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Helping Families Save Their Homes: The Role of
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(Statement of Professor Adam Levitin, Geo. U. L.
Center)

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Testimony of Adam Levitin

Associate Professor, Georgetown University Law Center

Hearing: "Helping Families Save Their Homes: The Role of Bankruptcy Law"

November 19, 2008

U.S. Senate Committee on the Judiciary

Mr. Chairman, Members of the Committee:

I am pleased to testify in support of the Helping Families Save Their Homes in Bankruptcy Act, legislation proposed by Senator Durbin that would significantly help ease the nationwide foreclosure crisis.

There are four major points I wish to make in my written testimony:

1. Voluntary, private-market efforts to address the foreclosure crisis have all failed.
2. Bankruptcy is the only method that can fully address the contractual and incentive problems created by securitization.
3. Bankruptcy modification of mortgages will not result in higher mortgage interest rates or less credit availability.
4. Bankruptcy modification of mortgages does not create moral hazard.

I. VOLUNTARY PRIVATE MARKET EFFORTS TO ADDRESS THE FORECLOSURE CRISIS HAVE FAILED

A. The Foreclosure Crisis and the Financial Crisis

The United States is in the midst of an unprecedented home foreclosure crisis. At no time since the Great Depression have so many Americans been in jeopardy of losing their homes. Over a million homes entered foreclosure in 2007¹ and another one to two million are expected to enter foreclosure in 2008.² We are on pace for 6.5 million homes, or 12.7% of all residential borrowers, to be in foreclosure by 2012.³ Nearly a quarter of a million homes were actually sold in foreclosure or otherwise surrendered to lenders in 2007.⁴ At the end of the first quarter of 2008, one in eleven homeowners was either past due or in foreclosure, the highest levels on record.⁵ Already nearly 20% of homeowners have negative equity in their homes,⁶ and by the time the housing market stabilizes, 40% of homeowners will have negative equity positions.⁷

The sheer number of foreclosures should be alarming because foreclosures create significant

deadweight loss.⁹ Historically, lenders are estimated to lose 40% - 50% of their investment in a foreclosure situation, ¹⁰ and in the current market, even greater losses are expected. If borrowers lose their homes and are forced to relocate, often to new communities. Foreclosure is an undesirable outcome for borrowers and lenders.

Foreclosures also have major third-party externalities. When families have to move to new homes, community ties are rent asunder. Friendships, religious congregations, schooling, childcare, medical care, transportation, and even employment often depend on geography. ¹² Homes root people in strong networks of community ties, and foreclosures destroy these key social bonds.

Foreclosures also depress housing and commercial real estate prices throughout entire neighborhoods. There is, on average, a \$3,000 property value decline for each of the closest fifty neighbors of a foreclosed property. ¹³ The property value declines caused by foreclosure hurt local businesses and erode state and local government tax bases. ¹⁴ Condominium and homeowner associations likewise find their assessment base reduced by foreclosures, leaving the remaining homeowners with higher assessments. ¹⁵

Foreclosed properties also impose significant direct costs on local governments and foster crime.¹⁶ A single foreclosure can cost the city of Chicago over \$30,000.¹⁷ Moreover, foreclosures have a racially disparate impact because African-Americans invest a higher share of their wealth in their homes ⁸ and are also more likely than financially similar whites to have subprime loans. ¹⁹

The foreclosure crisis has also been at the root of a larger financial crisis.

Because most residential mortgages are securitized into widely held securities, unprecedented default rates in the residential mortgage market affect not just mortgage lenders, but capital markets globally. The marketwide impact of defaults on mortgage-backed securities have been amplified by poorly understood and complex derivative

products that are bought and sold by financial institutions, which now find themselves insufficiently liquid or undercapitalized. This in turn has led to a global credit crisis as financial institutions have become hesitant to contract not knowing their counterparties' ultimate solvency.

As long as foreclosures continue at unabated rates, mortgage defaults will continue to rise as foreclosures depress real estate prices, fueling the cycle. Until housing prices stabilize, we will not see stability in the financial system, and housing prices cannot stabilize unless the tide of foreclosures is stemmed. In short, foreclosure is an inefficient outcome that is bad not only for lenders and borrowers, but for society at large.

