

Testimony of John Rao

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Before the United States Senate  
Committee on the Judiciary

“Mortgage Modifications During the Foreclosure Crisis:

Is There a Role for Bankruptcy Courts?”

August 20, 2009

Senator Whitehouse, thank you for holding this hearing and for inviting me to testify today concerning voluntary efforts to modify home mortgages and the potential role of bankruptcy courts in solving our foreclosure crisis. I testify here today on behalf of the low income clients of the National Consumer Law Center (NCLC).<sup>1</sup> NCLC provides legal and technical assistance on consumer law issues to legal services, government and private attorneys representing low-income consumers across the country. The clients and constituencies of NCLC collectively encompass a broad range of families and households who have been affected by current foreclosure crisis.

In my work as an attorney at NCLC, I provide training and technical assistance to attorneys and housing counselors across the country representing homeowners who are facing foreclosure. Because of my extensive experience in bankruptcy matters, I often speak at educational programs for bankruptcy attorneys, trustees and judges, and I serve as a member of the federal Judicial Conference Advisory Committee on Bankruptcy Rules. My testimony is based on this work and over twenty-five years experience representing consumers in debt

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<sup>1</sup> 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 eighteen practice treatises and annual supplements on consumer credit laws, including *Truth In Lending* (6th ed. 2007) 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 all federal laws affecting consumer credit since the 1970s, and regularly provide extensive comments to the federal agencies on the regulations under these laws. This testimony was written with the assistance of Alys Cohen, Staff Attorney, and Diane E. Thompson, Of Counsel, NCLC.

collection, bankruptcy and foreclosure defense matters, initially as an attorney with Rhode Island Legal Services and head of its Consumer Unit. I continue to assist attorneys at Rhode Island Legal Services with bankruptcy and foreclosure cases.

While federal bankruptcy law generally permits claims of secured creditors to be modified in bankruptcy cases, it currently singles out home mortgage claims and shields them from modification, other than through a plan which cures a mortgage default. This provision in the Bankruptcy Code prevents homeowners from changing the interest rate, amortization, or term of mortgage loans in a Chapter 13 case, the type of bankruptcy consumers often file to save a home from foreclosure. Over the past two years, Congress has considered legislation that would repeal this provision and allow modification of home-secured loans in Chapter 13 cases. This change in the law would greatly assist homeowners and would complement the Department of Treasury's loan modification program outside of bankruptcy.

### **Foreclosures Still Outpacing Voluntary Loan Modifications**

We are now three years into the foreclosure crisis and unfortunately there have been no signs of improvement. The statistics are grim. New foreclosure filings have continued to increase since 2007, with approximately 290,000 reported in March 2009. Realtytrac recently reported that an additional 300,000 homes go into foreclosure every month.<sup>2</sup> For 2008, foreclosure filings nationwide were up 81 percent over 2007 filings.<sup>3</sup> At the end of the first

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<sup>2</sup> Realtytrac, 1.9 Million Foreclosure Filings Reported On More Than 1.5 Million U.S. Properties in First Half of 2009, *available at* <http://www.realtytrac.com/ContentManagement/PressRelease.aspx?channelid=9&ItemID=6802>.

<sup>3</sup> RealtyTrac, Inc., Foreclosure Activity Increases 81 Percent in 2008 (Jan. 15, 2009), *available at* <http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=5681&acct=64847>.

quarter of 2009, 3.85 percent of residential mortgage loans were in foreclosure, which accounts for more than 2 million homes.<sup>4</sup> As of March 31, 2009, the Mortgage Bankers Association reported that 7.24 percent of residential mortgage loans were seriously delinquent. For subprime mortgage loans, an incredible 24.88 percent were reported as seriously delinquent. In addition, 9.12 percent of all loans outstanding as of the end of the first quarter of 2009 were in delinquent status. This delinquency rate is the highest in the MBA's records going back to 1972.<sup>5</sup> In fact, all of these statistics are record breaking and suggest that we are facing the greatest foreclosure crisis since the Great Depression.

