

Great Debates

Resolved: Congress Must Allow
Courts to Lienstrip
Home Mortgages

Paul D. Sinclair, Moderator

Polsinelli Shughart PS; Kansas City, Mo.

Pro - Tara Twomey

National Consumer Law Center; Carmel, Calif.

Con - Paul H. Berens

Bradshaw, Steele, Cochrane & Berens
Cape Girardeau, Mo.

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Is It Time to Reconsider Bankruptcy Reform?¹

Nationwide, millions of families are expected to lose their homes to foreclosure over the next several years.² Falling home prices and tighter credit markets have made it difficult or impossible for families to refinance their way out of unaffordable home loans. The safety net provided by appreciating real property values has crumbled, leaving homeowners at risk of serious financial distress. For many families, homeownership has become a financial liability, rather than a financial asset.

To date, responses to the foreclosure crisis have left homeowners who are in default on their mortgage loans with few options. Foreclosures starts continue to outpace loan modifications,³ despite being identified as a preferred strategy for reducing the number of foreclosures. The federal government and the credit industry largely have confined their efforts to voluntary programs that offer, at best, temporary or limited aid, such as forbearance agreements or short-term modifications.⁴ When other alternatives are unavailable or insufficient, families may turn to bankruptcy to prevent the loss of their home.

Bankruptcy permits homeowners to halt foreclosures and cure defaults on their mortgage loans by repaying missed payments over a period of years. However, families face serious challenges in saving their homes using bankruptcy law. Bankruptcy law does not permit debtors to modify the terms of mortgages secured by a principal residence. This limitation on restructuring home mortgage loans may pose an insurmountable barrier to families who are trapped in unaffordable loans or underwater homes. Such families may be unable to avoid foreclosure using the bankruptcy process because they cannot keep up with their ongoing mortgage payments or cannot do so while curing the defaults on their mortgage loans. Because the law does not permit courts to address ongoing problems with housing affordability or underwater mortgages, the anti-modification rule for home mortgages undermines bankruptcy's potential as a home-saving tool. Particularly for today's families, many of whom have adjustable-rate

¹ Adapted from John Eggum, Katherine Porter, and Tara Twomey, *Saving Homes in Bankruptcy: Housing Affordability and Loan Modification*, 2008 Utah L. Rev. 1123.

² See *Foreclosures to Affect 6.5 mln Loans by 2012-Report*, REUTERS, Apr. 22, 2008, <http://www.reuters.com/article/bondsNews/idUSN2233380820080422> (citing the Credit Suisse Report dated April 22, 2008, that estimated as many as 6.5 million foreclosures by the end of 2012, equating to 12.7% of all residential borrowers).

³ HOPE NOW National Data, July 07 to June 09; Alan White, *Deleveraging the American Homeowner: The Failure of 2008 Voluntary Mortgage Contract Modifications*, 41 Conn. L. Rev. 1107 (2009).

⁴ See, e.g., Anna Marie Kukec, *Trend Won't End Soon, So What's Being Done?*, DAILY HERALD, Nov. 28, 2007, at 1, (highlighting the temporary and limited extent of programs intended to help with the foreclosure crisis).

mortgages or other nontraditional loan products, bankruptcy may be an incomplete or inadequate solution to foreclosure. To help families sustain their attempt at homeownership and to reduce the harms of the foreclosure crisis, bankruptcy law should be amended to permit courts to modify the terms of the home mortgages of chapter 13 debtors.

The Antimodification Rule in Historical Context

During the current foreclosure crisis, Congress considered several proposals to eliminate the antimodification rule.⁵ Proponents of such change asserted that the existing law is a barrier to effective bankruptcy relief for homeowners that face foreclosure.⁶ To evaluate the merits of such a change, the antimodification rule should be examined in its historical context. This background highlights the significant changes in the modern mortgage market and the circumstances of the current foreclosure crisis that may undermine the traditional justification for the rule.

The Bankruptcy Code's anti-modification rule prohibits the modification of claims secured by real property that is the debtor's principal residence.⁷ The rule has its origins in the Bankruptcy Reform Act of 1978,⁸ which created the current Bankruptcy Code.⁹ Under bankruptcy law prior to the 1978 Code, chapter XIII of the Bankruptcy Act of 1898, a repayment plan could not be approved unless every secured creditor that would receive payments in the plan consented to it.¹⁰ Additionally, debtors under chapter XIII had no ability to address debts secured by their home residences because the term "claim" expressly excluded "claims secured by estates in real property or chattel real."¹¹ These limitations made bankruptcy relief of limited or no use for debtors who needed to deal with defaults on loans to mortgage creditors.