B. Loss Mitigation Options on Defaulted Loans

Foreclosure, of course, is never mandatory, It is only one possibility among a set of loss mitigation options for a lender confronted with a defaulted loan. A lender always has the option of forbearing or of modifying the terms of a non-performing loan so that it can

perform under less onerous terms. 20 Indeed, so long as the losses from a modification would be less than those from foreclosure, modification is the efficient economic outcome for a non-performing loan. Given the sizeable losses lenders incur in foreclosure, one would expect lenders to be making significant modifications to loans, including reduction of principal and interest.

Chart 2: Loan Modifications, Repayment Plans, and Foreclosures, HOPE Now Alliance Members, Third Quarter 2007-Second Quarter 2008. 21

Yet, to date, there have been relatively few voluntary, private modifications of non-performing loans. As Chart 2 shows, the workouts performed by the HOPE Now Alliance have failed to keep pace with foreclosures. Chart 3 presents a similar picture for all national banks and federal thrifts. Moreover, as both Charts 2 and 3 show, most of the workouts have been repayment plans, in which the arrearage is simply reamortized into the remaining term of the loan or tacked on at the end, thereby increasing or at best holding steady the borrower's monthly payments. While repayment plans are sensible solutions to temporary disruptions in the borrower's cash flow, they are wholly inadequate responses to the key problems of the current mortgage market-payment reset shock and negative equity. Payment reset shock from an adjustable rate mortgage or negative amortization trigger in an option-ARM can only be addressed by modifications that freeze or lower monthly payments, which requires a reduction in the interest rate or principal of the loan. Likewise, negative equity positions can only be corrected through principal write-downs.

Even among the modifications, the vast majority have failed to reduce monthly payments, making them near worthless.²³ As the State Foreclosure Prevention Working

Group has noted, one out of five loan modifications made in the past year are currently delinquent. The high number of previously-modified loans currently delinquent indicates that significant numbers of modifications offered to homeowners have not been sustainable [M]any loan modifications are not providing any monthly payment relief to struggling homeowners [U]nrealistic or "band-aid" modifications have only exacerbated and prolonged the current foreclosure crisis.²⁴

Unrealistic modifications have been a problem not just for the subprime loans examined by the State Foreclosure Prevention Working Group, but also for the predominantly non-subprime loans held in Fannie Mae's portfolio or securitized by Fannie Mae, the vast majority of loan workouts have been through Fannie's "HomeSaver Loan" program, which involves making defaulted homeowners a new unsecured loan for up to \$15,000 to cover the deficiency on their mortgage loan. The HomeSaver program thus increases financially distressed homeowners' debt burdens while masking non-performing loans. At best, HomeSaver is a bridge-loan program that buys time until a . modification can be done, but given that Fannie Mae is carrying the HomeSaver Loans on its books at about 2% of their face value/⁵ it clearly expects near universal default and no recovery on these loans.

The federal government's foreclosure prevention programs have even more dismal results.

The FHA's FHA Secure program, which was intended to let borrowers with non-FHA adjustable rate and interest-only mortgages refinance into fixed-rate FHA loans has only helped a few thousand borrowers,²⁶ instead of the predicted 240,000.²⁷ FHA's Hope for Homeowners program, enacted in July 2008, as part of the Housing and Economic Recovery Act of 2008, has also been an absolute failure. Predicted to help 400,000 homeowners,²⁸ it has, to date, helped only around 100 homeowners²⁹ in large part because the cooperation needed from private lenders and servicers for homeowners to enter the program has been lacking. As the State Foreclosure Prevention Working Group has noted, "[n]early eight out of ten seriously delinquent homeowners are not on track for any loss mitigation outcome," and "[n]ew efforts to prevent foreclosures are on the decline, despite a temporary increase in loan modifications through the [second quarter] of 2008. 0

II. BANKRUPTCY MODIFICATION IS THE ONLY WAY TO ADDRESS THE OBSTACLES TO MORTGAGE MODIFICATION CREATED BY SECURITIZATION

A major factor complicating private, voluntary loan modification efforts is securitization. The vast majority, somewhere upwards of 80%, of residential mortgages are securitized. Understanding securitization is key to understanding why private, voluntary efforts at mortgage modification will inevitably fail and why bankruptcy modification presents the only sure method of preventing preventable foreclosures.