Projections for the future are likewise bleak. Goldman Sachs estimates that, starting at the end of the last quarter of 2008 through 2014, 13 million foreclosures will be started.<sup>6</sup> The Center for Responsible Lending, based on industry data, predicts 2.4 million foreclosures in 2009, and a total of 9 million foreclosures between 2009 and 2012.<sup>7</sup> Recent reports also indicate that a new wave of foreclosures will take place affecting Alt-A mortgages. These are mortgages

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<sup>4</sup> Mortgage Bankers' Ass'n, Nat'l Delinquency Survey Q109 at 4 (2009) (reporting that 3.85% of 44,979,733, or 1.7 million, mortgages serviced were in foreclosure). Roughly half of these were serviced by national banks or federal thrifts. See Office of the Comptroller of the Currency & Office of Thrift Supervision, OCC and OTS Mortgage Metrics Report: Disclosure of National Bank and Federal Thrift Mortgage Loan Data, First Quarter 2009, at 8 (June 2009), available at <http://files.ots.treas.gov/482047.pdf> (reporting that 884,389 foreclosures were in process by national banks and federal thrifts at the end of the first quarter of 2009). The estimate of more than 2 million homes in foreclosure is achieved by extrapolating from the MBA numbers. The MBA survey only covers approximately 80% of the mortgage market. Thus,  $(44979733 * 3.85\%) / 0.8 = 2.16$  million.

<sup>5</sup> See MBA Press Release, Delinquencies and Foreclosures Continue to Climb in Latest MBA National Delinquency Survey, May 28, 2009.

<sup>6</sup> Goldman Sachs Global ECS Research, *Home Prices and Credit Losses: Projections and Policy Options* (Jan. 13, 2009), at 16; see also Rod Dubitsky, Larry Yang, Stevan Stevanovic & Thomas Suehr, Credit Suisse Fixed Income Research, *Foreclosure Update: Over 8 Million Foreclosures Expected* 1 (Dec. 4, 2008) (predicting 9 million foreclosures for the period 2009-2012).

<sup>7</sup> Center for Responsible Lending, *Soaring Spillover 1* (May 2009), available at <http://www.responsiblelending.org/mortgage-lending/research-analysis/soaring-spillover-3-09.pdf>.

that were generally given to borrowers with higher credit scores than subprime borrowers, but were made with non-traditional underwriting standards. One rating agency, Standard and Poor's, last month downgraded the ratings for mortgage-backed securities of Alt-A mortgages made between 2005-2007, based on higher unemployment and the continuing problems in the housing market.

Among the potential solutions to this crisis, loan modifications have been identified as one of the preferred strategies.<sup>8</sup> In fact, because many of the loans in or soon to be in foreclosure were made without considering the homeowner's ability to pay or were underwritten using inflated property appraisals, any plan to address the current crisis that does not include some form of loan modification as an essential component will fail. While the potential benefits of loan modifications are clear, the response from the financial services industry has been lacking and is dwarfed by the magnitude of the foreclosure problem.

Since the start of the current foreclosure crisis, there have been several efforts to encourage loan modifications through voluntary measures. Several were implemented before the Home Affordable Modification Program (HAMP), announced by President Obama's administration on March 4, 2009. In September 2007, federal and state banking regulators issued a joint statement on loss mitigation strategies, referencing earlier guidance and encouraging use of loss mitigation authority available under pooling and servicing agreements.<sup>9</sup> In October 2007, as part of the HOPE NOW program, former Treasury Secretary Paulson sought voluntary commitments from servicers to contact borrowers and explore new loan modification

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<sup>8</sup> See, e.g., Sheila C. Bair, Chairwoman, Federal Deposit Insurance Corp. (FDIC), Remarks to the American Securitization Form (ASF) Annual Meeting (June 6, 2007) ("The immediate task is to sustain homeownership by ensuring the servicers have the flexibility they need to make prudent loan modifications.").