In enacting the Bankruptcy Code, Congress sought to improve the ability of bankruptcy debtors to repay their mortgage creditors and save their homes from foreclosures.¹² The new chapter 13 bankruptcy system was designed to provide

⁵ See, e.g., Homeowner Assistance and Taxpayer Protection Act, S. 3690, 110th Cong. § 103 (2008); Helping Families Save Their Homes in Bankruptcy Act of 2007, S. 2136, 110th Cong. § 101 (2007); Emergency Home Ownership and Mortgage Equity Protection Act of 2007, H.R. 3609, 110th Cong. § 4 (2007); Foreclosure Prevention Act of 2008, S. 2636, 110th Cong. § 101 (2008); HOMES Act, S. 2133, 110th Cong. § 2 (2007); HOMES Act, H.R. 3778, 110th Cong. § 202 (2007).

⁶ CTR. FOR RESPONSIBLE LENDING, HR 3609—COMPROMISE BILL PERMITTING COURT-SUPERVISED LOAN MODIFICATIONS WOULD SAVE 600,000 HOMES 1 (2008), *available at* <http://www.responsiblelending.org/pdfs/hr-3609-support-brief.pdf>.

⁷ See 11 U.S.C. § 1322(b)(2) (2006).

⁸ Pub. L. No. 95-598, 92 Stat. 2549 (1978).

⁹ The Bankruptcy Code has been amended several times since its enactment in 1978, most recently by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005) (codified as amended in scattered sections of 11 U.S.C.). Nevertheless, the Code's overall structure remains very similar to the statute as enacted in 1978.

¹⁰ See Bankruptcy Act §§ 651–52, 11 U.S.C. §§ 1051–52 (1976).

¹¹ See Bankruptcy Act § 606, 11 U.S.C. § 1006(1) (repealed in 1979).

¹² See e.g., 11 U.S.C. § 1322(b) (2006).

individuals with the opportunity to repay debts, in full or in part, while retaining assets.¹³ An innovation of chapter 13 was enabling the debtor to cure defaults on secured claims through the repayment of loan arrearages over time, even if the terms of the loan or nonbankruptcy law did not give the borrower this right.¹⁴ The new chapter 13 also permitted debtors to modify the rights of holders of secured or unsecured claims.¹⁵ This provision allowed bankruptcy courts to approve repayment plans that changed the prebankruptcy terms of a debt. However, the law contained an important exception to this modification rule for claims “secured only by a security interest in real property that is the debtor’s principal residence”¹⁶ This antimodification rule has endured as a feature of chapter 13 for three decades.

The legislative history with respect to the antimodification rule is sparse. Section 1322(b)(2) as enacted in 1978 appears to have been a compromise between competing versions of legislation. The Senate bill provided that debtors’ plans could “modify the rights of holders of secured claims and holders of unsecured claims, except claims wholly secured by real estate mortgages”¹⁷ The House version of § 1322(b)(2) took a broader approach and simply stated that the debtors’ plan of reorganization could “modify the rights of holders of secured claims or of holders of unsecured claims.”¹⁸ Secured creditors objected strenuously to these changes. In particular, advocates for secured creditors argued that debtors should not be able to modify secured claims by reducing the monthly payment or by reducing the amount of the claim to the value of the collateral.¹⁹ Creditors also suggested that a right to modification would discourage savings and loan associations from making home loans.²⁰ While it is impossible to pinpoint the exact reason why Congress excluded debtors’ principal residences from the new rule that permitted the modification of claims, the solvency of the savings and loan industry probably was a pressing concern for Congress at the time that it was considering the adoption of the new Bankruptcy Code.

¹³ See S. REP. NO. 95-989 (1978), as reprinted in 1978 U.S.C.C.A.N. 5787, 5927 (“Chapter 13 is designed to serve as a flexible vehicle for the repayment of part or all of the allowed claims of the debtor.”); H.R. REP. NO. 95-595 (1977), as reprinted in 1978 U.S.C.C.A.N. 5963, 6079 (“The benefit to the debtor of developing a plan of repayment under chapter 13, rather than opting for liquidation under chapter 7, is that it permits the debtor to protect his assets.”).

¹⁴ See 11 U.S.C. § 1322(b)(5).

¹⁵ 11 U.S.C. § 1322(b)(2).

¹⁶ *Id.*

¹⁷ S. REP. NO. 95-989, at 141 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5927.

¹⁸ H.R. REP. NO. 95-595, at 429 (1977), reprinted in 1978 U.S.C.C.A.N. 5787, 6384.

¹⁹ See *Grubbs v. Houston First Am. Sav.*, 730 F.2d 236, 245 (5th Cir. 1984) (citing *Bankruptcy Reform Act, Pt. I: Hearings Before the Subcomm. on Improvements of the Judicial Machinery of the S. Comm. on Judiciary*, 94th Cong. 124, 127–28, 130, 132–34, 137–38, 139, 141–42, 167–68, 176–80 (1975) (statements of Walter Vaughan on behalf of the American Bankers Association, and of Alvin Wiese, National Consumer Finance Association)).