Securitization transactions are technical, complex deals, but the core of the transaction is fairly simple. A financial institution owns a pool of mortgage loans, which it either made itself or purchased. Rather than hold these mortgage loans (and the credit risk) on its own books, it sells them to a specially created entity, typically a trust (SPV). The trust pays for the mortgage loans by issuing bonds. The bonds are collateralized (backed) by the loans now owned by the trust. These bonds are so-called mortgage-backed securities (MBS).

Because the trust is just a shell to hold the loans and put them beyond the reach of the financial institution's creditors, a third-party must be brought in to manage the loans. This third-party is called a servicer. The servicer is supposed to manage the loans for the benefit of the MBS holders. The servicer performs the day-to-day tasks related to the mortgages owned by the SPV, such as collecting payments, handling paperwork, foreclosing, and selling foreclosed properties. These servicers are the entities that actually consider loan modification requests. Confusingly, the servicer is often, but not always, a corporate affiliate of originator; most of the major servicers are subsidiaries of bank holding companies: Countrywide Home Loans (Bank of America); CitiMortgage and CitiFinancial (Citigroup); Select Portfolio Servicing (Credit Suisse); Litton Loan Servicing LP (Goldman Sachs); Chase Home Finance and EMC Mortgage (JPMorgan Chase); Wilshire Credit (Merrill Lynch); Wells Fargo Home Mortgage and Homeeq Servicing (Wells Fargo).

Securitization creates numerous obstacles to voluntary loan modifications, but they may be reduced to three broad categories: contractual, practical, and economic.³¹ A.

Securitization Creates Contractual Limitations on Private Mortgage Modification

Securitization creates contractual limitations on private mortgage modification.

These limitations cannot be bypassed except through bankruptcy modification or a taking of MBS holders' property rights.

Servicers carry out their duties according to what is specified in their contract with the SPY. This contract is known as a "pooling and servicing agreement" or PSA. Although the decision to modify mortgages held by an SPY rests with the servicer, and servicers are instructed to manage loans as if for their own account, PSAs often place restrictions on servicers' ability to modify mortgages. Almost all PSAs restrict modifications to loans that are in default or where default is imminent or reasonably foreseeable in order to protect the SPY's pass-thru REMIC tax and off-balance sheet accounting status.³²

PSAs often further restrict modifications: sometimes the modification is forbidden outright, sometimes only certain types of modifications are permitted, and sometimes the total number of loans that can be modified is capped (typically at 5% of the pool). Additionally, servicers are frequently required to purchase any loans they modify at the face value outstanding (or even with a premium). This functions as an anti-modification provision.

No one has a firm sense of the frequency of contractual limitations to modification for residential MBS (RMBS). A small and unrepresentative sampling by Credit Suisse indicates that almost 40% of RMBS PSAs have limitations on loan modification beyond a near universal requirement that the loan be in default or imminently defaulting before it may be modified.³³ The Credit Suisse study, however, did not track all types of modification restrictions, such as face-value repurchase provisions, so the true number of restrictive PSAs is likely higher. Nonetheless, there are still a large number of homeowners whose mortgages are held by securitization trusts with restrictive PSAs. This includes both private-label securitizations and GSE securitizations; some Fannie Mae securitizations, for example, prohibit any reductions in either principal or interest rates.³⁴

It is virtually impossible to change the terms of a restrictive PSA in order to allow the servicer greater freedom to engage in modifications. The PSA is part of the indenture under which the MBS are issued. Under the Trust Indenture Act of 1939,³⁵ the consent of 100% of the MBS holders is needed in order to alter the PSA in a manner that would affect the MBS' cashflow, as any change to the PSA's modification rules would.