<sup>9</sup> Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages (Sept. 2007), available at <http://www.occ.treas.gov/ftp/bulletin/2007-38a.pdf>.

approaches.<sup>10</sup> Then in December 2007, Secretary Paulson announced a plan for “fast track” loan modifications.<sup>11</sup>

Despite industry claims to the contrary, these initial programs failed as a loan modification strategy to stop the foreclosure crisis. The HOPE NOW program’s first data issued in early 2008 demonstrated that little progress had been made.<sup>12</sup> The Mortgage Bankers Association’s report on loan modifications issued in January 2008 revealed similar results. The major finding was that, in the third-quarter of 2007, mortgage servicers worked out 183,000 repayment plans and 54,000 loan modifications, while starting 384,000 new foreclosures.<sup>13</sup> Both reports confirmed that servicers relied heavily during this period on repayment plans rather than loan modifications. Repayment plans require homeowners to make increased monthly payments to cure arrears. They do not address payment affordability problems caused by high interest rates and rate resets on adjustable rate mortgages.

A recent paper in the Boston Federal Reserve Bank’s Public Policy series found that less than eight percent of all the loans 60 days or more delinquent were modified during 2007-2008.<sup>14</sup>

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<sup>10</sup> Associated Press, Paulson to Mortgage Industry: Help Curb Defaults (Oct. 31, 2007), *available at* [http://money.cnn.com/2007/10/31/real\\_estate/paulson\\_housing.ap/](http://money.cnn.com/2007/10/31/real_estate/paulson_housing.ap/).

<sup>11</sup> Press Release, Statement of Treasury Secretary Henry M. Paulson, Jr. at Press Conference to Announce Framework to Help Preserve Communities by Preventing Foreclosure (Dec. 6, 2007), *available at* <http://www.treas.gov/press/releases/hp716.htm>.

<sup>12</sup> See HOPE NOW: Results in Helping Homeowners (Feb. 2008) (data covers eighteen servicers representing two-thirds of the industry), *available at* [http://www.fsround.org/hope\\_now/pdfs/JanuaryDataFS.pdf](http://www.fsround.org/hope_now/pdfs/JanuaryDataFS.pdf); *see also* HOPE NOW, Alliance Servicers, Prime and Subprime Residential Mortgages: 2007 Loss Mitigation Activities (Feb. 2008), *available at* <http://www.fsround.org/media/pdfs/NationaldataFeb.pdf>.

<sup>13</sup> Jay Brinkmann, Mortgage Bankers Association, An Examination of Mortgage Foreclosures, Modifications, Repayment Plans and other Loss Mitigation Activities in the Third Quarter of 2007 (Jan. 2008), *available at* [http://www.mortgagebankers.org/files/News/InternalResource/59454\\_LoanModificationsSurvey.pdf](http://www.mortgagebankers.org/files/News/InternalResource/59454_LoanModificationsSurvey.pdf).

<sup>14</sup> Manuel Adelino, Kristopher Gerardi & Paul S. Willen, *Why Don’t Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization* 35 (Fed. Reserve Bank of Boston

Professor Alan White, in examining pools of securitized mortgages, found that the number of modifications varied dramatically by servicer, ranging from servicers who modified as many as 35 percent of the loans in foreclosure to as few as 0.28 percent of the loans in foreclosure in November 2008.<sup>15</sup> Even at the high end of 35 percent of all mortgages in foreclosure, the modification rate is not enough to reduce the foreclosure rate to pre-crisis levels.<sup>16</sup>

Worse, the modifications offered pre-HAMP (and presumably still by servicers not offering HAMP modifications) were overwhelmingly ones that increased the borrower's payment and principal balance. Only about three percent of the delinquent loans studied in Boston Federal Reserve Bank paper received modifications that reduced the payment.<sup>17</sup> Professor White's data shows that, in the aggregate, modifications increase the principal balance.<sup>18</sup> While the first quarter 2009 data from the OCC and OTS show that a majority of the modifications (excluding short term payment plans or forbearance agreements) decreased the

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Pub. Pol'y Paper No. 09-4, July 6, 2009), available at <http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf>.

<sup>15</sup> Alan M. White, *Deleveraging the American Homeowner: The Failure of 2008 Voluntary Mortgage Modification Contracts*, Conn. L. Rev. 12-13 (forthcoming 2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1325534](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1325534).

<sup>16</sup> See Ben S. Bernanke, Chairman, Bd. of Governors, Fed. Reserve Sys., Address at the Federal Reserve System Conference on Housing and Mortgage Markets (Dec. 4, 2008), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20081204a.htm#f12> (noting that the number of foreclosures has more than doubled from pre-crisis levels).