²⁰ See *id.* at 245 n.13 (citing *Bankruptcy Reform Act of 1978: Hearings Before the Subcomm. on Improvements of the Judicial Machinery of the S. Comm. on the Judiciary*, 95th Cong. 652–53, 703, 707, 714–15, 719–21 (1977) (statements of Alvin Wiese and John V. Kulik, National Association of Real Estate Investment Trusts) (discouraging savings and loan associations from making home loans)).

During the 1970s, savings and loan institutions dominated the residential mortgage market in the United States.²¹ The secondary mortgage market, in which loans were originated and then sold, was in its nascence. The typical late 1970s home mortgage loan was a thirty-year mortgage with a fixed interest rate and equal monthly payments.²² While bankruptcy reform was being debated in Congress, the savings and loan industry was being squeezed by a mismatch of high short-term interest rates paid on deposits and lower fixed interest rates and level payments being paid on residential mortgage loans.²³ Because the savings and loan institutions funded mortgage loans from federally-insured deposits, trouble for the industry created large potential liability for the federal government. Congress may have created an exception for home mortgage loans from modification in chapter 13 bankruptcy as a concession to the financial challenges facing savings and loan institutions. The special treatment of home mortgages certainly reflects a political compromise, as well as the broader financial context, of the time in which chapter 13 was created.

However, the days in which the savings and loan industry dominated the residential mortgage market in the United States have long past. Efforts to protect the savings and loan industry and expand the availability of credit in the late 1970s were replaced by concerns about the growth of abusive lending practices in the late 1980s and early 1990s. During this period, home mortgage lending was profoundly transformed. The secondary mortgage market expanded exponentially, and the securitization of residential mortgage loans became common. Non-depository mortgage lenders, such as finance companies, became the primary originators of residential mortgage loans, and the subprime market that made mortgage loans on less robust underwriting standards began to flourish.

Early subprime loans, often fixed-rate, were characterized by high interest rates and high points and fees at origination.²⁴ For example, in 1999 subprime mortgage loans had interest rates as high as 19.99%, with a median interest rate between 11% and 11.99%. By contrast, for the same year the interest rate for conventional prime thirty-year mortgages was 7.43%.²⁵ The higher interest rates on subprime loans translated into higher monthly mortgage payments for loans of identical amounts. These higher monthly payments increased the incidence of unaffordable housing costs while concomitantly

²¹ See Douglas B. Diamond, Jr. & Michael J. Lea, *Housing Finance in Developed Countries: An International Comparison of Efficiency: United States*, 3 J. OF HOUSING RES. 145, 145 (1990).

²² See *id.* (explaining that deregulation of lending practices in the late 1970s and early 1980s gave rise to adjustable rate mortgages).

²³ See *id.*; see also Richard K. Green & Susan M. Wachter, *The American Mortgage in Historical and International Context*, 19 J. OF ECON. PERSP. 93, 98 (2005). Fixed-rate mortgages paid between five and six percent while yield on short term Treasury bills generally did not exceed four percent. See *id.* at 97. The year before the Bankruptcy Code was enacted, the yield rate on three-month Treasury bills had begun a steady climb from a 4–6% range in 1977 to 6–9% in 1978 and into double digit figures to reach an annualized high of over 14% in 1981. See Fed. Reserve, Statistical Release H15, 3-Month Auction High Bill Rate by Issue Date (June 30, 2000), http://www.federalreserve.gov/releases/H15/data/Annual/discontinued_AH_M3.txt.

²⁴ 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, 527–28 (2000).. at 536–37 (providing data on interest rate range for subprime loans).

²⁵ See *id.*

expanding the homeownership markets to lower income families, many of whom had fewer assets and weaker credit histories than traditional homeowners.

Loan-to-value ratios for mortgages also increased during the 1990s as lenders aggressively marketed home equity loans and debt consolidation programs in which the debt on the home exceeded the value of the property. Lenders knowingly allowed borrowers to leverage their homes beyond the current market value of those homes.²⁶ Rather than relying on equity in the collateral, lenders counted on borrowers' abilities to refinance as home prices appreciated and borrowers' fear of foreclosure to protect their interests.²⁷ These high loan-to-value lenders also "turned away from traditional mortgage lending standards in favor of underwriting standards similar to those used for unsecured (primarily, credit card) loan products."²⁸ Despite looser underwriting standards and subprime loan products that put families in home loans that greatly exceeded affordability criteria, lenders nevertheless had some modicum of protection from loss because bankruptcy's antimodification rule limited the attractiveness and scope of chapter 13 relief for homeowners in financial distress. During the late 1990s and early 2000s, however, lenders primarily escaped foreclosure because of borrowers' ability to refinance as home prices appreciated and because of strong demand for mortgage-backed securities that expanded underwriting standards. While Chapter 13 bankruptcy could do little to help homeowners during the early 2000s, the market largely provided a safety valve for families in unaffordable loans.

