBA has been actively involved in promoting reasonable and fair bankruptcy legislation since it was founded in 1992.

difficult in recent years because our bankruptcy laws have not kept pace with the enormous changes in the mortgage marketplace that have occurred since those laws were first enacted. New non-traditional loan products have challenged the ability of hard-working families who have fallen on difficult times to effectively use Chapter 13 to save their homes.

I. Saving Homes in Chapter 13.

Since the enactment of the Bankruptcy Code in 1978, homeowners facing foreclosure have often turned to Chapter 13 as a last resort for saving their homes. One of the most significant provisions in Chapter 13 is the right to cure defaults on loans, even if the lender has called the loan due (“accelerated”) before the bankruptcy is filed and even if such right to cure does not exist under state law or the consumer’s loan contract. For long-term loans a consumer has fallen behind on and is not able to pay-off in full within the three to five years of a Chapter 13 plan, such as a home mortgage, section 1322(b)(5) permits the homeowner to cure the default within a reasonable time by making payments on the arrears together with the ongoing payments during the plan.

The cure right in Chapter 13 currently serves an important role because of the limitations of voluntary workout options. Some mortgage servicers are not permitted by the investors of the mortgage loans to approve repayment or forbearance plans longer than six to twelve months, which is too short a period for many borrowers to affordably cure a default. Those that do offer longer plans often impose restrictions and paperwork burdens that homeowners may not be able to satisfy in the frenzy of the foreclosure process. Other servicers have simply been too aggressive in pursuing foreclosure without offering workout options or may be the cause of the homeowner’s foreclosure problem

because of negligent servicing.³ Chapter 13 makes long-term repayment plans available when mortgage lenders and their servicers have not been willing to negotiate reasonable similar plans.

The cure provisions in current law work best when homeowners have had a temporary loss of income (unemployment, illness, divorce, natural disaster, and so forth) which caused the default, and they now have sufficient income at the time the Chapter 13 case is filed to pay during the plan the arrears which have accumulated and the regular monthly payment. For this model to be successful, it goes without saying that the mortgage loan must have been affordable for the homeowner when the loan was made. Likewise the homeowner must be able to prospectively afford the regular monthly payments, taking into consideration any changes in terms permitted under the loan documents that would affect the monthly payment, during the three to five years of the plan.

The following example demonstrates how the current Chapter 13 cure provisions can help a homeowner avoid foreclosure in comparison to a typical workout plan.

**Comparison between Workout and
Current Chapter 13 Bankruptcy Plan**

The borrowers have a fixed-rate mortgage they obtained five years ago (\$185,000 principal). The interest rate is 7.50%, with monthly principal and interest payments of \$1,292. Due to unemployment of one spouse last year for a period of six months, they fell behind on the mortgage and other bills. They now have mortgage arrears and foreclosure fees of \$14,000. They are currently both employed, though at about 85% of their prior income. Their monthly gross income is \$4,500. Despite efforts to negotiate a workout plan modifying the mortgage, their mortgage servicer has only agreed to a

³ See Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 *Housing Policy Debate* 753, 756–58 (2004).

12-month forbearance agreement.

Status Under 12-month Workout Agreement

\$ 14,000	total arrears
\$ 1,517	ongoing monthly mortgage payment (including taxes and insurance)
\$ 1,167	payment on arrears (assuming cure over 12 mos.)
\$ 2,684	monthly to keep current and cure the arrears

The couple can scrape together enough to make the first monthly payment but know that they will soon default on the workout agreement as the monthly payment represents 57% of their gross monthly income.

Result After Addressing Problem in Chapter 13 Bankruptcy

\$ 1,517	ongoing monthly mortgage payment (including taxes and insurance)
\$ 389	payment on arrears (assuming cure over 36 mos.)
\$ 46	interest on arrears payment each month (assuming required by mortgage documents)
\$ 44	trustee's fee each month (assuming plan permits regular monthly payments to be made directly to servicer and not considering other administrative costs, such as attorney's fees, or other payments under plan)
\$ 1,966	monthly to keep current and cure the arrears for 36 month plan (TOTAL)

With this chapter 13 plan, the couple will pay approximately \$718 less per month than a workout to cure the delinquency on the mortgage. This total housing payment during the plan will represent 44% of their gross income. The plan under current bankruptcy law will be difficult for them but is much more affordable than the workout.

II. Problems with Cure Provisions and High Cost Loans.

When Chapter 13 was enacted in 1978, a much different mortgage market existed than does today. The typical American pursuing the homeownership dream would have obtained a thirty-year mortgage with a fixed interest rate and monthly payment. This

loan would have been made by a bank using accepted underwriting guidelines which considered the homeowner's ability to repay the loan.⁴ Risks to the lender and the homeowner were kept in check by ensuring that the loan amount did not exceed an appropriate loan-to-value ratio, typically no more than 80% LTV. The loan would likely have been kept in the bank's own portfolio of loans and not assigned to another entity, and it would have been serviced by that same bank.⁵ Although a time of record-high interest rates, borrowers generally obtained loans within a small range of prevailing market rates and a subprime market for home borrowers was virtually nonexistent.

The 1990s saw the enormous growth in the use of asset-based securities to fund an ever increasing supply of mortgage credit.⁶ Creating capital flow in this way,

⁴ In considering potential borrower's ability to repay, lenders have traditionally considered the borrower's housing expense ratio and debt-to-income ratio. In the conventional mortgage market, lenders generally require that the borrower's housing expense ratio, which considers the principal, interest, taxes and insurance (PITI) on the loan in comparison to income, be less than 28%. Such lenders also require that the debt-to-income ratio, which is the PITI plus the sum of other recurring debt such as auto loans and credit card obligations in comparison to income, be less than 36%. In the case of government insured loan programs intended to promote home ownership by low and moderate income borrowers, different ratios may apply. For instance, lenders originating FHA loans generally have used qualifying benchmarks of 29% as a monthly housing expense ratio and 41% for a debt-to-income ratio. A similar 41% debt-to-income ratio has been used for VA mortgages.

⁵ In 1990, Congress imposed new requirements on servicers of federally related mortgage loans through amendments to RESPA. *See* Cranston-Gonzalez National Affordable Housing Act, Pub. L. No. 101-625, 104 Stat. 4079 (1990) (codified at 12 U.S.C. § 2605). These amendments followed reports of a substantial number of consumer complaints about mortgage servicing problems particularly related to changes in the industry involving the transfer of servicing. *See* U.S. Gen. Accounting Office, Report, Home Ownership--Mortgage Servicing Transfers Are Increasing and Causing Borrower Concern (1989).

⁶ The Asset-Back Securities Market: The Effects of Weakened Consumer Loan Quality, FDIC Regional Outlook, Second Quarter, 1997.

subprime mortgage lending took off during this period. In 1994, approximately \$10 billion worth of home equity loans were securitized.⁷ By the end of 1997, the volume had leaped to about \$90 billion, and by 2002, more than \$134 billion in subprime mortgage-backed securities were issued.⁸ Homeowners were encouraged (as they are today), often through aggressive marketing campaigns that deceptively tout lower payments and tax benefits, to use their home equity to consolidate non-mortgage debts.

The range of interest rates charged to subprime borrowers during this period was very broad, especially compared to the range in the conventional mortgage market. The rate range for subprime loans in the mid- to late-1990s, often on fixed-rate loans, was as much as 17 percentage points, as compared to the conventional market's range of no more than 2 percentage points.⁹ I have reviewed loans from this period in which some of the most abusive subprime lenders made loans with APRs from 15% to 20%. Practices such as charging high points and fees and flipping loans through multiple refinancings often stripped homeowners of their most valuable asset, the equity in their homes.

Thus, even before the advent of today's more dangerous "exotic" subprime mortgages, Chapter 13 was becoming less viable as a safety net for the growing numbers

⁷ Daniel Immergluck & Marti Wiles, *Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development*, at 12, Woodstock Institute (Nov. 1999).

⁸ Inside Mortgage Finance Publications, *The 2003 Mortgage Market Statistical Annual* (2003); Glenn B. Canner, Thomas A. Durkin & Charles A. Luckett, *Recent Developments in Home Equity Lending*, 84 Fed. Res. Bull. 241, 250 (April 1998).

⁹ See Cathy Lesser Mansfield, *The Road to Subprime "HEL" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. Rev. 473 (Spring 2000)(based on loan data for over 1 million loans securitized between 1995 and 1999).

of homeowners in foreclosure. In my experience working with housing counselors and bankruptcy attorneys who assist homeowners facing foreclosure during this period, a common concern I would hear was that options for curing a mortgage default, whether under a Chapter 13 plan or workout agreement, were becoming increasingly incapable of helping homeowners with high-cost loans, especially those made without proper consideration of the homeowner's ability to pay.

Not surprisingly, the ability of homeowners in the above example to cure their mortgage default would be seriously undermined if they had a higher interest rate loan:

**Workout and Current Chapter 13 Plan
with High-Cost Loan**

Assume that the borrowers have a fixed-rate subprime mortgage with an interest rate of 10.50%. Their monthly principal and interest payment is \$1,692. Once again, they have not been able to negotiate a reasonable workout agreement with the lender. Since the loan was made based on an inflated appraisal the originating lender had obtained, and the loan includes a prepayment penalty, the borrowers have also not been able to refinance their loan.

Current Status Under 12-month Workout Agreement

\$ 14,000	total arrears
\$ 1,917	ongoing monthly mortgage payment (including taxes and insurance)
\$ 1,167	payment on arrears (assuming cure over 12 mos.)
\$ 3,084	monthly to keep current and cure the arrears

The monthly payment under the workout agreement represents 69% of their gross monthly income and is completely unaffordable.

Result After Addressing Problem in Chapter 13 Bankruptcy

\$ 1,917	ongoing monthly mortgage payment (including taxes and insurance)
\$ 389	payment on arrears (assuming cure over 36 mos.)
\$ 46	interest on arrears payment each month (assuming required by mortgage documents)

\$	44	trustee’s fee each month (assuming plan permits regular monthly payments to be made directly to servicer and not considering other administrative costs, such as attorney’s fees, or other payments under plan)
\$	2,396	monthly to keep current and cure the arrears for 36 month plan (TOTAL)

This total housing payment during the plan will represent 53% of their gross income. The plan under current bankruptcy law will likely fail.

III. Specific Limitations under Current Law.

The right to cure a mortgage default under section 1322(b)(5) has several significant limitations. Taken alone, this provision does not permit the homeowner to change the amount and timing of installment payments, the interest rate, and other similar terms of the mortgage. It also does not give the homeowner the right to reduce the mortgage creditor’s lien to the value of the collateral as compared with the outstanding balance owed on the secured debt.