<sup>17</sup> Manuel Adelino, Kristopher Gerardi & Paul S. Willen, *Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization* (Fed. Reserve Bank of Boston Pub. Pol'y Paper No. 09-4, July 6, 2009), available at <http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf>.

<sup>18</sup> Alan White, *Rewriting Contracts, Wholesale: Data on Voluntary Mortgage Modifications from 2007 and 2008 Remittance Reports*, Fordham Urb. L. J. 20 (forthcoming 2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1259538#](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1259538#)

payment, virtually all of those modifications also increased the principal balance by capitalizing arrears.<sup>19</sup> Unsurprisingly, redefault rates on loan modifications remain high.<sup>20</sup>

HAMP has attempted to overcome problems with earlier administration programs and the long standing reluctance by servicers to perform large numbers of sustainable loan modifications. HAMP seeks to change the dynamic that leads servicers to refuse even loan modifications that would be in the investors' best interests by providing both servicers and investors with payments to support successful loan modifications. Several months into the Home Affordable Modification Program (HAMP), however, homeowners and their advocates report that the program is not providing a sufficient number of loan modifications to homeowners, the modifications offered often do not meet the guidelines of the program, and the program itself still presents serious barriers to mass loan modifications. Moreover, even if HAMP operated at its full capacity as envisioned by Treasury officials, HAMP's loan modifications still would be substantially outpaced by foreclosures, and the modifications themselves lack the mandated principal reductions that we believe are necessary to stem the foreclosure tide.

To date, implementation of HAMP by servicers has been slow and sporadic. The Administration's recent efforts to hold servicers accountable<sup>21</sup> are a welcome and necessary step forward, however, further changes to the program's design are needed for the program to reach even its stated goals. On August 4, 2009, the Administration released its first report on HAMP

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<sup>19</sup> Office of the Comptroller of the Currency & Office of Thrift Supervision, OCC and OTS Mortgage Metrics Report: Disclosure of National Bank and Federal Thrift Mortgage Loan Data, First Quarter 2009, at 5 (June 2009), *available at* <http://files.ots.treas.gov/482047.pdf>.

<sup>20</sup> Office of the Comptroller of the Currency & Office of Thrift Supervision, OCC and OTS Mortgage Metrics Report: Disclosure of National Bank and Federal Thrift Mortgage Loan Data, First Quarter 2009, at 6 (June 2009), *available at* <http://files.ots.treas.gov/482047.pdf>.

<sup>21</sup> Renae Merle, *White House Prods Banks: Letter Tells Chiefs To Start Backing Mortgage Relief*, Wash. Post, July 10, 2009, *available at* [http://www.washingtonpost.com/wp-dyn/content/article/2009/07/09/AR2009070902928.html?nav=rss\\_business](http://www.washingtonpost.com/wp-dyn/content/article/2009/07/09/AR2009070902928.html?nav=rss_business).



progress.<sup>22</sup> During the period from May to July, 2009, it was reported that approximately 230,000 trial modifications had begun. While this may appear to be a good start, it is actually less total modifications than had been made by the industry in the period just before HAMP. For the first quarter of 2009, the mortgage industry reported that 360,000 modifications had been made.<sup>23</sup> Of more significant concern is that several large servicers, such as Bank of America, Wells Fargo, Ocwen and Wachovia, have failed to extend modifications to a significant portion of homeowners estimated to be eligible for HAMP. According to Treasury figures, while these four servicers have a total of 1,243,920 eligible homeowners, they started trial modifications for only 2 percent to 6 percent of this total (4% for Bank of America, 6% for Wells Fargo, 5% for Ocwen and 2% for Wachovia). One servicer, National City Bank, had extended HAMP modifications to **0 percent** of its estimated 37,126 eligible homeowners. And these figures even overestimate the progress because they are based only on homeowners who are 60-plus days delinquent. These figures do not consider the much larger group that would include homeowners who are eligible based on being in imminent default.

The Treasury report also noted that based on the initial figures, it has been projected that HAMP will modify 3 to 4 million mortgages over the next three years. Assistant Treasury Secretary Herbert Allison, in responding to questioning from the Senate Banking Committee, agreed that in order to meet Treasury's goals, the program would need to do 1 million per year—

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<sup>22</sup> United States Department of the Treasury, *Making Home Affordable Progress Report*, May 14, 2009, available at <http://www.treas.gov/press/releases/docs/05142009ProgressReport.pdf>.