The more recent advent of "exotic" or "non-traditional" subprime loan products has exacerbated the extent to which the antimodification rule hampers bankruptcy's effectiveness as a home-saving tool. Many of these new mortgage products become severely unaffordable within a few years of origination by virtue of changing terms. The most dominant non-traditional mortgage product is the adjustable-rate mortgage (ARM). The most common product, the 2/28 ARM, is characterized by a fixed rate for the first two years, followed by an adjustment every six months thereafter. Often these loans are structured with an initial "teaser" or discounted rate. After the two-year fixed period for these loans expires, the interest rate, and accordingly the borrower's payments, can increase significantly.²⁹ To determine whether the borrower had the ability to make payments on the 2/28 ARM loan, lenders typically considered only whether the monthly payment based on the teaser rate would be affordable.³⁰ The expiration of the fixed-rate

²⁶ *See id.*

²⁷ *See* CHARLES CALOMIRIS & JOSEPH MASON, HIGH LOAN-TO-VALUE MORTGAGE LENDING: PROBLEM OR CURE? 11 (1999), *available at* http://www.aei.org/doclib/20021130_71252.pdf; Posting of Elizabeth Warren to Credit Slips: A Discussion on Credit and Bankruptcy, <http://www.creditslips.org/creditslips/2007/11/hostage-value.html> (Nov. 21, 2007, 16:54).

²⁸ CALOMIRIS & MASON, *supra* note 27, at 11.

²⁹ Typically, there is a cap on the increase in the first adjustment of 2% and caps on subsequent adjustments of 1%.

³⁰ Beverlea (Suzy) Gardner & Dennis C. Ankenbrand, *Hybrid ARMs: Assessing the Risks, Managing the Fallout*, SUPERVISORY INSIGHTS, Summer 2008, at 14, 17, *available at* <http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum08/sisum08.pdf> (listing underwriting weakness with hybrid ARM originations from 2004 until 2007, including qualifying buyers based on introductory payment); Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37,569 (July 10, 2007) ("The Agencies are concerned that many subprime borrowers may not

period brings with it a sharp increase in monthly payment, often referred to as “payment shock.”³¹ By mid-2006, hybrid ARMs such as 2/28s or 3/27s, made up 81% of the securitized subprime market.³²

Similarly, borrowers with option ARM loans are also subject to payment shock. With an option ARM, borrowers have the “option” of making a minimum payment, an interest-only payment, or a fully amortized payment. For most borrowers who took out such loans, the minimum payment is the only affordable payment on their incomes. However, this payment is insufficient to cover accrued interest on the loan, which results in any unpaid interest being added to the principal balance. As a result, the loan balance increases with time (i.e., negatively amortizes). Despite making payments over a period of months or years, the homeowner will find herself owing an increasing amount of mortgage debt, rather than building equity. Almost all option ARMs have trigger points that cause the loans to recast so that they will fully amortize over the remaining duration of the loan terms. Most option ARMs will recast five years from origination (a time trigger) or if the loan balance exceeds 110% of the original loan amount (a loan balance trigger).³³ Like the expiration of the teaser rate on a 2/28 ARM, the recasting of an option ARM leads to a very large increase in the monthly payment amount for most borrowers.

Additionally, weaker underwriting standards have led to the rapid growth of no documentation or low documentation loans that require no or limited verification of ability to repay the loan.³⁴ As a result of these changes in the modern mortgage market, traditional tools for preventing foreclosures such as nonbankruptcy forbearance agreements or chapter 13 bankruptcy repayment plans are much less effective than in the past. The bankruptcy right to repay mortgage arrearages over time does not address the ongoing increase in mortgage payments that millions of homeowners face with the nontraditional loan products originated in the last decade.

The antimodification rule enacted in 1978, at least in part to protect the savings and loan industry, has not been amended in thirty years, despite these vast changes in the residential mortgage market. The dramatic growth of high interest rate loans and nontraditional loan products has translated into far more unaffordable home loans. Particularly as the new products age, the changes in these loan terms have created sharp upticks in mortgage payments that cannot be met by families whose incomes rarely have experienced similar, dramatic increases. Unaffordable housing costs are a widespread feature of today’s American homeownership experience and are the driving factor of the foreclosure crisis. Absent the ability to address exploding interest rates, negatively

have sufficient financial capacity to service a higher debt load, especially if they were qualified based on a low introductory payment.”).

³¹ Gardner & Ankenbrand, *supra* note 30, at 17.

³² DERIVATIVE FITCH, STRUCTURED FINANCE: U.S. SUBPRIME RMBS IN STRUCTURED FINANCE CDOs 2 (2006).