Other provisions of the Bankruptcy Code do however provide the right to “modify” secured claims to debtors in Chapter 11, 12 and 13 cases.¹⁰ This ability to modify secured claims is possible for virtually every type of debt except for the mortgage on the borrower’s primary residence.¹¹ This well-entrenched principle of bankruptcy law generally permitting modification of secured claims and the exception for home mortgages in Chapter 13 cases can be summarized as follows:

¹⁰ See 11 U.S.C. §§ 1123(b)(5), 1222(b)(2), 1322(b)(2).

¹¹ Chapter 12 “family farmers” are permitted to modify home mortgages.

Bifurcation and Modification. In determining the allowed amount of a creditor’s secured claim, section 506(a) of the Code provides that the claim is secured only to the extent of the value of the collateral and that any amount of the claim in excess of the collateral will be treated as an unsecured claim. This “bifurcation” or “cram down” of the creditor’s claim means that the unsecured portion of the claim will be paid with other unsecured claims the debtor may have, based on the plan’s treatment of unsecured claims. In addition to this claim bifurcation, section 1322(b)(2) permits the plan to modify the rights of holders of secured claims, such as by extending the payment term or adjusting the interest rate and installment payment amount under the underlying contract.

Cram Down Limitation. Although section 1322(b)(2) generally authorizes the modification of allowed secured claims in a Chapter 13 plan, an exception preventing modification is provided for those claims secured “*only by a security interest in real property that is the debtor's principal residence.*” While four Circuit Courts had found that this language in the 1978 Bankruptcy Code did not prevent a cram down of a mortgage lender’s lien when considered with section 506(a),¹² the Supreme Court in *Nobleman v. American Savings Bank*, 113 S.Ct. 2106 (1993) held that modification of home mortgage lender’s rights, including the cram down of its lien, is impermissible.

¹² *In re Bellamy*, 962 F.2d 176 (2d Cir. 1992); *In re Hart*, 923 F.2d 1410 (10th Cir. 1991); *Wilson v. Commonwealth Mortgage Corp.*, 895 F.2d 123 (3d Cir. 1990); *In re Hougland*, 886 F.2d 1182 (9th Cir. 1989).

While there is scant legislative history directly addressing the anti-modification clause in section 1322(b)(2),¹³ it may have been intended to promote the flow of capital into the residential mortgage market at a time when such lending was experiencing pressures from record-high interest rates. Congress enacted other laws at approximately the same time, for example, to assist lenders in making market-rate loans despite state usury caps.¹⁴

As mentioned earlier, however, efforts to expand the availability of credit at that time were soon replaced by serious concerns about the explosive growth in the residential mortgage lending and abusive lending practices. In 1994, Congress passed the Home Ownership and Equity Protection Act (HOEPA) to prevent some predatory lending practices after reviewing compelling testimony and evidence presented during a number of hearings that occurred in 1993 and 1994. This law created a special class of regulated closed-end loans made at high rates or with excessive costs and fees.¹⁵ It was hoped that HOEPA would reverse the trend of the prior decade, which had made abusive home equity lending a growth industry and contributed to the loss of equity and homes for many Americans.

¹³ *See Grubbs v. Houston First American Savings Assn.*, 730 F.2d 236 (5th Cir. 1984).

¹⁴ Depository Institution Deregulation and Monetary Control Act (“DIDMCA”), 12 Pub. L. No. 960221, 94 Stat. 161 (1980), and the Alternative Mortgage Transaction Parity Act (“AMTPA”) (1982), 12 U.S.C. §3801. The legislative history for these laws suggests that Congress was concerned about the solvency of the savings and loan industry, as well as concerns about the general viability of consumer lending. *See* Cathy L. Mansfield, *The Road to Subprime “Hel” was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C.L. Rev. 473, 495 (2000).

¹⁵ 15 U.S.C. § 1602(AA)(1)(B).

Regulators had also begun to express alarm at the practice of making high loan-to-value (LTV) mortgages.¹⁶ In issuing a warning to lenders in 1998 about the risks involved with such loans in comparison to traditional mortgage loans, the Office of Thrift Supervision described the practice as follows:

An increasing number of lenders are aggressively marketing home equity and debt consolidation loans, where the loans, combined with any senior mortgages, are near or exceed the value of the security property.... Until recently, the high LTV home mortgage market was dominated by mortgage brokers and other less regulated lenders. Consumer groups and some members of Congress have expressed concern over the growth of these loans, and the mass marketing tactics used by some lenders.¹⁷

Unfortunately, as is apparent from the current foreclosure crisis, HOEPA and limited regulatory efforts have not stopped abusive lending practices. Indeed, the problem has only grown worse. Bankruptcy attorneys, legal services offices, housing counselors, and attorneys who assist homeowners in foreclosure now routinely see clients with mortgages whose terms are so oppressive that traditional tools for dealing with foreclosures such as workout agreements and Chapter 13 cure plans are no longer effective. Many of these non-traditional loans which predominate in the subprime market take the form of adjustable rate mortgages (ARMs), such as payment-option ARMs or the more common the 2/28 hybrid ARMs. These loans have an initial short-term fixed rate for the first twenty-four months that is followed by annual or six-month rate adjustments

¹⁶ In 1995, home equity lenders had made \$1 billion in such loans. By 1997, the amount of these loans had increased to \$8 billion. High-Loan-To-Value Lending, General Accounting Office, GAO/GGD-98-169, August, 13, 1998; “Paines's High LTV Specialist is Out”, National Mortgage News, October 27, 1997, 1997 WL 12863567.

¹⁷ Thrift Bulletin TB 72, Office of Thrift Supervision, Department of the Treasury, August 27, 1998, at 1.

for the balance of the loan term. By mid-year 2006, hybrid ARMs made up 81 percent of securitized subprime loans.¹⁸

Almost all 2/28 loans include terms by which the interest rate that applies for the initial fixed period of the loan is the *lowest* rate that can ever be charged. In other words, the interest rate can climb, but even if the index upon which the interest rate is based drops, the interest rate charged the borrower can never go down. Many of these loans have an initial rate set lower than the fully indexed rate when the loan was made, often referred to a “teaser” rate.

The interest rates and payments can rise significantly on these loans. Almost all of the subprime ARM loans I have reviewed are based on the six month LIBOR index. During the past eight years, the six month LIBOR index has had peaks and valleys from a low of 1.12% (in June, 2003) to a high of 7.06% (in May, 2000).¹⁹ The first rate change on these loans is generally in the 24th month, with the change payment rate occurring in the 25th month. Subsequent rate changes occur every six months thereafter. Typically, there is a cap on the increase in the first adjustment of 200 basis points, and caps on subsequent adjustments of 100 basis points.

¹⁸ Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs, Fitch Ratings Credit Policy (August 21, 2006).

¹⁹ HSH Associates Financial Publishers, <http://www.hsh.com/indices/fnmalibor-2007.html>.

Consider the following changes in interest based on the six month LIBOR history and the effect on the payments on a loan for \$185,000 made in December 2002.²⁰ Note that this example is based on a loan *without* a teaser rate, so the payment shock is *less* than many borrowers are experiencing.

Months	LIBOR rate	LIBOR + index	Payment
1-24	1.38% (Nov. 2004)	7.38%	\$1,278.39
25-30	2.63% (May 2004)	8.63%	\$1,433.40
31-36	3.51% (Nov. 2005)	9.51%	\$1,545.70
37-42	4.58% (May 2006)	10.58%, but capped at 10.51%	\$1,674.80
43-48	5.32% (Nov. 2006)	11.32%	\$1,781.14
49-54	5.35% (May 2007)	11.35%	\$1,785.08

Such rate increases and changing payment amounts can cause serious affordability problems for many homeowners who do not have the flexibility to make adjustments to their household expenses. In a Chapter 13 plan, there is even less flexibility because the consumer's disposable income based on his or her expenses is fixed at the time of confirmation for the duration of the plan, and must be paid to the trustee to satisfy creditors' claims and other obligations under the plan.²¹ In effect, every dollar the family earns is accounted for and whatever small cushion the family has in

²⁰ This example assumes a \$185,000 principal amount in a standard sub-prime 2/28 adjustable loan, with an initial rate based on the LIBOR rate plus a margin of 6, and applicable rate caps.

²¹ While modification of the plan may be possible, doing so every six months would be impractical and costly, and other requirements the debtor must satisfy under § 1322 and § 1325 may prohibit it.

their budget will cover only minimal additional expenses. A change in mortgage payment of over \$500 per month (or \$700 or more for loans with initial teaser rates) can be more than an average family spends on their entire food budget.

Bankruptcy courts are currently powerless to defer or change these payment increases as that would be a modification of the mortgage not permitted under section 1322(b)(2). Quite simply, while consumers outside of bankruptcy have great difficulty absorbing the payment shock from ARMs, the problems are compounded in Chapter 13 resulting in almost certain plan failure.

Using the examples above, it becomes obvious that an ARM, even with modest reset adjustments and no initial teaser rate, will make it impossible for the borrowers to propose a feasible Chapter 13 plan.

Current Chapter 13 Plan with ARM

Assume that the borrowers now have a subprime 2/28 ARM mortgage with an initial interest rate of 7.38%. Their monthly principal and interest payment is \$1,278 for the first 24 months. The borrowers file Chapter 13 bankruptcy in the eighteenth month to stop a foreclosure sale. To cure the arrears and maintain current payments based on rate adjustments, they would need to make the following payments using the historical example above. This assumes that taxes and insurance will remain constant during the plan.

Result Addressing Problem in Chapter 13 Bankruptcy

\$	389	payment on arrears (assuming cure over 36 mos.)
\$	46	interest on arrears payment each month (assuming required by mortgage documents)
\$	44	trustee's fee each month (assuming plan permits regular monthly payments to be made directly to servicer and not considering other administrative costs, such as attorney's fees, or other payments under plan)
\$	1,982	monthly to keep current and cure arrears for first six months of plan (including taxes and insurance)
\$	2,137	monthly to keep current and cure arrears for months 7-12

\$ 2,250	of plan monthly to keep current and cure arrears for months 13 - 18 of plan
\$ 2,379	monthly to keep current and cure arrears for months 19 - 24 of plan
\$ 2,485	monthly to keep current and cure arrears for months 25 - 30 of plan
\$ 2,489	monthly to keep current and cure arrears for months 31 - 36 of plan

By the third year of the plan, the total housing payment will represent 55% of the couple's gross income. The monthly payment in year three will also be \$986 more than what the borrowers were paying for their total housing expense (\$1503) before filing bankruptcy.