<sup>23</sup> See HOPE NOW Mortgage Loss Mitigation Statistics, available at <http://www.hopenow.com/industry-data/HOPE%20NOW%20National%20Data%20July07%20to%20Jun09%20.pdf>.

approximately 20,000 per week.<sup>24</sup> Even if the Administration reaches those numbers, that will address no more than one-third of all foreclosures.<sup>25</sup> This leaves a majority of all foreclosures still unaddressed.

Another reason why HAMP should not be the sole loan modification program for responding to the foreclosure crisis is that a large number of homeowners are apparently not eligible for HAMP or are being steered by servicers to less helpful non-HAMP loan modifications. While this may reflect servicer disincentives and administrative problems discussed below, it has the potential to significantly reduce the Administration's projections of homeowners that will be helped by HAMP. For example, just before the first HAMP report was issued, Chase released figures on June 30, 2009 showing that since the servicer started processing HAMP modifications on April 6, 2009, it had approved 87,100 HAMP trial modifications and another 50,900 non-HAMP trial modifications to borrowers Chase said were not eligible for HAMP. It is of grave concern that 37 percent of Chase's loan modifications were not HAMP modifications because the borrowers were claimed to be ineligible for HAMP. Chase failed to report the number of homeowners who were not approved for any modifications during the period, nor did they disclose the terms on the non-HAMP loan modifications.

Moreover, the lack of mandated principal reductions under HAMP raises questions about the long-term sustainability of the modifications. Absent a mandate of principal reduction,

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<sup>24</sup> *Preserving Homeownership: Progress Needed to Prevent Foreclosures: Hearing Before the Senate Comm. on Banking, Housing & Urban Affairs*, 111<sup>th</sup> Cong. (July 16, 2009) (Senator Schumer's question of Assistant Treasury Secretary Herbert Allison).

<sup>25</sup> If we compare the Center for Responsible Lending's predictions of 9 million foreclosures for the period 2009-2012, Center for Responsible Lending, *Soaring Spillover 1* (May 2009), available at <http://www.responsiblelending.org/mortgage-lending/research-analysis/soaring-spillover-3-09.pdf>, with Treasury's prediction that HAMP will provide 3-4 million modifications over the same period, and then recognize that not every modified loan would have resulted in a foreclosure absent modification, one-third seems a generous estimate for the amount of reduction in the foreclosure rate afforded by HAMP.

almost all borrowers are likely denied the possibility of principal reductions, which undermines the long-term success of their modifications, and thus their homeownership. The double-whammy of declining home values and job losses helps fuel the current foreclosure crisis.<sup>26</sup> Homeowners who could normally refinance their way out of a lost job or sell their home in the face of foreclosure are denied both options when they owe more on their home than it is worth. Without principal reductions, homeowners who lose their jobs, have a death in the family, or otherwise experience a drop in income are more likely to experience redefault and foreclosure.<sup>27</sup> The threat of high rates of redefault looms without a meaningful way to reduce the principal balance of mortgages.

### **HAMP Design and Implementation Problems**

Creating affordable and sustainable loan modifications for distressed homeowners on a loan-by-loan basis is labor intensive.<sup>28</sup> In fact, HAMP has imposed data collection and documentation requirements that in many cases exceed that which was done when many of the troubled loans were originated. Under many current pooling and servicing agreements, additional labor costs incurred by servicers engaged in this process are not compensated by the loan owner. While HAMP does provide servicer compensation for successful modifications, it is too early to determine whether servicers will view that as fair compensation for the additional administrative burdens. By contrast, servicers' costs in pursuing a foreclosure are compensated.

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<sup>26</sup> *Preserving Homeownership: Progress Needed to Prevent Foreclosures: Hearing Before the Senate Comm. on Banking, Housing & Urban Affairs*, 111<sup>th</sup> Cong. (July 16, 2009), at 4-5 (testimony of Paul Willen).

<sup>27</sup> This is especially so since the HAMP modification program does not permit a second HAMP modification for any reason, even if there is a subsequent, unavoidable drop in income.