³³ If the borrower makes only minimum payments every month, the loan balance trigger will usually be reached before the time trigger.

³⁴ By 2006 no or low documentation loans made up 49% of mortgage loans originated in the United States. See CREDIT SUISSE, MORTGAGE LIQUIDITY DU JOUR: UNDERESTIMATED NO MORE 38 (2007), available at <http://billcara.com/CS%20Mar%2012%202007%20Mortgage%20and%20Housing.pdf>.

amortizing loans, and over-leveraged homes, bankruptcy will be an incomplete or inadequate solution to the current foreclosure crisis.

Current Mortgage Markets and Mortgage Servicers Misaligned Interests

Because of the anti-modification provision of section 1322(b)(2), bankruptcy has been an ineffective tool in stemming the tide of foreclosures. Instead, government and industry have continued to rely on voluntary loan modifications. While the number of modifications has grown over the past two years, to date few modification offer principal reductions that are necessary to the long-term recovery of the housing market, and the economy. Investors are losing mind-boggling large sums of money on foreclosures.³⁵ The available data suggests that investors lose ten times more on foreclosures than they do on modifications.³⁶ In particular, leading investor groups have advocated broader use of principal reductions as part of the anti-foreclosure arsenal, but only a handful of servicers have obliged.³⁷

Servicers Have Different Interests Than Investors.

Solving the puzzle of why servicers are not engaging in greater principal writedowns requires an understanding of the relationship between the servicer and the investor. Servicers are ostensible agents for investors. Investors hold the note, or a beneficial interest in it, and are, in general, entitled to repayment of the interest and principal. Servicers collect the payments from the homeowners on behalf of the investors. The bulk of their income comes from a percentage payment on the outstanding principal balance in the pool; the bulk of their net worth is tied to the value of the mortgage servicing rights they purchased. A servicer may or may not lose money—or lose it in the same amounts or on the same scale—when an investor loses money. And it is servicers, not investors, who are making the day-to-day, on the ground, decisions as to whether or not to modify any given loan.

Servicers continue to receive most of their income from acting as largely automated pass-through accounting entities, whose mechanical actions are performed offshore or by personified computer systems.³⁸ Their entire business model is predicated on making money by skimming profits from what they are collecting: through a fixed percentage of the total loan pool, fees charged homeowners for default, interest income on the payments during the time the servicer holds them before they are turned over to the owners, and affiliated business arrangements. Servicers make their money largely

³⁵*Home Foreclosures: Will Voluntary Mortgage Modification Help Families Save Their Homes? Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary, 111th Cong. (2009) (testimony of Alan M. White) (65% loss severity rates on foreclosures in June 2009).*

³⁶*Home Foreclosures: Will Voluntary Mortgage Modification Help Families Save Their Homes? Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary, 111th Cong. (2009) (testimony of Alan M. White).*

³⁷*Preserving Homeownership: Progress Needed to Prevent Foreclosures: Hearing Before the Senate Comm. on Banking, Housing & Urban Affairs, 111th Cong. (July 16, 2009) (testimony of Curtis Glovier, on behalf of the Mortgage Investors Coalition).*

³⁸*See, e.g., In re Taylor, 2009 WL 1885888 (Bankr.E.D.Pa. Apr 15, 2009).*

through lucky or strategic investment decisions: purchases of the right pool of mortgage servicing rights and the correct interest hedging decisions. Performing large numbers of loan modifications would cost servicers upfront money in fixed overhead costs, including staffing and physical infrastructure.

Servicers' Business Model Involves As Little Service As Possible.

As with all businesses, servicers add more to their bottom line to the extent that they can cut costs.³⁹ Servicers have cut costs by relying more on voicemail systems and less on people to assist homeowners, by refusing to respond to homeowners' inquiries and by failing to resolve borrower disputes. Servicers sometimes actively discourage homeowners from attempting to resolve matters.

As one attorney in Michigan attempting to arrange a short sale with Litton reports, the voice mail warns "If you leave more than one message, you will be put at the end of the list of people we call back." Recent industry efforts to "staff-up" loss mitigation departments have been woefully inadequate.⁴⁰ As a result, servicers remain unable to provide affordable and sustainable loan modifications on the scale needed to address the current foreclosure crisis. Instead homeowners are being pushed into short-term modifications and unaffordable repayment plans.

Creating affordable and sustainable loan modifications for distressed homeowners on a loan-by-loan basis is labor intensive.⁴¹ Under many current pooling and servicing agreements, additional labor costs incurred by servicers engaged in this process are not compensated by the loan owner. By contrast, servicers' costs in pursuing a foreclosure are compensated. In a foreclosure, a servicer gets paid before an investor; in a loan modification, the investor will usually continue to get paid first. Under this cost and incentive structure, it is no surprise that servicers continue to push homeowners into less labor-intensive repayment plans or foreclosure.