IV. Proposals for Change.

To help families save their homes from foreclosure, we propose an amendment to the Bankruptcy Code to give bankruptcy courts the same authority to modify home mortgage loans as they have for virtually every other kind of secured and unsecured debt. Our recommendation does not attempt to revisit the changes to the Code made by the 2005 amendments. Rather, it addresses the limitations in current Chapter 13 based on the special protection afforded to home mortgage lenders by the 1978 Bankruptcy Code. With respect to this issue, we suggest the following changes:

Repeal Special Protection for Home Mortgages in Section 1322. This change will permit some borrowers who were provided unaffordable loans to lower their monthly payment to an amount they can pay and to keep that payment amount permanent by converting their ARM to a fixed rate mortgage. It will help borrowers blunt the devastating effect of future rate adjustments which were often not properly considered by lenders when assessing ability to repay at the time the loans were made. For high LTV

loans made based on the lender's careless underwriting decisions and inflated or fraudulent appraisals, and which have prevented borrowers from refinancing out of unaffordable loans, borrowers who file Chapter 13 to deal with a foreclosure would have the right to reduce the mortgage claim to the value of the property. This change will extend to low- and middle-income consumers the same protections that are afforded family farmers, corporations, and wealthy individuals who own investment properties.

Amend Section 1322 to Permit Reamortization. Permitting modification by itself does not fully address the problem based on the current structure of the Code. This is because modified secured claims in Chapter 13 must be paid in full during the three to five years of the plan. For home mortgages with large outstanding balances, this is impossible for most borrowers and they would not benefit from the change permitting modification. To address this, we propose a solution which Congress has already provided for family farmers in Chapter 12 cases. Section 1322 should be amended to include a provision similar to section 1222(b)(9) which permits the borrower's loan to be reamortized based on the modified terms and paid over a period beyond the plan term, generally up to thirty years.

Based on the above example, these changes would permit the homeowners to save their home from foreclosure by obtaining an affordable reamortized loan and still return to the lender the value of its lien with reasonable interest.

Proposed Chapter 13 Plan with Mortgage Modification

The borrowers propose to extend the mortgage term, so that it has another 360 months to run, to reduce the interest rate going forward at a fixed rate of 8.5%, and to reduce the current loan balance to \$165,000 based on the fair market value of the property.

\$165,000	current loan balance
360	month term
8.5%	interest
\$ 1,494	ongoing monthly mortgage payment (including taxes and insurance)
\$ 60	trustee's fee each month (assuming mortgage payments are made by the trustee under the plan and based on a reduced commission of 4%)
\$ 1,554	monthly to keep current for 3 year duration of plan
\$ 1,494	monthly to keep current for remaining 27 years of mortgage term (subject to adjustment only for taxes and insurance)

These changes allow debtors to repay their mortgages on fair and reasonable terms that fully protect the mortgage holder. Like any secured creditor, the mortgage holder would be entitled to adequate protection of its property interest during the Chapter 13 case. Lenders will receive at least as much as they would realize if the property were foreclosed, even if there is a cram down based on the property's value. For lenders who make high LTV or no equity loans based on risky underwriting practices, they can hardly expect a different outcome since they did not take a security interest in the consumer's home based on its true economic value.²²

²² This was clearly recognized by the Office of Thrift Supervision in its 1998 announcement to lenders:

When the combined LTV exceeds 90 percent, however, the proceeds from the sale of the security property will likely not be sufficient to fully liquidate the

These changes will also provide borrowers with an opportunity for loan modifications similar to those which many lenders have said they are willing to make. However, for many homeowners, these workout offers have been illusory. Some of the pooling and servicing agreements of securitized loans which control the mortgage servicer's loss mitigation practices place restrictions on the servicer's ability to offer loan modifications.²³ Homeowners are often unable to get through to someone in the servicer's operation with authority to negotiate such deals, or may find out at the last minute just before a scheduled foreclosure sale that the modification has not been approved or that some additional paperwork requirement is needed. Because of these practices, bankruptcy attorneys and other attorneys who assist homeowners are often contacted just days before a scheduled sale when servicers may no longer be willing to negotiate reasonable workouts.

Incorporating this modification right in Chapter 13 will provide needed assistance to families who for one of many possible reasons have not been able to obtain workouts which include loan modifications. It will also provide an incentive for many lenders and servicers to work with homeowners and their representatives early in the foreclosure process and to make good on their claims that loss mitigation options are available. In

home equity loan and any outstanding senior liens. The portion of such loans that exceeds 100% of value is effectively unsecured, ... High LTV lenders state that they recognize that these loans are more or less unsecured, and it is not likely they will benefit from foreclosure.

Thrift Bulletin TB 72, Office of Thrift Supervision, Department of the Treasury, August 27, 1998, at 1.

²³ In one review of such agreements, it was found that one-third of the agreements included a limit on the percent of loans that may be modified, typically requiring that no more than 5 percent of the loans in the original loan pool may be modified. See "The Day After Tomorrow: Payment Shock and Loan Modifications," CreditSuisse Fixed Income Research, April 5, 2007.

my experience, consumers are never eager to file Chapter 13, so a change that encourages the availability of reasonable modifications will help many homeowners actually avoid filing Chapter 13 bankruptcy.

Suggestions that these changes will deter investment in mortgage-backed securities or drive up costs to homeowners are unfounded. Simply put, the number of residential mortgages that would realistically be subject to cram down is so insignificant in comparison to the total mortgages made that such an impact is highly unlikely. As mentioned, these changes could cause fewer Chapter 13s to be filed. But even if current filings remain constant or even modestly increase, the number of potential Chapter 13 filings will be small. Given the difficulties of living under a strict court-supervised plan in which all of disposable income must be dedicated for a three to five year period, only homeowners who have no other option for dealing with foreclosure can reasonably be expected to seek a loan modification in Chapter 13. And consumers in Chapter 13 cases do not receive the benefit of any cram down of secured debts until they have completed their plans at the end of a three- to five-year period.

While there are other changes to Chapter 13 not discussed here which we would welcome the opportunity to discuss with the Subcommittee, we also urge consideration of the following:

Lender Fees During Bankruptcy. Another necessary change is a provision to control the enormous problem of mortgage creditors adding unauthorized or excessive fees to the accounts of debtors who are in Chapter 13. Many of these debtors emerge from a Chapter 13 case after three to five years of struggling to cure an arrearage only to have the lender begin foreclosure anew based on claims of unpaid fees for such items as

attorney's fees, property inspections, broker price opinions, and other charges allegedly incurred during the Chapter 13 case. These fees and charges are added to mortgage accounts without notice to the borrower, trustee or bankruptcy court while the case is pending. Many bankruptcy courts have decried these abuses, but usually they go unremedied because the bankruptcy case is over and the debtor has no money to litigate about them. A provision to remedy this problem could provide that all fees and charges based upon occurrences during the pendency of a chapter 13 case must be disclosed to the debtor and trustee, who may then have an opportunity to file an objection with the court.

Prebankruptcy Credit Counseling for Consumers in Foreclosure. The requirement of a prebankruptcy credit counseling briefing added by the 2005 Bankruptcy Code amendments often causes a delay that borrowers facing bankruptcy cannot afford, and could make these proposed amendments meaningless for borrowers who need them most. Several courts have also held that a pending foreclosure is not a sufficient "exigent circumstance" which would merit a deferral of the counseling under the procedure Congress adopted in the 2005 law to presumably deal with emergencies such as foreclosures. Credit counselors deal primarily with unsecured debts and generally do not assist borrowers with foreclosures. The services they offer, debt management plans and budget advice, cannot stop a foreclosure. Thus, the requirement should be eliminated for debtors who are responding to a scheduled foreclosure. Of course, these debtors would remain subject to the requirements of section 1328(g) that they complete an instructional course in personal financial management.

Mandatory Arbitration Clauses. Mandatory arbitration clauses are found in many consumer contracts, including home mortgages. The enforcement of these arbitration agreements under the Federal Arbitration Act is often in direct conflict with the goal of bankruptcy jurisdiction to have one centralized forum for the prompt resolution of disputes affecting the bankruptcy estate. In order to protect homeowners, both Fannie Mae and Freddie Mac have prohibited the use of arbitration clauses in home loans they purchase. This conflict between the Bankruptcy Code and the Federal Arbitration Act has led most courts to hold that, at least as to core proceedings such as claims and defenses raised as objections to a creditor's proof of claim, a bankruptcy judge may refuse to enforce an arbitration agreement and may stay any pending arbitration proceedings. Unfortunately, two Circuit Courts have recently held that the bankruptcy courts in those cases did not have discretion to decide claims asserted by the debtors in core proceedings.²⁴ An amendment which clarifies that bankruptcy courts may properly exercise discretion in core proceedings to deny a referral to arbitration will assist borrowers who may need to challenge an abusive mortgage loan as part of the bankruptcy claims process.

²⁴ *In re Mintze*, 434 F.3d 222 (3d Cir. 2006); *MBNA America Bank, N.A. v. Hill*, 436 F.3d 104 (2d Cir. 2006).

John Rao is an attorney with the National Consumer Law Center, Inc. Mr. Rao focuses on consumer credit and bankruptcy issues and has served as a panelist and instructor at numerous bankruptcy and consumer law trainings and conferences. He is a contributing author and editor of NCLC's *Consumer Bankruptcy Law and Practice*; co-author of NCLC's *Bankruptcy Basics*; *Foreclosures*; and *Guide to Surviving Debt*; and contributing author to NCLC's *Student Loan Law*; *Stop Predatory Lending*; and NCLC Reports: *Bankruptcy and Foreclosures Edition*. He is also a contributing author to *Collier on Bankruptcy* and the *Collier Bankruptcy Practice Guide*. Mr. Rao serves as a member of the federal Judicial Conference Advisory Committee on Bankruptcy Rules, appointed by Chief Justice John Roberts in 2006. He is a member of the board of directors for the National Association of Consumer Bankruptcy Attorneys and the American Bankruptcy Institute. Before coming to NCLC, Mr. Rao served as a managing attorney of Rhode Island Legal Services and headed the program's Consumer Unit. His practice included a broad range of cases dealing with consumer, bankruptcy and utility issues, requiring representation of low-income clients before federal, state and bankruptcy courts, and before administrative agencies. Mr. Rao is a graduate of Boston University and received his J.D. in 1982 from the University of California (Hastings).

110TH CONGRESS
1ST SESSION

H. R. 3609

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

IN THE HOUSE OF REPRESENTATIVES

SEPTEMBER 20, 2007

Mr. MILLER of North Carolina (for himself, Ms. LINDA T. SÁNCHEZ of California, Mr. FRANK of Massachusetts, Mrs. MALONEY of New York, and Mr. WATT) introduced the following bill; which was referred to the Committee on the Judiciary

A BILL

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

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE.**

4 This Act may be cited as the “Emergency Home
5 Ownership and Mortgage Equity Protection Act of 2007”.

6 **SEC. 2. DETERMINATION OF SECURED STATUS.**

7 Section 506(b) of title 11, the United States Code,
8 is amended by adding at the end the following:

1 “While a case is pending, no fee, costs, or charges may
 2 be added to a debt that is provided for in a chapter 13
 3 plan and is secured by the debtor’s principal residence un-
 4 less the holder of the secured claim gives timely notice of
 5 such fee, costs, or charge to the debtor and to the trust-
 6 ee.”.