<sup>28</sup> Joseph R. Mason, *Mortgage Loan Modification: Promises and Pitfalls* 7 (Oct. 3, 2007), available at [papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1027470](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1027470).

Under this cost and incentive structure, it is no surprise that servicers continue to push homeowners into less labor-intensive repayment plans, non-HAMP loan modifications, or foreclosure. Even though HAMP has now been in operation for four months, attorneys and housing counselors continue to report to NCLC that homeowners they are working with are being offered less helpful non-HAMP loan modifications. In most cases, they are not told whether they were processed for a HAMP modification, or if they were, the reasons why they were denied a HAMP modification. The HAMP program does not require servicers to give homeowners this essential information. Whether or not homeowners who are offered non-HAMP modifications were in fact eligible for HAMP is uncertain.

Homeowners have encountered numerous bureaucratic barriers in attempting to obtain HAMP modifications. Homeowners' loan files are routinely lost.<sup>29</sup> Housing counselors report waits of months to hear back on review for a trial modification. A recent story in the Providence Journal reported that a Rhode Island homeowner mailed 99 pages of financial documentation to her servicer and four months later, still had not been notified that her modification had been approved. In another case, Select Portfolio Services advised counsel for a New York borrower on three separate occasions over six weeks that the necessary broker price opinion had been cancelled due to "system errors" and a new request would have to be submitted.

One of the key benefits to having a national loan modification program is that it can provide uniformity and standardization to the loan modification process. To some extent, HAMP has achieved that goal by providing eligibility guidelines and standard form agreements. Curiously, though, Treasury chose not to standardize the application process. HAMP does not require the use of a uniform loan modification application form and checklists for homeowners

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<sup>29</sup> Peter S. Goodman, *Paper Avalanche Buries Plan to Stem Foreclosures*, N.Y. Times, June 28, 2009.

to provide the required information and documentation. That makes it particularly difficult for housing counselors to assist homeowners since each servicer has different forms. To make matters worse, homeowners are expected to return required documents within days of receipt. Homeowners in both New York and Florida have reported receiving the trial modification agreements the same day the servicer required their return. One Illinois homeowner received her trial modification agreement three days after she was required to return the agreement.

More seriously, homeowners have no leverage to obtain a HAMP loan modification from even a participating servicer. It is unclear if the Administration's compliance efforts will be able to detect and remedy servicer noncompliance. Servicers are not even required to stop foreclosure proceedings while they are processing a homeowner for HAMP; they are merely encouraged to do so. This exacerbates the problem by adding thousands of dollars in additional foreclosure and attorney costs that ultimately are borne by the homeowner and capitalized into a higher loan principal amount. It also creates confusion for homeowners and discourages them from completing the arduous application process and trial period. Moreover, homeowners have no clear remedies if they are improperly denied a HAMP modification, assuming they can even figure out that the denial was improper due to the lack of transparency of the Net Present Value test and the lack of denial notices.

What is lacking in the system is not a carrot; what is lacking is a stick.<sup>30</sup> Servicers must be required to make modifications, where appropriate, and the penalties for failing to do so must

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<sup>30</sup> See *Helping Families Save Their Homes: The Role of Bankruptcy Law: Hearing Before the S. Comm. on the Judiciary*, 110<sup>th</sup> Cong., 2<sup>nd</sup> Sess. (Nov. 19, 2008), available at [http://judiciary.senate.gov/hearings/testimony.cfm?renderforprint=1&id=3598&wit\\_id=4083](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.”).

be certain and substantial. The leverage missing from HAMP is directly addressed by other proposals, including judicial modifications of distressed mortgages.

### **Specific Limitations under Current Bankruptcy Law**

When homeowners facing foreclosure have been unable to obtain a loan modification or other loss mitigation option from their mortgage holders, they have often turned to Chapter 13 bankruptcy as a last resort for saving their homes. One of the most significant provisions in Chapter 13 has been the right to cure defaults on loans, even if the lender has called the loan due before the bankruptcy is filed and even if such right to cure does not exist under state law or the consumer's loan contract. Bankruptcy law currently permits homeowners to cure defaults within a reasonable time by making payments on the arrears together with the ongoing payments during the plan.