Practically speaking, it is impossible to gather up 100% of any MBS issue. There can be thousands of MBS certificates from a single pool and these certificate holders might be dispersed world-wide. The problem is exacerbated by collateralized mortgage obligations (CMOs), second mortgages, and mortgage insurance. MBS issued by an SPY are typically tranches-divided into different payment priority tiers, each of which will have a different dividend rate and a different credit rating. Because the riskier tranches are not investment grade, they cannot be sold to entities like pension plans and mutual funds. Therefore, they are often resecuritized into what are known as CMOs. A CMO is a securitization in which the assets backing the securities are themselves mortgage-backed securities rather than the underlying mortgages. CMOs are themselves then tranches, and the senior tranches can

receive investment grade ratings, making it possible to sell them to major institutional investors. The non-investment grade components of CMOs can themselves be resecuritized once again into what are known as CM02s. This process can be repeated, of course, an endless number of times.

The upshot of this financial alchemy is that to control 100% of an MBS issuance in order to alter a PSA, one would also have to own 100% of multiple CMOs to alter the CMOs' PSAs and of multiple CM02s to alter the CM02s' PSAs. .

The impossibility of modifying PSAs to permit modification on a wide scale is further complicated because many homeowners have more than one mortgage. Even if the mortgages are from the same lender, they are often securitized separately. If a homeowner is in default on two or three mortgages it is not enough to reassemble the MBS pieces to permit a modification of one of the mortgages. Modification of the senior mortgage alone only helps the junior mortgage holders, not the homeowner. In order for a loan modification to be effective for the first mortgage, it is necessary to also modify the junior mortgages, which means going through the same process. This process is complicated because senior lenders frequently do not know about the existence of the junior lien on the property.]

A further complication comes from insurance. An SPV's income can exceed the coupons it must pay certificate holders. The residual value of the SPV after the certificate holders are paid is called the Net Interest Margin (NIM). The NIM is typically resecuritized separately into an NIM security (NIMS), and the NIMS is insured by a financial institution. This NIMS insurer holds a position similar to an equity holder for the SPV. The NIMS insurer's consent is thus typically required both for modifications to PSAs and modifications to the underlying mortgages beyond limited thresholds. NIMS insurers' financial positions are very similar to out-of-the-money junior mortgagees—they are unlikely to cooperate absent a payout because they have nothing to lose.

Thus, the contractual structure of securitization creates insurmountable obstacles to voluntary, private modifications of distressed and defaulted mortgages, even if that would be the most efficient outcome.

B. Practical Obstacles to Voluntary Modification

There are a range of practical difficulties that impede voluntary modification programs. Servicers lack sufficient personnel to handle a large volume of customer contacts. Servicers lack the trained loan officers necessary to handle the volume of requested modifications, which are essentially the underwriting of a new loan. Servicers often have trouble contacting financially distressed borrowers. And the computer software that servicers use to do their net present value calculations to compare returns from foreclosure or successful modifications may use obsolete inputs, such as assuming that housing prices are rising, which will lead servicers to wrongly believe that foreclosure is the best loss mitigation outcome.

C. Economic Disincentives for Servicers to Engage in Voluntary Modifications

Securitization also creates serious incentive misalignment problems that can lead to inefficient foreclosures. Mortgage servicer compensation structures create a situation in which foreclosure is often more profitable to servicers than loan modification. Therefore servicers are incentivized to foreclose rather than modify loans, even if modification is in the best interest of the MBS holders and the homeowners. 36

Servicers receive three main types of compensation: a servicing fee, which is a percentage of the outstanding balance of the securitized mortgage pool; float income from investing homeowners mortgage payments in the period between when the payments are received and when they are remitted to the trust; and ancillary fees. When a loan performs, the servicer has largely fixed-rate compensation. This is true also when a loan performs following a modification.