7 **SEC. 3. LIMITATION OF 1978 EXEMPTION THAT PREVENTS**
 8 **FEDERAL BANKRUPTCY COURTS FROM MAK-**
 9 **ING MODIFICATIONS TO THE TERMS OF A**
 10 **MORTGAGE ON A DEBTOR’S PRINCIPAL RESI-**
 11 **DENCE.**

12 Section 1322(b)(2) of title 11, United States Code,
 13 is amended by striking “, other than a claim secured only
 14 by a security interest in real property that is the debtor’s
 15 principal residence,”.

16 **SEC. 4. MODIFICATION OF CLAIMS SECURED BY DEBTOR’S**
 17 **PRINCIPAL RESIDENCE.**

18 (a) CONTENTS OF PLAN.—Section 1322(b) of title
 19 11, the United States Code, is amended—

20 (1) in paragraph (10) by striking “and” at the
 21 end,

22 (2) by redesignating paragraph (11) as para-
 23 graph (12), and

24 (3) by inserting after paragraph (10) the fol-
 25 lowing:

1 “(11) provide for payment of allowed claims se-
2 cured by the debtor’s principal residence consistent
3 with section 1325(a)(5), over a period exceeding the
4 period permitted under section 1322(d); and”.

5 (b) CONFIRMATION OF PLAN.—Section 1325(b)(5) of
6 title 11, the United States Code, is amended by inserting
7 “except as otherwise provided in section 1322(b),” after
8 “(5)”.

9 **SEC. 5. ELIMINATION OF CREDIT COUNSELING REQUIRE-**
10 **MENT FOR CHAPTER 13 DEBTORS FACING**
11 **FORECLOSURE.**

12 Section 109(h) of title 11, United States Code, is
13 amended by adding at the end the following:

14 “(5) The requirements of paragraph (1) shall not
15 apply with respect to a debtor in a case under chapter
16 13 who submits to the court a certification that the holder
17 of a claim secured by the debtor’s principal residence has
18 initiated a judicial or non-judicial foreclosure on the debt-
19 or’s principal residence.”.

20 **SEC. 6. CONFIRMATION OF PLAN.**

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

23 (1) in paragraph (8) by striking “and” at the
24 end,

1 (2) in paragraph (9) by striking the period at
2 the end and inserting “; and”, and

3 (3) by inserting after paragraph (9) the fol-
4 lowing:

5 “(10) notwithstanding paragraph (5)(B)(i)(I),
6 the holder of a claim that is paid pursuant to section
7 1322(b)(11) shall retain the lien securing such claim
8 until payment of such claim.”.

9 **SEC. 7. DISCHARGE.**

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

12 (1) in subsection (a)—

13 (A) by inserting “(other than payments to
14 holders of allowed claims provided for under
15 section 1322(b)(11))” after “paid” the 1st place
16 it appears, and

17 (B) in paragraph (1) by inserting “or
18 1322(b)(11)” after “1322(b)(5)”, and

19 (2) in subsection (c)(1) by inserting “or
20 1322(b)(11)” after “1322(b)(5)”.

○



HR 3609 - Compromise Bill Permitting Court-Supervised Loan Modifications Would Save 600,000 Homes

CRL Issue Brief

January 18, 2008

The subprime crisis is severe and will get worse.

Dangerous lending practices and loose underwriting in the subprime mortgage market have put 2.2 million families in danger of losing their homes to foreclosure and is predicted to cause \$350 billion of losses to financial institutions.¹ Millions of thousands of families are trapped in “exploding” adjustable-rate mortgages (ARMs) that are due to increase to unaffordable interest rates in 2008, at the same time that their houses are worth less than their mortgage balance.

Very few of these homeowners will be able to sell or refinance. Loan servicers who could modify loans to make them more affordable aren’t doing so: A recent report by Moody’s found that loan servicers had only modified 3.5 percent of mortgages that increased to higher rates, compared with industry estimates that up to half of subprime borrowers facing reset will lose their homes to foreclosure.² Unless Congress takes action quickly, these families lose homeownership, surrounding neighborhoods lose property value, and the entire economy suffers.

Current law excludes homeowners from relief available to yacht owners.

Today distressed homeowners are denied equal access to court-supervised protections. Judicial modification of loans under a chapter 13 payment plan is available for owners of commercial real estate and yachts, 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 courts are not permitted to modify.

HR 3609 would be effective and cost the Treasury nothing.

Legislation is urgently needed that would allow lenders and loan servicers to modify mortgages to allow families to continue paying on their loans and keep their home. HR 3609 would provide judges the authority to modify harmful mortgages marketed by subprime lenders in recent years, and would help more than 600,000 families stuck in bad loans keep their homes.³

HR 3609 was reported out of the House Judiciary Committee on December 12, after being amended pursuant to a compromise between Committee Chairman John Conyers (D-MI), Subcommittee Chairwoman Linda Sanchez (D-CA) and Rep. Brad Miller (D-NC), and Representative Steve Chabot (R-OH). The compromise bill tightens the original HR 3609 by limiting relief as follows:

- Relief available only when family lacks sufficient income to pay their mortgage and foreclosure is imminent. A strict means test limits relief to those homeowners whose income is insufficient, after deducting modest living expenses allowed by the IRS, to cover their mortgage obligations. In addition, relief is limited to borrowers who have received notice from their servicer that foreclosure is imminent. Finally, 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 after a one- to two-year process.

- Judicial discretion limited; favorable loan terms guaranteed. The compromise bill would require courts to set interest rates at a commercially reasonable, market rate – the current 30-year conventional fixed rate plus a reasonable “risk premium.” The bill provides that the principal balance cannot be reduced below the value of the property, and that the term of 30 year loans will be unchanged. It also makes relief available only to those families who have sufficient income to afford their loans as modified.
- Relief available for existing loans only. Applying these changes prospectively would have no negative impact on interest rates – this is because loan modifications would be available only where the home would otherwise be lost to foreclosure, and the risk of foreclosure is already factored into interest rates – but the compromise goes further, and limits the bill’s application to existing loans only. New loans would not be subject to modification. This removes any concerns that could reasonably be raised about the bill’s impact on the cost or availability of credit.
- Bill applies only to loan products federal regulators deem potentially dangerous. Even as to existing loans that will otherwise end in foreclosure, the compromise bill applies only to those that fall within one of the two categories of loans that the federal regulators have determined to be potentially dangerous given recent poor underwriting by many lenders: subprime, and “non-traditional” loans (that is, interest-only loans, and payment option ARMs). Conventional fixed-rate or adjustable-rate loans are not eligible.
- Sunrise/Sunset. The bill applies only to loans originated on or after January 1, 2000, and, for these loans, is subject to a seven-year sunset.

The Benefits of Court-Supervised Loan Modifications

- No cost to the U.S. Treasury.
- Narrowly targets families who would otherwise lose their homes, and excludes families who do not need assistance.
- Helps maintain property values for families who live near homes at risk of foreclosure. Saves American families not facing foreclosure \$72.5 billion in wealth by avoiding 600,000 foreclosures by their neighbors.⁴
- Guarantees lenders at least the value they would obtain through foreclosure, since a foreclosure sale can only recover the market value of the home. In addition, saves lenders the high cost and significant delays of foreclosures.

About the Center for Responsible Lending

The Center for Responsible Lending (CRL) is a national nonprofit, nonpartisan research and policy organization dedicated to protecting home ownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, one of the nation's largest community development financial institutions.

For additional information, please visit our website at www.responsiblelending.org.
Eric Stein and Ellen Harnick, 919/956-4400.

1 Center for Responsible Lending, "Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners," December 2006, <http://www.responsiblelending.org/pdfs/foreclosure-paper-report-2-17.pdf>); Merrill Lynch, Weekly guidebook for the global investor, Dec. 14, 2007.

2 Aashish Marfatia, Moody's Investors Service, Structured Finance Special Report, US Subprime Market Update: November 2007, (Dec. 17, 2007) at 2; 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 Calculations by the CRL using data from its "Losing Ground" report cited above, research from the University of North Carolina, the Home Mortgage Disclosure Act, and Bloomberg research; <http://www.responsiblelending.org/pdfs/stein-statement-to-senate-judiciary-looming-foreclosure-crisis.pdf>, Appendix A. Mark Zandi, chief economist of Moody's Economy.com, similarly concludes that the legislation would save the homes of 570,000 families. http://judiciary.senate.gov/testimony.cfm?id=3046&wit_id=6807

4 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/>. Median house value of \$212,000 * 1.14% * 50 houses/block = \$121,000 cost/foreclosure * 600,000 avoided = \$72.5 billion saved. [http://www.realtor.org/Research.nsf/files/MSAPRICESF.pdf/\\$FILE/MSAPRICESF.pdf](http://www.realtor.org/Research.nsf/files/MSAPRICESF.pdf/$FILE/MSAPRICESF.pdf)

January 29, 2008

COMMENTARY

A Mortgage 'Tweak' We Don't Need

By DICK ARMEY
January 29, 2008; Page A17

Politicians are always willing -- if not quite qualified -- to play the role of economic savior. And with fresh bad news about the economy coming out regularly, there are plenty of would-be saviors auditioning for the role.

Some of their proposals are serious reforms. Others are Keynesian-inspired, more silly than harmful. But too many are dangerous ideas that would undermine recovery and do long-term harm to both homeowners and our general prosperity.

One of the most dangerous proposals is now moving through the House of Representatives. The Emergency Home Ownership and Mortgage Equity Protection Act was voted out of the Judiciary Committee recently. It takes aim at Chapter 13 bankruptcy proceedings to make it easier for buyers to rewrite the terms of their mortgage contracts in court. It would do this by changing how a debtor's principal residence is treated in bankruptcy, allowing mortgage contracts to be modified by the courts.


In short, if this bill becomes law a mortgage would no longer be a matter between a borrower and a lender, but instead, between a borrower, a lender and a judge. Rather than interpreting private contracts, judges would suddenly be able to rewrite them.

Current bankruptcy law has existed for more than 100 years, and was designed to promote homeownership by making mortgages secure from outside meddling. Strong contracts make for a vibrant mortgage industry. Weakening mortgage contracts would endanger the future of American homeownership by making it harder for homebuyers to obtain a loan.

The bill's backers, of course, claim otherwise. Former Housing and Urban Development Secretary Jack Kemp, for instance, argues that this is merely a "tweak" to the law that would benefit subprime mortgage holders at risk of foreclosure. According to Mr. Kemp, "when servicers are unwilling or unable to voluntarily modify exploding, unsustainable home mortgage loans, Congress has a duty to consider involuntary modification in bankruptcy court." This type of modification is more commonly known in the industry as a "cram down."

By introducing uncertainty into mortgage contracts, this rule change would make it harder and more expensive for buyers to get a mortgage. The Mortgage Bankers Association recently estimated that, if this reform becomes law, borrowers will have to start putting down 20% on a home to get a loan,

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which is much higher than today's standard. So in their efforts to cushion the fall of a few, advocates of this reform would raise costs on an untold number of future mortgage seekers.