The cure right in Chapter 13 has long served an important role for the same reason that court-ordered loan modifications are now needed. Because of the limitations of voluntary workout options, some mortgage servicers even before the current foreclosure crisis were not permitted by investors of 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. Other servicers were simply too aggressive in pursuing foreclosure without offering workout options or were the cause of the homeowner's foreclosure problem because of negligent servicing.<sup>31</sup> Chapter 13 therefore made long-term repayment plans available when mortgage lenders and their servicers had not been willing to negotiate reasonable similar plans.

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<sup>31</sup> See Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 *Housing Policy Debate* 753, 756–58 (2004).

However, 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 right to cure a mortgage default in a Chapter 13 bankruptcy 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.<sup>32</sup> This ability to modify secured claims is possible for virtually every type of debt except for the mortgage on the borrower's primary residence.<sup>33</sup> 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:

**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

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<sup>32</sup> See 11 U.S.C. §§ 1123(b)(5), 1222(b)(2), 1322(b)(2).

<sup>33</sup> Chapter 12 "family farmers" are permitted to modify home mortgages.

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),<sup>34</sup> 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.

While there is scant legislative history directly addressing the anti-modification clause in section 1322(b)(2),<sup>35</sup> 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.<sup>36</sup>

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

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<sup>34</sup> *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).

<sup>35</sup> See *Grubbs v. Houston First American Savings Assn.*, 730 F.2d 236 (5th Cir. 1984).

<sup>36</sup> 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).



(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.<sup>37</sup> 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.

Unfortunately, as is apparent from the current foreclosure crisis, HOEPA and limited regulatory efforts did not stop abusive lending practices. Indeed, the problem grew worse. Bankruptcy attorneys, legal services offices, housing counselors, and attorneys who assist homeowners in foreclosure now routinely see clients with mortgages that were unaffordable when made and 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.

Bankruptcy courts are currently powerless to defer or change payment terms that would be a modification of the mortgage not permitted under section 1322(b)(2).

### **Voluntary to Mandatory: Court-ordered Mortgage Modification**

To help families save their homes from foreclosure, Congress has considered legislation that would amend 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. This legislation addresses the limitations in current Chapter 13 based by making the following key changes:

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<sup>37</sup> 15 U.S.C. § 1602(AA)(1)(B).

**Repeal Special Protection for Home Mortgages in Section 1322.** This change would 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 borrowers with negative equity due to depreciating home values, 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 Bankruptcy 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. The solution to this is one which Congress has already provided for family farmers in Chapter 12 cases. Chapter 13 should be amended to include a provision similar to Bankruptcy Code 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.

These changes would allow homeowners in foreclosure 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. Mortgage holders 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.<sup>38</sup>

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<sup>38</sup> 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 home equity loan and

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. In fact, these changes could cause fewer Chapter 13s to be filed as more homeowners can be expected to obtain voluntary modifications outside bankruptcy. But even if current filings remain constant or even modestly increase, the number of potential Chapter 13 filings will be small in comparison to the overall mortgage market. 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. Congress has also considered reasonable limitations on cramdown, such as a “clawback” provision, that would limit any impact on future mortgage rates.

### **Advantages of the Bankruptcy Option**

It is clear that some form of enforcement mechanism is needed to encourage servicers to modify home mortgages. Unlike other enforcement tools that Treasury or Congress might consider which would be subject to legal challenges and costly government administrative costs, bankruptcy court-ordered modifications have already been tested to withstand constitutional and

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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.

administrative challenges. A court system is already in place that would oversee modifications without the use of taxpayer dollars. It would also provide homeowners with the legal right to a modification even if the servicer claims that the securitization documents prevent it from modifying the loan.

A recent report by Deutsche Bank suggests that the problem of “negative equity” is growing worse.<sup>39</sup> At present, the report notes that approximately 14 million, or 27 percent of all homeowners, owe more on their mortgages than their houses are worth. Significantly, they estimate that 25 million, or 48 percent of all homeowners, will have negative equity before home prices stabilize as projected in 2011.