Post hoc reimbursement for individual loan modifications is not enough to induce servicers to change their existing business model. This business model—of fee-collecting and fee-skimming—has been extremely profitable. A change in the basic structure of the business model to active engagement with homeowners is unlikely to

³⁹ See Joseph R. Mason, Servicer Reporting Can Do More for Modification than Government Subsidies 17 (Mar. 16, 2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1361331 (noting that "servicers' contribution to corporate profits is often . . . tied to their ability to keep operating costs low").

⁴⁰Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang, & Eileen Mauskopf, *The Incentives of Mortgage Servicers: Myths and Realities* 9-10 (Fed. Reserve Bd. Fin. & Econ. Discussion Series Div. Research & Statistical Affairs Working Paper No. 2008-46); State Foreclosure Prevention Working Group, Analysis of Subprime Mortgage Servicing Performance, Data Report No. 3 at 8 (2008), <http://www.csbs.org/Content/NavigationMenu/Home/SFPWGReport3.pdf>; Preston DuFauchard, California Department of Corporations, Loss Mitigation Survey Results 4 (Dec. 11, 2007); cf. Aashish Marfatia, Moody's, U.S. Subprime Market Update November 2007 at 3 (2008) (expressing concern as to servicers' abilities to meet staffing needs).

⁴¹ Joseph R. Mason, Mortgage Loan Modification: Promises and Pitfalls 7 (Oct. 3, 2007), available at papers.ssrn.com/sol3/papers.cfm?abstract_id=1027470.

come by piecemeal tinkering with the incentive structure. Indeed, some of the attempts to adjust the incentive structure of servicers have resulted in confused and conflicting incentives, with servicers rewarded for some kinds of modifications, but not others,⁴² or told both to proceed with a foreclosure and with a modification. Until recently, servicers received little if any explicit guidance on which modifications were appropriate and were largely left to their own devices in determining what modifications to make.⁴³ In the face of an entrenched and successful business model, fragmented oversight, and weak, inconsistent, and post hoc incentives, servicers need powerful motivation to perform significant numbers of loan modifications. Servicers clearly have not yet received such powerful motivation.

Servicers may make a little money by making a loan modification, but it will definitely cost them something. On the other hand, failing to make a loan modification will not cost the servicer any significant amount out-of-pocket, whether the loan ends in foreclosure or cures on its own. Until servicers face large and significant costs for failing to make loan modifications, until servicers are actually at risk of losing money if they fail to make modifications, no incentive to make modifications will work. What is lacking in the system is not a carrot; what is lacking is a stick.⁴⁴ Servicers must be required to make modifications, where appropriate, and the penalties for failing to do so must be certain and substantial.

Servicers Maximize Income in Ways that Hurt Both Homeowners and Investors.

Servicers are designed to serve investors, not borrowers. Despite the important functions of mortgage servicers, homeowners have few market mechanisms to employ to ensure that their needs are met. Rather, in the interest of maximizing profits, servicers have engaged in a laundry list of bad behaviors, which have considerably exacerbated foreclosure rates, to the detriment of both investors and homeowners.⁴⁵

⁴²See, e.g., Ben S. Bernanke, Chairman, Bd. of Governors of the Federal Reserve System, Speech at the Federal Reserve System Conference on Housing and Mortgage Markets: Housing, Mortgage Markets, and Foreclosures (Dec. 4, 2008), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20081204a.htm> (“The rules under which servicers operate do not always provide them with clear guidance or the appropriate incentives to undertake economically sensible modifications.”).

⁴³American Securitization Forum, Discussion Paper on the Impact of Forborne Principal on RMBS Transactions 1 (June 18, 2009), available at http://www.americansecuritization.com/uploadedFiles/ASF_Principal_Forbearance_Paper.pdf.

⁴⁴See *Helping Families Save Their Homes: The Role of Bankruptcy Law: Hearing Before the S. Comm. on the Judiciary*, 110th Cong., 2nd Sess. (Nov. 19, 2008), available at http://judiciary.senate.gov/hearings/testimony.cfm?renderforprint=1&id=3598&wit_id=4083 (statement of Russ Feingold, Member, Sen. Comm. on the Judiciary) (“One thing that I think is not well understood is that because of the complex structure of these securitized mortgages that are at the root of the financial calamity the nation finds itself in, voluntary programs to readjust mortgages may simply be doomed to failure.”).

⁴⁵See National Consumer Law Center, *Foreclosures*, Ch. 6 (2d ed. 2007 & Supp.) (describing the most common mortgage servicing abuses).