Cram downs might not even provide security to those in risk of default. Changing the terms of a loan provides no assurance that the homeowner will not default at a later date. Moreover, recent research by the Federal Reserve Bank of Boston suggests that subprime borrowers are particularly susceptible to fluctuations in home prices. The end result of assistance may be to prolong the problems in the subprime market by extending the opportunity for borrowers to borrow to the point of default.

Only in Washington, where a billion dollars is treated as pocket change, could a change affecting millions of current and future homeowners, as well as the stability and success of the entire mortgage market, be referred to as "a tweak."

In recent congressional testimony on the economic stimulus package, Congressional Budget Office Director Peter Orszag noted that mortgages are treated differently than other property in bankruptcy, specifically to provide benefits to consumers: "The rationale for the current differential treatment of residential mortgages is that exempting mortgage debt from reduction [in bankruptcy] would lower mortgage interest rates and encourage homeownership." Mr. Orszag predicts that such a change in the bankruptcy laws will yield higher mortgage rates.

Not only does this upend more than 100 years of public policy promoting homeownership, it also raises important questions about the sanctity of contract. "The definition of injustice is no other than the not performance of covenant," wrote Thomas Hobbes in "Leviathan." Yet now, it seems that some in Congress want to enshrine breach of contract into the law itself, ostensibly in service of assisting the nation's homeowners. Such a move would not serve homeowners in the least, but it would surely be an injustice.

Mr. Armev, Republican majority leader of the U.S. House of Representatives from 1995 to 2001, is chairman of FreedomWorks.

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Statement of
David G. Kittle, CMB
Chairman-Elect, Mortgage Bankers Association
Before the
Subcommittee on Commercial and Administrative Law
Committee on Judiciary
United States House of Representatives
January 29, 2008
Hearing on
“Growing Mortgage Foreclosure Crisis: Identifying
Solutions and Dispelling Myths”

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

The myths most in need of dispelling concern H.R. 3609, the "Emergency Home Ownership and Mortgage Equity Protection Act of 2007," introduced by Representative Brad Miller and Chairwoman Linda Sanchez and amended by Representative Steve Chabot in the full Judiciary Committee. The amended bill makes key changes to Chapter 13 of the Bankruptcy Code including allowing the following changes for seven years:

- modification of "subprime" and "non-traditional" mortgages secured by principal residences ("home mortgages") originated between 2000 and the date of enactment of the bill;
- allowing home loans to be repaid beyond the term of the Chapter 13 plan, which today cannot exceed three to five years;
- eliminating the requirement to obtain credit counseling before the debtor can file for bankruptcy when the lender has notified the debtor that it may foreclose the loan; and
- requiring that fees and charges, accruing during the bankruptcy proceeding be filed with the court and that such fees do not exceed the value of the property.

If these provisions are enacted, there will be significant consequences for future borrowers, mortgage servicers, investors, pension funds and other global investors in mortgage-backed securities (MBS), as well as, the entire American economy. For these and other reasons, MBA opposes H.R. 3609.

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

Myth: H.R. 3609 Simply Closes a Loophole in the Bankruptcy Code

Fact: Congress Deliberately Acted to Improve Mortgage Market Liquidity

Today, a mortgage secured by the principal residence of a debtor cannot be modified in bankruptcy. This policy has been in existence over 100 years, since the Bankruptcy Act of 1898, and is a cornerstone to an efficient U.S. residential mortgage market. The protection provided to home mortgages was not a loophole or oversight. It was a deliberate act of Congress to ensure the continued low cost and free flow of home mortgage credit (see Legislative History, Attachment A). A shift in public policy to remove such protections will encourage debtors not to pay their contractual mortgage obligations and would dramatically change the residential mortgage market. H.R. 3609 would introduce significant risks for home lenders, investors and loan servicers. The risks include the ability to set aside certain mortgage contracts and modify interest rates and other terms. It would also allow liens to be stripped down to the fair market value of the underlying properties, although the bill does not define fair market value. The increased risk would result in mortgage lenders passing on the associated costs to borrowers in the form of higher interest rates and fees.

Myth: Passing H.R. 3609 (Chabot Compromise) Will Have Little Impact on Servicers and the Mortgage Market

Fact: H.R. 3609 Will Have Immediate and Long-Term Impact on the Mortgage Market

If H.R. 3609 were enacted, lenders, securitizers, investors, and loan servicers would see significant new risks on their existing portfolios. Because the bill, as amended by the Chabot Compromise, continues to be retroactive, these parties would absorb significant immediate losses that could have dire financial consequences. The obvious outcome of the bill would be that large principal losses never anticipated or priced into the interest rate or closing costs when the loan was made would have to be absorbed. Bondholders, including mutual funds, pension funds and government entities would see their investments decline. Servicers who never assumed principal risk of loss would suddenly have to absorb losses due to the loss of credit enhancements. Servicers and portfolio lenders with origination capability could offset the losses with new lending, however, such loans would have to carry higher interest rates and costs. Given the decline in originations, the costs would have to be concentrated on a smaller population and thus the cost of credit would be higher per borrower than if applied across a larger home buying or refinance population. The correlation of losses to income is not perfect and, as a result, new loan costs would be higher than necessary to cover real and anticipated losses and to ensure mortgage companies' continued solvency.

Moreover, bankruptcy attorneys would aggressively advertise to borrowers to seek the benefits of this bill if their homes have declined in value, whether or not

the borrower is in default. The cost of defending these bankruptcy cases would be staggering to the industry.

We believe that it is important for Congress to understand what H.R. 3609 actually does, to understand why it would so drastically affect the mortgage market and why MBA opposes its passage. In addition to the risks previously described, other risks are introduced, perhaps unintended, but which would have serious consequences. We would like to discuss the full range of risks in greater detail, which will illustrate why MBA is so concerned with this bill.

Myth: H.R. 3609 Would Not Have a Negative Effect on Mortgage Market Participants

Fact: Key Provisions of H.R. 3609 Would Introduce Substantial New Risks and Losses for Mortgage Market Participants

A. Permits Modifications and Strip Downs of Home Mortgages

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

The modification provisions in H.R. 3609 apply to the vast majority of “subprime” and all “non-traditional” mortgages secured by principal residences.” Unfortunately, the definition of “subprime” would also cover a significant number of prime loans. Needless to say, this broad application of cram downs to these mortgages would introduce substantial new risks not priced into the product or contemplated when originally setting servicing fees.

B. H.R. 3609 Eliminates Substantial Controls

In addition to permitting cram downs of home mortgages, H.R. 3609 goes further and would remove significant controls that virtually ensure that bankruptcy filings will skyrocket. Consumer groups perpetuate the myth the bill will *not* substantially increase creditor risk or mortgage costs because there are few cram downs of second homes and investor properties since cram downs were

permitted on those property types in 1978. Consumer groups fail to mention the whole truth.

H.R. 3609 would create a quintessential moral hazard. Today, the Bankruptcy Code generally allows mortgages other than those secured by principal residences of the debtor to be crammed down. However, if such loans are crammed down, the debtor must pay the *entire amount* of the secured claim within the three-to-five-year duration of the Chapter 13 plan.² The unsecured portion of the claim that gets crammed down gets an apportioned payment to the extent there is additional income or cash that can support those payments. If there are no funds remaining to pay unsecured creditors after paying secured and priority claims, the unsecured creditors receive nothing and the unsecured debt is discharged upon termination of the plan. For example, under current law, if a mortgage contract of \$150,000 gets stripped down to \$100,000, the debtor must pay the entire \$100,000 within three-to-five years in equal monthly installments. This control limits unbridled runs on the bankruptcy court whenever property values or rates decline. This control, however, is stripped from the rights of creditors by allowing the modified home mortgages to be paid over 30 years. H.R. 3609 thereby would ensure more borrowers will seek Chapter 13 bankruptcy for home loans.

In addition to the restriction mentioned above, vacation homes and investment properties seldom get to the point of cram down because there is generally little reason to cram down these loans. A vacation home clearly is not necessary to provide a roof over the borrower's head and with no equity, and little or no income, is a burden on the estate. Likewise, an investor property that has no equity and a negative cash flow is not necessary for reorganization and is a burden on the estate.³ Thus, cram down of these types of loans is seldom attempted. Instead, the lender obtains termination of the automatic stay and the property is foreclosed without stripping down the lien. Conversely, a principal residence *is essential* to the reorganization of the borrower and thus if H.R. 3609 were enacted, courts would not release the assets from the stay and judges would be required to impose strip down of the lien. In effect, H.R. 3609 would treat home mortgage debt far worse than other secured debts in bankruptcy.

By stripping down secured debt, H.R. 3609 also would make more funds available in the repayment plan for credit cards and other unsecured debts. This is contrary to the basic legal premise of secured debt. Bankruptcy is generally a zero sum proposition. If funds are deducted from one set of debts – the priority debts, such as a home mortgage – it makes more funds available for non-priority and unsecured debts. While it may not be this Committee's intent to shift the bankruptcy process to the advantage of credit card and other unsecured lenders, this would be one of the impacts.

² 11 USC 1322(d)(2007). See also *In re Enewally*, 368 F.3d 1165 (9th Cir., 2004).

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

Because H.R. 3609 also removes the credit counseling requirement when the debtor has received notice of possible foreclosure, the bill would remove the final control against unfettered bankruptcy filings. Congress enacted the pre-filing counseling requirement to assure that debtors in financial difficulty had the benefit of two independent sources of information – approved non-profit counselors and bankruptcy attorneys. Credit counselors are well-versed in housing assistance to help a borrower save his home without filing bankruptcy.

There is no doubt the impact of the modification provision combined with elimination of all creditor protections would result in increased Chapter 13 filings. The considerable incentive of financial gain to the borrower would ensure cram downs on home loans would skyrocket. Servicers, portfolio lenders and bondholders would suffer significant losses. New creditworthy borrowers would have to pay for the value of these “takings.” Financially responsible borrowers in the future would pay for the risky behavior and speculative decisions made by existing borrowers. Lenders would have a fiduciary duty to offset losses created by this bill through higher interest rates, points and fees on new loans. Anticipated losses from cram downs could trigger additional lay-offs in the mortgage industry, including lay-offs at mortgage servicers. The legislation would result in a further constriction of mortgage credit. These would not be welcome developments as most companies have tripled or quadrupled staffing to process loss mitigation requests and handle delinquent loans.

C. Cram Downs Voids Significant Types of Credit Enhancements

Proponents of bankruptcy reform argue creditors will take the same losses if the loan is stripped down to the fair market value as they would if the loan is foreclosed. This is a myth, as it fails to recognize certain insurance contracts would be voided for the amount of the cram down.

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

VA and FHA loans are not insulated from the havoc H.R. 3609 would wreak. In fact, the Chabot Compromise’s definition of subprime as a loan with a three point spread over Treasury securities of comparable maturity measured at the time of

application ensures a significant number of government loans (and prime loans) would be eligible for lien stripping.