Loan modifications with principal reductions appear to have the lowest redefault rates.<sup>40</sup> In areas with high cost mortgage markets, HAMP modifications may simply not be possible without principal reduction based on the “waterfall” for reaching payment affordability. HAMP’s use of principal forbearance instead of principal reduction results in large balloon payment obligations that prevent future refinancing and continue the stigma of negative equity. Thus, HAMP’s greatest weakness in ensuring sustainable modifications may be its failure to mandate principal reductions. The first quarter 2009 data from the OCC and OTS shows that virtually all of the modifications on GSE and private investor securitized loans did not involve any principal reduction.<sup>41</sup> Loans that were not securitized and held by banks in portfolio were

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<sup>39</sup> See Deutsche Bank Securitization Report, *Drowning in Debt - A Look at “Underwater” Homeowners*, Aug. 5, 2009.

<sup>40</sup> See, e.g., Roberto G. Quercia, Lei Ding, Janneke Ratcliffe, *Loan Modifications and Redefault Risk: An Examination of Short-Term Impact* (Center for Community Capital, March 2009), available at [http://www.ccc.unc.edu/documents/LM\\_March3\\_%202009\\_final.pdf](http://www.ccc.unc.edu/documents/LM_March3_%202009_final.pdf).

<sup>41</sup> Office of the Comptroller of the Currency & Office of Thrift Supervision, OCC and OTS Mortgage Metrics Report: Disclosure of National Bank and Federal Thrift Mortgage Loan Data, First Quarter 2009, at 5 (June 2009), available at <http://files.ots.treas.gov/482047.pdf>.

more likely to have principal reduction, but still only accounted for 5.9% of portfolio loan modifications. The stark reality is that absent a mandate of principal reduction or a bankruptcy modification option, virtually all borrowers will be denied the possibility of principal reductions. The availability of a cram down in Chapter 13 will encourage servicers and mortgage holders to consider principal reduction when making HAMP modifications. It was the experience of family farmers that when Chapter 12 was enacted, more voluntary modifications involving principal reduction were negotiated.

Incorporating a loan modification right in Chapter 13 will provide needed assistance to families who for one of many possible reasons have not been able to obtain HAMP or other 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 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.

Another major impediment to loan modifications has been the existence of secondary mortgage loans. Treasury estimates that up to 50 percent of at-risk mortgages have second liens.<sup>42</sup> Many servicers are reluctant to modify a first mortgage if the second mortgage holder does not consent or subordinate its mortgage, and second mortgage holders have not been willing to cooperate. HAMP attempts to address this problem through its Second Lien Program which provides two alternatives for second lien holders - accept a modification of the loan (reduction of interest rate to one to two percent) or receive a small payment in exchange for release of the lien (ranging from 3 to 12 cents per dollar of unpaid principal). It is unclear whether second

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<sup>42</sup> See Dept. of Treasury Making Home Affordable Program Update, April 29, 2009.

mortgage holders will find either of these options acceptable. Once again, bankruptcy court modifications address this problem because all of the liens on the property can be addressed at the same time based on a uniform set of laws and valuation standards.

Finally, another problem not addressed by HAMP is that many homeowners are burdened with debt other than their home mortgages. Unable to refinance their homes, many homeowners are struggling to pay off credit card and other non-mortgage debt. This problem is made more acute by the current unemployment situation, with many homeowners experiencing a loss or reduction in family income. While HAMP requires borrowers whose total monthly debt ratio ("back-end ratio") is 55 percent or greater to obtain credit counseling, there is no plan to directly assist homeowners in dealing with unmanageable debt. A bankruptcy option in which all of the family's financial problems can be dealt with under the supervision of a court approved plan would greatly assist homeowners who would otherwise likely redefault on a HAMP mortgage modification.

## **Conclusion**

Thank you for the opportunity to testify today. A timeline should be set to evaluate whether HAMP, along with other existing programs, can sufficiently address the foreclosure crisis.

Unless HAMP both increases its reach and mandates principal reductions, Congress should pass legislation to allow bankruptcy judges to modify home loans in bankruptcy. Adoption of court-supervised mortgage loan modifications would sidestep many of the structural barriers in the servicing industry that today are preventing mass loan modifications from occurring. Congress soon should recognize that voluntary measures, even with incentives, by entities that profit from homeowner default can not lead us out of this crisis.

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