Most servicers derive the majority of their income based on a percentage of the outstanding loan principal balance.⁴⁶ For most pools, the servicer is entitled to take that compensation from the monthly collected payments, even before the highest-rated certificate holders are paid. The percentage is set in the PSA and can vary somewhat from pool to pool, but is generally 25 basis points for prime loans and 50 basis points for subprime loans.⁴⁷ This compensation may encourage servicers to refuse principal reductions and to seek capitalizations of arrears and other modifications that increase the principal balance.

Servicers also receive fees paid by homeowners and the “float”—the interest earned on funds they are holding prior to their disbursement to the trust.⁴⁸ For many subprime servicers, late fees alone constitute a significant fraction of their total income and profit.⁴⁹ Servicers thus have an incentive to push homeowners into late payments and keep them there: if the loan pays late, the servicer is more likely to profit than if the loan is brought and maintained current. Float income encourages servicers to delay turning over payments to investors for as long as possible.

For servicers, their most important asset is the value of their mortgage servicing rights. Whether or not the servicer made the correct speculative investment decision when it bought the mortgage servicing rights to a pool of mortgages does more to shape its profitability than any other single factor. A servicer’s performance has only a marginal impact on the performance of the loan pool; the way a servicer increases its net worth is not by doing a top-notch job of servicing distressed mortgages but by gambling on market trends. Servicers with thin margins may need to squeeze all they can out of increasing performance from delinquent loans; servicers with stronger pools are likely to be less invested in the performance of the loans they manage.⁵⁰ This dynamic leaves many servicers indifferent to the performance of the loans they service and unmotivated to hire and train the staff needed to improve performance.

Servicers Have Disincentives to Perform Principal Reductions, Even When Doing So Would Benefit the Trust

Some servicers, notably Ocwen, Litton, and, to a lesser extent, Carrington, have made significant numbers of principal reductions. But other servicers—including those who are also major lenders—have not. In part, this represents nothing more than experience:

⁴⁶See, e.g., Ocwen Fin. Corp., Annual Report (Form 10-K), at 3 (Mar. 17, 2008) (typically receive 50 basis points annually on the total outstanding principal balance of the pool).

⁴⁷Anthony Pennington-Cross & Giang Ho, *Loan Servicer Heterogeneity & The Termination of Subprime Mortgages 2* (Fed. Res. Bank of St. Louis Working Paper No. 2006-024A); 26 NCLC Reports, *Follow the Money: How Servicers get Paid* May/June 2008..

⁴⁸See generally *In re Stewart*, 391 B.R. 327, 336 (Bankr.E.D.La. 2008) (overviewing servicer compensation).

⁴⁹See, e.g., Ocwen Fin. Corp., Annual Report (Form 10-K), at 3 (Mar. 17, 2008); Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 Housing Pol’y Debate 753, 758 (2004).

⁵⁰Vikas Bajaj & John Leland, *Modifying Mortgages Can Be Tricky*, N.Y. Times, Feb. 18, 2009 (reporting views of Credit Suisse analyst that “[s]maller companies . . . that are under more financial pressure and have more experience in dealing with higher-cost loans have been most aggressive in lowering payments” than larger companies, who offer weaker modifications).

Ocwen has more experience modifying loans than many other servicers. In part, it reflects the varying incentives servicers have weighing against loan modifications.

Of key importance is whether or not the loss of a principal reduction is recognized immediately or if it is delayed. Most PSAs are silent on the treatment of principal reductions or forbearance.⁵¹ If recognition of the loss is immediate, servicers face reduced income in two ways, their monthly servicing fee and income from any subordinate tranches. Only if recognition of the loss is delayed are servicers likely to be neutral or even positive towards principal reductions.⁵² This accounting nicety accounts, in part, some industry analysts believe, for the high rate of loan modifications with principal reductions performed by Ocwen in 2007.⁵³

As discussed above, servicers derive the bulk of their income from the monthly servicing fee. The monthly servicing fee is set as a percentage of the outstanding loan principal balance in the pool. Once a principal write down is recognized, the outstanding principal balance of the pool declines and so does the servicer's monthly fee.

Servicers will also take a hit against their residual income if the loss is recognized immediately. Commonly, servicers also derive some income from the lowest level investment interests in the pool, called residuals.⁵⁴ Residuals represent payment of the surplus income after the senior certificate holders have been paid. If the pool shrinks, through foreclosure, prepayment, or principal reduction, or the interest rate drops on the loans in the pool due to modifications, there will be less of a surplus, and the servicer will suffer a loss. Once a pool suffers a certain level of loss, further payments out of residual income are cut off. If the loss is recognized immediately, the subordinate tranches in most cases bear the entire cost.⁵⁵ Since industry practice, despite the silence in the PSAs, has now moved towards recognizing the principal write down as an immediate loss, many

⁵¹See American Securitization Forum, Discussion Paper on the Impact of Forborne Principal on RMBS Transactions 1 (June 18, 2009), *available at*

http://www.americansecuritization.com/uploadedFiles/ASF_Principal_Forbearance_Paper.pdf.