The risk of uninsured losses and repurchase risk created by H.R. 3609 would cause existing servicing portfolios to decline in value, requiring accounting write downs of servicing assets. The velocity at which loans would enter bankruptcy could cause capital and liquidity problems for servicers. This disruption could also cause significant problems with voluntary mortgage workouts as bankruptcy cram downs would consume the servicer's financial and personnel resources. The stated objective of encouraging more voluntary workouts through H.R. 3609 would simply not materialize because (1) the reward in bankruptcy is far more lucrative than what servicers could offer and (2) servicers may have to cut costs to offset losses by eliminating critical jobs.

When these government programs were created, there was no risk of cram down on home mortgages. As a result, authorizing statutes and regulations of the government programs fail to deal appropriately with the risk that would be created by H.R. 3609. Statutes were developed to deal with foreclosures, not bankruptcy modifications and strip downs. FHA and VA are not permitted *by statute* to pay an insurance claim or guarantee for the strip down amount.⁴ It was simply not contemplated. An additional act of Congress would be required to restore these credit enhancements.

At a time when the public policy process is moving toward an increased reliance on the FHA and VA to serve the low income and first time homebuyers, H.R. 3609 would disadvantage government lending and drive lenders away from it.

D. Impact of Cram Downs on Investors and the MBS Market

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

Securitization of mortgages is based on the underlying value of those mortgage contracts. Granting bankruptcy judges the authority to retroactively modify a mortgage in Chapter 13 proceedings would have a materially adverse impact on the mortgage contract. The resulting uncertainty would mean securitizers or

⁴ 12 USC 1710a (2007). FHA can only pay a claim when it receives title to the property, the mortgage is foreclosed, the loan gets assigned, there is a pre-foreclosure sale or there is a loss mitigation partial claim. A partial claim is a specialized loss mitigation tool, which allows arrearages to be subordinated into a junior lien held by HUD. VA is only allowed to pay the unpaid principal balance, plus accrued interest and applicable charges. 38 USC 3832 (2007).

investors could not assess prices or calculate the risk of how many mortgages could be modified. If, with a stroke of a pen, the US government could eliminate the entire secured nature of these investments whenever there is a cyclical downturn in the real estate market, why would investors return to our mortgage markets? They would simply take their money to other more secure and predictable investments. Existing MBS values would also decline as investors dump MBS collateralized by subprime and at-risk assets and as credit rating agencies further downgrade securities.

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

E. Lenders Will be Forced to Absorb the Risk of Properties Damaged by Natural Disasters or Borrower Misconduct

Another significant concern created by H.R. 3609 would be the windfall borrowers would obtain when the property is either 1) damaged by the borrower or 2) damaged by natural disasters such as Hurricanes Katrina and Rita or the recent wildfires of southern California.

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

Likewise, we do not think borrowers should be able to wipe out the security interests of creditors when their properties are destroyed by natural disasters, but H.R. 3609 could do just that. A recent relevant example is the damage to properties from Hurricanes Katrina and Rita. As you may know, lenders have offered borrowers who were impacted by the hurricanes over two years of forbearance and/or have also modified their mortgages. Some properties have zero or negative values. Now that insurance and Community Development Block Grant (CDBG) money is flowing to homeowners to rebuild these properties, this legislation would render a devastating blow to investors and servicers: the ability for borrowers to wipe out *all or significant portions* of the debt in Chapter 13 bankruptcy.

The impact of lien stripping on insurance proceeds and grant funds as secured assets is also brought into question. Based on cases associated with other secured debts, it appears creditors may lose their secured interests in hazard insurance proceeds for the amount of the cram down, with possibly no recourse to recover the value of the original debt. H.R. 3609 would place lenders, servicers and investors in an inappropriate role of property insurers of last resort

and/or guarantors of property values. Lenders and servicers would not have priced for the risk at origination, and would require cross-subsidization from new originations to avoid massive losses. That cross-subsidization would result in higher costs for new loans.

Myth: Consumers' Only Benefit Will Be Foreclosure Avoidance

Fact: H.R. 3609 Gives Enormous Windfalls to Borrowers

What is probably one of the most inequitable results of H.R. 3609 is the fact that debtors in depressed real estate markets or with damaged or destroyed properties would reap a windfall at the expense of borrowers who honor their debts, as well as servicers and investors. This windfall would occur if the borrower is permitted to reduce the debt to the depressed value of the property, retain the property and realize future appreciation in value when market conditions improve (or repairs get made with insurance and government aid), while having no obligation to pay the lender the full contractually agreed upon debt. Executing a strip down based on a snapshot of value ensures borrowers will make significant profits when the property appreciates later in time. The case in point is illustrated by In re: Enewally 368 F.3d 1165 (9th Cir., 2004).⁵ Despite the current market turndown, over the last 30 years home prices nationally have risen six percent per year on average.⁶

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

Myth: H.R. 3609 Is Needed Because the Mortgage Industry Is Not Doing Enough to Help Borrowers in Need

Fact: Industry is Engaged in Historic Efforts to Assist Distressed Borrowers

Recently, MBA released an empirical report on how servicers helped borrowers in the third quarter of 2007. As indicated earlier, this was before the HOPE NOW initiative got off the ground, so it gives a good sense of servicers' traditional

⁵ At the time of the bankruptcy court's ruling in 2001, the debtor's property had declined in value to \$210,000. The mortgage debt was approximately \$245,000 and the borrowers sought cram down. However by the time the United States Supreme Court rejected the Writ of Certiorari three years later, that same property was worth \$600,000. Had the debtors' cram down not been overturned on appeal, the debtors would have received a significant windfall.

⁶ OFHEO House Price Index.

ability to help, while also setting a floor from which the industry could be judged moving forward. The report is included in the testimony, but several important facts should be highlighted.

During the third quarter of last year, mortgage servicers helped about 183,000 borrowers through repayment plans. They modified the rates or terms on about 54,000 more loans, 3,000 of which were subprime ARM loans, 15,000 subprime fixed rate loans, 4,000 prime ARM loans and 21,000 prime fixed-rate loans. As you can see from these numbers, the industry helped over 230,000 borrowers.

The MBA paper also discussed something known in our industry as the “Moody’s One Percent Number.” In September 2007, Moody’s released a study suggesting the mortgage industry had assisted only one percent of the people who needed help. A later report then increased the number to 3.5 percent. Unfortunately, these numbers were not put into the proper context and represent a poor picture of how many people have been helped. In fact, the Moody’s report that indicated loan modifications had increased to 3.5 percent, clearly noted the actual percentage of borrowers who received some type of *workout* was 24 percent.

The problem with this type of analysis is the math was off in two places. In order to come up with a percentage, a researcher uses simple high school level division, with a numerator and a denominator. The Moody’s report limits the numerator to loan modifications and excludes all other types of assistance offered to borrowers. As discussed earlier, borrower assistance can come in many different forms. This is not the kind of process that produces a single solution for every consumer. The denominator Moody’s used was the complete universe of subprime ARMs whose rates reset in a particular period. In the third quarter of 2007, according to MBA’s National Delinquency Survey, over 80% of subprime ARM borrowers were paying on time. Certainly Moody’s was not advocating that mortgage servicers modify the loans of people who are paying on time and who had not contacted the servicer for assistance?

A more appropriate measure is to look at the number of people helped relative to the number who become seriously delinquent or request help. It makes no sense to compare the smallest possible number of people who get help (those who receive formal loan modifications) against the largest possible number of borrowers (the total number of resetting subprime ARMs).

Members of this Committee have discussed their goal of keeping people in their homes. The Mortgage Bankers Association absolutely shares that goal. No one wants a family to lose its home and MBA’s members are trying their best to help. Servicers are providing unprecedented levels of loss mitigation to eligible borrowers in distress. These alternatives to foreclosure include forbearance and repayment plans, modifications, partial claims, short sales and deed in lieu of foreclosure.

The single largest barrier to helping consumers is the low contact rate servicers have with borrowers. Historically, 50 percent of borrowers who reached foreclosure had no contact with the servicer despite multiple efforts on the servicer's part to reach out. Contact volume is still low and borrowers often simply don't know where to turn for reliable advice and assistance. Servicers have been working diligently to ensure all borrowers know about alternatives to foreclosure and to coordinate with housing counselors if borrowers are uncomfortable talking to their servicers. To help provide a coordinated and centralized approach to foreclosure prevention, the industry, with the assistance of the Department of Treasury and Department of Housing and Urban Development launched HOPE NOW.⁷ While Faith Schwartz, Executive Director of HOPE NOW, will provide greater detail on the accomplishments of the industry, it is important to highlight HOPE NOW servicers have mailed approximately 500,000 letters to no-contact delinquent borrowers alerting them of the servicer's loss mitigation telephone number and the toll free HOPE Hotline. In addition, HOPE NOW servicers are centralizing their points of contact for expedited service to counselors and are providing counselors with new technology to expedite loss mitigation solutions.

Myth: Bankruptcy is the Preferable Way to Help Consumers

Fact: Bankruptcy is a Long, Difficult and Burdensome Process with Severe Long-Term Negative Consequences for Consumers

The proponents of bankruptcy reform fail to acknowledge the very real and severe consequences for consumers who declare bankruptcy. A bankruptcy stays on a consumers' credit report for 10 years, making it difficult to acquire future credit, especially in the tighter credit environment. Bankruptcy makes it more difficult for borrowers to get credit cards, buy a home, car or hazard insurance and in some cases, obtain employment. Bankruptcy costs consumers about \$3,000 in attorney and court fees. Two-thirds of bankruptcy repayment plans fail. Moreover, bankruptcy repayment plans do not take into account new expenses that an individual incurs, such as unanticipated health related costs or emergencies. Attached to the testimony is a document produced by Professor Lynn M. LoPucki detailing the bankruptcy process (also available at <http://www.bankruptcyvisuals.com/viewcharts.html>). It is inconceivable Congress would rather push people into this process rather than focus on other more effective and less burdensome ways to help consumers.

Myth: H.R. 3609 Will Put Second Lien Holders in No Worse Position Than They Are Today

Fact: The Second Lien Market Will Be Badly Hurt from this Legislation

The second mortgage market has been particularly hard hit by current declining real estate values. Many borrowers are not paying their second mortgages when the fair market value of their property declines below the principal balance of the

⁷ <http://www.hopenow.com/>

second loan. The second lien holder is left with no other option, but to allow the delinquency to continue, but retain the lien. They are not foreclosing on the second mortgages. These delinquent borrowers are not necessarily insolvent. Eventually home values will rise and these borrowers will begin repaying their second liens. H.R. 3609 would take away the lender's right to retain the lien and seek repayment at a later date. H.R. 3609 would wipe out existing second lien holders that are deemed subprime.