⁵²See generally American Securitization Forum, Discussion Paper on the Impact of Forborne Principal on RMBS Transactions (June 18, 2009), *available at*

http://www.americansecuritization.com/uploadedFiles/ASF_Principal_Forbearance_Paper.pdf (discussing impact of accounting for principal forbearance).

⁵³Ocwen was apparently not recognizing the loss immediately, and thus shifting more of the pain to senior bond holders and away from the subordinate tranches. Rod Dubitsky, Larry Yang, Stevan Stevanovic, Thomas Suer, Credit Suisse, Subprime Loan Modifications Update 7-8 (2008).

⁵⁴See, e.g., Ocwen Fin. Corp., Annual Report (Form 10-K), at 20 (Mar. 17, 2008); Joseph R. Mason, Mortgage Loan Modification: Promises and Pitfalls 8 (Oct. 2007) (servicers who own residual interests always lose money when loans are modified). In some cases, the servicer may even bet against itself, by purchasing a credit default swap on the pool, in which case it makes money if there is a foreclosure. See Patricia A. McCoy & Elizabeth Renuart, The Legal Infrastructure of Subprime and Nontraditional Home Mortgages 36 (2008), *available at*

http://www.jchs.harvard.edu/publications/finance/understanding_consumer_credit

⁵⁵See American Securitization Forum, Discussion Paper on the Impact of Forborne Principal on RMBS Transactions 3-6 (June 18, 2009), *available at*

http://www.americansecuritization.com/uploadedFiles/ASF_Principal_Forbearance_Paper.pdf.

servicers may be doubly reluctant to write down principal, regardless of the investors' druthers.⁵⁶

Reconsidering Bankruptcy Reform

In the wake of rapidly rising foreclosure rates in late 2007, policymakers struggled to formulate solutions. A popular proposal was to repeal the antimodification provision of the Bankruptcy Code to improve bankruptcy relief as a means to help families struggling with unaffordable home loans. Current law was criticized as a major roadblock to keeping families in their homes. Several bills were introduced in Congress to allow bankruptcy courts to modify the terms of chapter 13 debtors' residential mortgage loans.⁵⁷ Consumer advocates backed the legislation, citing a continued escalation in the number of foreclosures and describing the harms that families and communities suffer from foreclosure.⁵⁸ The lending industry mounted a strong and continuous opposition to the bills, relying mainly on their predictions that the modification of home mortgages in bankruptcy would cause mortgage rates to rise 1.5% to 2% on future loans.⁵⁹ The industry's figures were heavily criticized for being unsupported by empirical analysis,⁶⁰ but the industry generated enough concern over mortgage market liquidity that efforts to reform the Bankruptcy Code to permit modification of home-secured debt were rejected by the Senate in April 2009. Instead, government and industry have continued to rely on voluntary measures to stem the tide of foreclosures.

Nearly two years into this foreclosure crisis it is clear that relying on servicers to voluntarily modify loans is an insufficient solution. Maybe it is time to reconsider bankruptcy reform that would treat home secured debt like any other debt. Maybe it is time to modify the anti-modification provision of section 1322(b)(2).

⁵⁶See Rod Dubitsky, Larry Yang, Stevan Stevanovic, Thomas Suer, Credit Suisse, Subprime Loan Modifications Update 7-8 (2008).

⁵⁷See *supra* note 5.

⁵⁸CTR. FOR RESPONSIBLE LENDING, H.R. 3609: COMPROMISE BILL PERMITTING COURT-SUPERVISED LOAN MODIFICATIONS WOULD SAVE 600,000 HOMES (2008), available at <http://www.responsiblelending.org/pdfs/hr-3609-support-brief.pdf>.

⁵⁹*Straightening Out the Mortgage Mess: How Can We Protect Home Ownership and Provide Relief to Consumers in Financial Distress?—Part II: Hearing Before Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 110th Cong. at 3. (2007) [hereinafter Kittle Testimony] (statement of David Kittle, Mortgage Bankers Association), available at <http://www.mortgagebankers.org/files/StoptheBankruptcyCramDown/StatementofDavidKittle.pdf>; see Mortgage Bankers Association, Press Release, "Stop the Cram Down Resource Center" Puts a Price Tag on Bankruptcy Reform, Jan. 15, 2007, available at <http://www.mortgagebankers.org/NewsandMedia/PressCenter/59343.htm>.

⁶⁰Adam J. Levitin & Joshua Goodman, *The Effect of Bankruptcy Strip-Down on Mortgage Markets* (Georgetown Public Law and Legal Theory Working Paper Series, Research Paper No. 1087816, 2008), available at <http://ssrn.com/abstract=1087816>.