These second liens serve as credit enhancements for many first mortgages in the subprime market and thus are not and should not be extinguished indiscriminately. Proponents claim lenders are no worse off in bankruptcy than in foreclosure. This is a myth. This facile analysis fails to recognize many lenders, especially second lien lenders, are not seeking foreclosure, and are thus preserving their assets. H.R. 3609 would strip lien holders of this crucial right, effectively taking the asset from them.

**Myth: Congress Has Not Done Enough to Address the Subprime Crisis
Fact: Congress Can Take Great Pride in Its Response to the Crisis**

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

Moreover, the House passed H.R. 3915 that would create a new legal regime for the mortgage market. This is a very serious piece of legislation. The mortgage industry believes it should be significantly improved. As this activity shows, the answer to this problem lies in improving the statutes governing lending, not in amending the bankruptcy code.

In addition to Congressional actions, FHA recently announced FHASecure,⁸ which allows borrowers the opportunity to refinance into FHA insured loans. What is remarkable about this program is that it would allow a borrower who is six months delinquent on an ARM to refinance into an FHA loan, despite his or her delinquency, provided the borrower had a good payment history prior to the ARM rate reset and can afford the new payments. The program also allows borrowers who are upside down on their mortgages (i.e., owe more than their property is worth) to refinance a portion of their loan into non-FHA insured subordinate liens. In the past, combined loan-to-value requirements prohibited

⁸ <http://www.fha.gov/about/fhasfact.cfm>

such activity. Unfortunately, it is unclear whether the threat of H.R. 3609 would discourage these subordinate loans from being originated, thus depriving borrowers of useful assistance.

While Congress has made strides in assisting borrowers in distress, H.R. 3609 would go too far. It encourages damaging behavior that would only serve to increase the cost of credit to financially responsible borrowers in the future and would place at risk the solvency of mortgage servicers and lenders, while also reducing the value and yield on certain securities. It would repudiate existing contracts, void credit enhancements, rights to certain insurance claims, trigger mandatory buyback options and impose a home price guaranty on existing mortgages. For proponents to argue these changes would not have a significant affect on lenders, servicers and bondholders is either dangerously naïve or simply disingenuous.

Conclusion

MBA opposes H.R. 3609 because of the harm it would cause to the mortgage market and borrowers who seek home mortgages. While well-intentioned, H.R. 3609 would increase rates significantly, dry up investor interest in mortgage-backed securities and impose significant losses on the mortgage industry and bondholders. Credit enhancements that protect lenders and investors from loss in the event of foreclosure would be void for the amount of the lien strip. Noteholders' interest in insurance claims would be at risk. With investor appetite for U.S. mortgages waning, it is ill-advised to pass legislation that would further disrupt the mortgage market. We urge Members of the House to look deeper into the implications of H.R. 3609. We are convinced that upon further detailed analysis you will agree that further action on this legislation is ill-advised.

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

Study: Bankruptcy-Law Change Won't Affect Mortgage Interest

By *Jacqueline Palank*

Legislation that aims to save Americans from foreclosures of their homes would have "little or no impact" on mortgage interest rates, according to a new study that rebuts the mortgage industry's claim that borrowing costs would surge.

The study, by Adam J. Levitin, a professor at Georgetown University, found that allowing bankruptcy judges to "strip down" a secured mortgage loan, or reduce the loan claim to the home's value and grant the lender an unsecured claim for the loan's interest, raised mortgage interest by a scant 5 to 15 basis points, or 0.05 to 0.15 percentage point.

"Permitting unlimited strip-down would have a nonexistent, or a very, very small, impact on mortgage interest rates," Levitin, a law professor, said at a news conference Thursday.

As growing numbers of consumers default on their home loans and file for bankruptcy, Congress has proposed several changes to the federal Bankruptcy Code designed to allow more people to stay in their homes.

None of the bills have gone before the full House or Senate yet. All of them give bankruptcy judges the authority to modify the mortgage on a primary residence.

Foreclosure rates soared 75% in 2007, according to foreclosure-listing service RealtyTrac. More than 1% of all U.S. households were in some stage of foreclosure last year, up from 0.58% in 2006.

Consumer advocates have urged Congress to pass the bankruptcy legislation. Business groups, including the Mortgage Bankers Association and the U.S. Chamber of Commerce, say the change would raise borrowing costs, tighten credit for consumers and increase risks for lenders.

But Levitin, along with coauthor Columbia University doctoral candidate Joshua Goodman, say mortgage-industry data collected between 1988 and 1995 show strip-downs had little impact on rates.

Inspired by the vigorous debate over the proposed legislation, Levitin and Goodman looked at the mortgage data from the Federal Housing Finance Board for all 50 states between 1988 and 1995, when judicial districts had different strip-down rules.

In 1993, the Supreme Court ruled to outlaw strip-down nationwide, and current bankruptcy law only allows individual debtors to modify such mortgages as vacation homes and investment properties.

Levitin said that, because strip-down had such an insignificant effect on mortgage interest rates when it was allowed without limits, the current, more limited, legislation would have an even smaller effect.

He said the bills would only allow judges to modify nontraditional loans, such as adjustable-rate mortgages with interest rates that reset to higher levels after an introductory low rate. The relief would only be available to consumers who seek Chapter 13 bankruptcy protection, which requires debtors to follow a repayment plan.

"Because of these proposed limitations, the pending legislation would likely have an even smaller impact than the unlimited strip-down regime we tested in our study," Levitin and Goodman said in the study.

The Mortgage Bankers Association, however, has said allowing mortgage strip-down would increase interest rates by at least 150 basis points, or 1.5 percentage points, 10 times more than the estimate put forth by Levitin and Goodman.

Jay Brinkmann, vice president for research and economics for the trade group, called the MBA's projection "a reasonable ball park estimate." He said giving bankruptcy judges power to modify mortgages would ultimately lead to more defaults, which would in turn give rise to higher interest rates.

"If you then allow this type of treatment in bankruptcy, you're just going to see the default rate go up much higher than you see now, and that's going to drive up interest rates," Brinkmann said.

Levitin and Goodman say their study proves that the trade group's projections are way off. Judges now have the power to change the mortgages on vacation homes and investment properties, and this hasn't caused interest rates on such properties to go up, they say.

Levitin said there's a "zero percent chance" the MBA's projections are accurate.

Levitin said a review of 530 mortgage rates generated between Jan. 17 and Jan. 27 from lenders eLoan, IndyMac Bank, JPMorgan Chase & Co. and Wachovia Corp. for 11 states demonstrated that the mortgage market is "insensitive" to the risks that its borrowers will file for bankruptcy and seek a modification of their loan. Mortgages that can currently be modified are priced "exactly the same" as a mortgage on a primary residence, which can't be modified.

Levitin said the proposed bankruptcy-law change isn't likely to spur a rash of Chapter 13 filings. According to the study, strip-down had no impact on the number of such filings.

"I would expect to see relatively few Chapter 13 filings if strip-down were available," Levitin said. "People go into Chapter 13 bankruptcies as a last resort." *DBR*



Questions and Answers About the Mortgage Modification Bankruptcy Bills (H.R. 3609 and S. 2136/ S. 2636)

by **John Rao**
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1. What is the status of the bills?

Two bills currently pending in Congress would repeal the Bankruptcy Code provision which prohibits modification of home secured loans. While the Bankruptcy Code generally permits secured claims to be modified, section 1322(b)(2) singles out mortgage claims and shields them from modification, other than through a plan which cures a mortgage default. This provision prevents consumers from changing the interest rate, amortization, or term of mortgage loans in a chapter 13 plan. The decision in *Nobleman v. American Savings Bank*, 508 U.S. 324 (1993) also makes clear that mortgage claims are not subject to stripdown to the value of the collateral.

Both bills¹ would permit stripdown and loan term modifications on home mortgages:

- The House bill is H.R. 3609 (“Emergency Home Ownership and Mortgage Equity Protection Act of 2007”). Following two subcommittee hearings, H.R. 3609 (as amended by substitute bill) was voted favorably out of the Judiciary Committee on December 12, 2007 on a 17-15 vote. A floor vote by the House is expected in early 2008.
- The Senate bill is S. 2136 (“Helping Families Save Their Homes in Bankruptcy Act of 2007”). S. 2136 has been referred to the Judiciary Committee, which held a hearing on the bill on December 5, 2007. It has now been included as Title IV in a larger stimulus bill, S. 2636 (“Foreclosure Prevention Act of 2008”), and is expected to proceed to a Floor vote in late February, 2008.

¹ Copies of the bills are available on NCLC’s website, at:
<http://www.nclc.org/issues/bankruptcy/index.shtml>.

2. What is the most significant feature of the bills which would make stripdown for mortgages different than under current law for other loans?

Normally, a secured claim which is subject to stripdown under Code section 1325 must be paid in full within the three to five year duration of the plan. While this may work for claims secured by personal property, few debtors are able to pay a mortgage claim of \$100-500,000, or more, during the plan. The bills provide a solution which is borrowed from chapter 12 farmer cases. Similar to Code § 1222(b)(5), the bills allow payment of the modified mortgage, regardless of the original amortization, over a period beyond the life of the chapter 13 plan. By eliminating the need to make additional payments on prepetition arrearages as under a cure plan, and by combining the term extension with interest rate and principal reduction, many debtors facing a home foreclosure would be able to propose feasible and affordable plans if this change is enacted. (The last question below provides a comparison between a cure plan under current law and a modification under the bills).

The period of time over which the mortgage debt can be reamortized varies slightly under the bills. S. 2136 provides in Sec. 101(a) that the mortgage term can be extended for a period up to 30 years after the case is filed, reduced by the period the loan has been outstanding. Thus, a chapter 13 case filed shortly after the first rate reset on a 2/28 mortgage (at the end of the loan's second year) could provide for payment of the mortgage claim as modified over a 28-year term. The House bill, in Sec. 4 of H.R. 3609, uses this same timeframe but would also allow repayment over the remaining term of the loan if that period is longer, such as might occur with a 40-year mortgage.

3. Can the debtor freeze or reduce the interest rate on the loan?

The bills explicitly provide that the plan may modify the interest rate due under the mortgage, providing for payment of the mortgage claim at a "fixed annual percentage rate." Significantly, this would permit the debtor to stop adjustments on an exploding adjustable rate mortgage (ARM), convert an ARM into a fixed rate loan, and reduce the rate on a high-cost subprime loan.

In *Till v. SCS Credit Corp.*, 541 U.S. 465, 479 (2004), the Supreme Court held that in modifying the interest rate on a car claim being paid under a chapter 13 plan, the bankruptcy court should use the prime rate, adjusted to reflect potential risk, taking into account "such factors as the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan."

Both bills contain almost identical language on determining the appropriate interest rate. Sec. 101(a) of S. 2136 and Sec. 4 of H.R. 3609 state that the plan may provide for payment of interest on the mortgage claim at an annual percentage rate based on the Federal Reserve Board's annual yield for conventional mortgages, plus a reasonable premium for risk. Although the interest rate starting point for mortgages

would therefore be different than for other secured claims, using a conventional mortgage rate rather than a prime rate,² courts can be expected to apply the *Till* factors in setting the risk premium.

4. How will the amount of stripdown be determined?

Neither bill provides any specific additional guidance or limitations on how courts would determine the amount of permitted stripdown. Thus, a mortgage creditor's allowed secured claim will be determined in the customary manner by applying Code § 506. Since the debtor in such cases will be proposing to retain the home, valuation generally will be based on the home's fair market value (rather than its liquidation value) as of the effective date of the plan.

5. Are all mortgages covered by the bills?

The Senate bill would apply to all claims secured by the debtor's principal residence. The House bill would apply to "nontraditional" and "subprime" mortgages. Sec. 2 of H.R. 3609 adds definitions for these terms to Code § 101:

- A "nontraditional" mortgage is defined to include interest-only and negative amortization loans, including payment-option ARMs. The definition excludes reverse mortgages and home equity lines of credit which are in a subordinate position.
- A "subprime" mortgage is defined as having an annual percentage rate which is greater than the sum of a Treasury security having a comparable maturity plus 3 percent on a first mortgage, and plus 5 percent on a subordinate mortgage.³ The applicable Treasury rate would be for the time period as of the 15th day of the month preceding the loan application date. For example, on a 30-year mortgage made in 2006 with an application date of April 4, 2006, a "subprime" mortgage covered by H.R. 3609 would have an interest rate greater than 7.72% (Treasury rate of 4.72% plus 3%) on a first mortgage and 9.92% (Treasury rate of 4.72% plus 5%) on a subordinate mortgage.⁴

² It has generally varied over time as to which of these two indexes have been lower. For example, the annual contract interest rate for conventional fixed-rate first mortgages in 2007 was 6.34%, while the annual prime rate for that year was 8.05%. In 2004, the annual conventional fixed-rate first mortgage rate was 5.84% and the annual prime rate was 4.34%. See <http://federalreserve.gov/releases/h15/data.htm>.

³ For adjustable rate mortgages with an initial teaser rate, the House bill provides that the annual percentage rate used shall be the greater of the introductory rate and the fully indexed rate.

⁴ See <http://federalreserve.gov/releases/h15/data.htm>.

Sec. 4 of H.R. 3609 also provides that the mortgage must be subject to a foreclosure notice and have been made during a specified period. The bill states that the mortgage must:

- be the “subject of a notice that a foreclosure may be commenced;” and
- have been incurred during the period from January 1, 2000 until the effective date of the bill.

6. Are all debtors eligible to seek a modification?

Under both bills, the debtor may seek to modify a mortgage only if a plan to cure the default is not possible based on income and expense considerations used in the means test under BAPCPA. Sec. 101(a) of S. 2136 and Sec. 4 of H.R. 3609 provide that modification would be permitted if, after deducting from the debtor’s current monthly income⁵ the means test expenses allowed under section 1325(b)(3)⁶ other than payments on the mortgage claim, the debtor does not have sufficient income to cure the mortgage default and maintain the ongoing payments during the plan. Many low- and moderate-income debtors who have defaulted on loans with abusive terms even before adjustable rates have reset should have little difficulty satisfying this test.

7. Are there any specific plan confirmation requirements?

Sec. 6 of H.R. 3609 provides that if the plan proposes to modify a home secured loan, the modification must be proposed in good faith. This section of H.R. 3609 also provides that a mortgage creditor shall retain its lien until the later of: 1) payment of the claim as modified, or 2) discharge under Code section 1328.

8. Do the bills address problems with excessive and undisclosed creditor fees in chapter 13 cases?

An enormous problem for many debtors who attempt to save homes from foreclosure in chapter 13 is that mortgage creditors often misapply payments and add unauthorized or excessive fees to the mortgage accounts while the case is pending. These debtors emerge from bankruptcy after three to five years of struggling to cure an arrearage only to have the creditor begin foreclosure anew based on claims of unpaid fees for such items as attorney’s fees, property inspections, broker price opinions, and other charges allegedly incurred during the case. These fees and charges are added to mortgage accounts without notice to the borrower, trustee or bankruptcy court.

⁵ See 11 U.S.C. § 101(10A).

⁶ Section 1325(b)(3) references the expenses permitted under § 707(b)(2)(A) and (B).

Both bills include a provision to remedy this problem. Sec. 201 of S. 2136 and Sec. 5 of H.R. 3609 provide that fees and charges incurred during the pendency of a chapter 13 case may be charged to the debtor or added to the account only if:

- the mortgage creditor discloses the fee or charge in a notice filed with the court within 1 year after the fee or charge is incurred, or 60 days before the case closing; and
- the fee or charge is lawful under applicable nonbankruptcy law, reasonable, and provided for in the agreement.

Both bills specify that the failure of the mortgage creditor to provide the required notice would amount to a waiver of the subject fee or charge and that any attempt to collect the fee or charge would be a violation of the automatic stay or the discharge injunction.

Both bills also have separate provisions (Sec. 201 of S. 2136 and Sec. 5 of H.R. 3609) which state that a plan may provide for the waiver of any prepayment penalty on a mortgage claim.

9. Do the bills repeal any of the changes made by the 2005 Act?

None of the BAPCPA changes are repealed. Both bills do, however, address the requirement of a prebankruptcy credit counseling briefing added by BAPCPA, which has caused problems for some borrowers facing foreclosure. Sec. 3 of H.R. 3609 states that the debtor may obtain the briefing within 30 days after the case is filed if the debtor certifies that he or she has received a notice from the mortgage creditor that a “foreclosure may be commenced.” This provision would effectively overrule court decisions which have held that a pending foreclosure is not a sufficient “exigent circumstance” which would merit a deferral of the counseling under the procedure Congress adopted in the 2005 law presumably to deal with emergencies such as foreclosures.

Sec. 102 of S. 2136 provides that the prepetition counseling requirement would not apply to a debtor who certifies that a foreclosure sale “has been scheduled.”

10. Are there any tax consequences for debtors resulting from a mortgage modification?

To the extent that the modification provided in the debtor’s plan includes a stripdown, the mortgage claim is bifurcated and the unsecured portion of the creditor’s claim would be discharged upon successful completion of the plan. The debtor’s plan would also provide for continuing payments on the reamortized mortgage after the case is closed. Sec. 7 of H.R. 3609 clarifies through an amendment to Code section 1328 that

the remaining balance owed (as reduced by the stripdown) on the reamortized mortgage at the conclusion of the case is not discharged.

Importantly, the amount of the mortgage stripdown, like all other debt discharged in bankruptcy, is not treated as discharge of indebtedness income for tax purposes.⁷ Given the limitations of the recently enacted Mortgage Forgiveness Debt Relief Act of 2007 (Pub. L. No. 110-142) in regard to home equity debt,⁸ a mortgage modification in bankruptcy under these bills would avoid tax consequences for the debtor which might exist if the modification were made outside of bankruptcy.

11. Do the bills address any other issues?

The Senate bill contains several additional provisions which would:

- limit application of judicial estoppel doctrine by permitting trustees or debtors to pursue unscheduled legal claims in certain circumstances (Section 202 of S. 2136);
- confirm that bankruptcy judges can rule on core proceedings rather than refer the matter to arbitration (Section 203 of S. 2136);
- set a higher homestead floor for homeowners over the age of 55, which would help older homeowners who are fighting to keep their homes as they go through bankruptcy but live in states with low homestead exemptions (Section 204 of S. 2136);
- reinforce that consumer protection claims may be asserted in the claim allowance process in bankruptcy (Section 205 of S. 2136).

12. Do the bills make permanent changes to the Bankruptcy Code?

H.R. 3609 includes a sunset provision for two of the Code amendments; the changes permitting mortgage modifications and delay of counseling would apply only to chapter 13 cases filed within the 7-year period following enactment. All other provisions in H.R. 3609, including those dealing with creditor fee abuses, do not sunset and would be permanent changes to the Code. The Senate bill does not include a sunset provision.

12. Can you provide a comparison between a cure plan under current law and a mortgage modification under the proposed bills?

Assume that the borrowers have a subprime 2/28 ARM mortgage with an initial teaser interest rate of 8.63%. Their monthly principal and interest payment is \$1,748

⁷ 26 U.S.C. § 108.

⁸ See NCLC Reports, Bankruptcy and Foreclosures Edition, "How Congress Did (or Did Not) Save Your Clients from Foreclosure: The Mortgage Forgiveness Debt Relief Act of 2007" (Nov.-Dec. 2007).

(\$1,973 with taxes & ins.) for the first 24 months. The borrowers are unable to afford even the teaser rate payment and fall behind. They file chapter 13 bankruptcy in the eighteenth month to stop a foreclosure sale. The principal owing at the time of filing is \$225,000, with a total arrearage of \$14,000, and their home is now valued at \$200,000. To cure the arrears and maintain current payments with rate adjustments, they would need to make the following payments, assuming rate adjustments based on a LIBOR index plus a margin of 6, with applicable rate caps and using historical rates for the period 2004-2007. This also assumes that taxes and insurance remain constant during the plan.

Chapter 13 Plan to Cure Default on ARM under Current Law:

- \$ 389 payment on arrears (assuming cure over 36 mos.)
- \$ 46 interest on arrears payment each month (assuming required by mortgage documents)
- \$ 44 trustee's fee each month (assuming plan permits regular payments to be made directly to servicer and not considering administrative costs, such as attorney's fees, or other payments under plan)

- \$ 2,227** monthly to keep current and cure arrears for first six months of plan (including taxes and insurance)
- \$ 2,364** monthly to keep current and cure arrears for months 7-12 of plan
- \$ 2,522** monthly to keep current and cure arrears for months 13 - 18 of plan
- \$ 2,651** monthly to keep current and cure arrears for months 19 - 24 of plan
- \$ 2,656** monthly to keep current and cure arrears for months 25 - 30 of plan
- \$ 2,664** monthly to keep current and cure arrears for months 31 - 36 of plan

If the Code changes made by the bills were enacted, the borrowers could propose to 1) extend the mortgage term, so that it would have another 342 months to run (360 original term less 18 months loan has been outstanding), 2) reduce the interest rate going forward at a fixed rate of 7.25%, and 3) reduce the current loan balance to \$200,000 based on the fair market value of the property.

Proposed Chapter 13 Plan with Mortgage Modification:

- \$200,000 current loan balance
- 342 month term
- 7.25% interest

- \$ 1,643 ongoing monthly mortgage payment (including taxes and insurance of \$225/month)

- \$ 66 trustee's fee each month (assuming mortgage payments are made by the trustee under the plan and based on a reduced commission of 4%)

- \$ 1,709** monthly to keep current for 3 year duration of plan

\$ 1,643 monthly to keep current for remaining 25 1/2 years of mortgage term
(subject to adjustment only for taxes and insurance)

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