Thus, if a servicer modifies a loan in a way that reduces monthly payments, the servicer will have a reduced income stream itself. This reduced income stream will only last as long as the loan is in the servicing portfolio. If the loan is refinanced or redefaults, it will leave the portfolio. Generally servicers do not expect loans to remain in their portfolios for very long. For example, a 2/28 ARM is likely to be refinanced by year three, when the teaser rate expires, and move to another servicer's portfolio. Moreover, for non-GSE RMBS, servicers are not compensated for the sizeable costs of loan modification.

Thus, when a servicer modifies a loan, the servicer loses servicing and float income (which it will not have long into the future anyhow) and incurs expenses.

When a servicer forecloses, servicer compensation shifts to a cost-plus basis. The servicer does not receive any additional servicing fee or float revenue from the loan, but does receive all expenses of the foreclosure, including any fees it tacks on, such as collateral inspection fees, and process serving fees, etc. These fees are paid off the top from foreclosure recoveries, so it is the MBS holders, not the servicer, that incur the loss in foreclosure.³⁷ The fees servicers can lard on in foreclosure can be considerable, and there is effectively no oversight of their reasonableness or even authorization. ³⁸ MBS holders lack the ability to monitor servicer decisions, and securitization trustees do not have the responsibility to do so. Servicers are essentially able to receive cost-plus-percentage-of-cost compensation when foreclosing. The incentive misalignments from this form of compensation are so severe that it is flatly prohibited for federal government contracts. ³⁹

The choice between modification and foreclosure is a choice between limited fixed-price income and a cost-plus contract arrangement with no oversight of either the costs or the plus components. For mortgage servicers, this creates a very strong incentive to foreclose on defaulted loans rather than modify them, even if modification is in the best interest of the MBS holders.⁴⁰ The principal-agent conflict between RMBS holders and mortgage servicers is a major factor inhibiting voluntary loan modifications.

III. PERMITTING MODIFICATION OF ALL MORTGAGES IN BANKRUPTCY WILL NOT RESULT IN HIGHER MORTGAGE RATES OR LESS CREDIT AVAILABILITY

Traditionally, bankruptcy is one of the major mechanisms for resolving financing distress. Bankruptcy creates a legal process through which the market can work out the problems created when parties end up with unmanageable debt burdens. Although the process can be a painful one for all parties involved, bankruptcy allows an orderly forum for creditors to sort out their share of losses and return the deleveraged debtor to productivity; a debtor hopelessly mired in debt has little incentive to be economically productive because all of the gain will go to creditors. Moreover, the existence of the bankruptcy system provides a baseline against which consensual debt restructurings can occur. Thus, for over a century bankruptcy has been the social safety net for the middle class, joined later by Social Security and unemployment benefits.

The bankruptcy system, however, is incapable of handling the current home foreclosure crisis because of the special protection it gives to most residential mortgage claims. Debtors may generally modify all types of debts in bankruptcy-reducing interest rates, stretching out loan tenors, changing amortization schedules, and limiting secured claims to the value of collateral ("strip down" or "cram down"). Under current law, debtors can modify mortgages on vacation homes, investor properties, and multifamily residences in which the owner occupies a unit. 41 Debtors can also currently modify wholly unsecured second mortgages on their principal residences,42 as well as loans secured by yachts, jewelry, household appliances, furniture, vehicles, or any other type of personalty. 43

The Bankruptcy Code, however, forbids the modification of mortgage loans secured solely by the debtor's principal residence.44 Single-family owner-occupied property mortgage loans must be cured and then paid off according to their original terms, including all fees that have been levied since default, or else the bankruptcy automatic stay will be lifted, permitting the mortgagee to foreclose on the property. As a result, if a debtor's financial distress stems from an unaffordable home mortgage, bankruptcy is unable to help the debtor retain her home, and foreclosure will occur.

The Bankruptcy Code's special protection for home mortgage lenders reflects an economic assumption that preventing modification of home mortgage loans in bankruptcy limits lenders' losses and thereby encourages greater mortgage credit availability and lower mortgage credit costs, which in turn encourage homeownership.45 Underlying the economic assumption embedded in the Bankruptcy Code's anti-modification provision is another assumption-that mortgage markets are sensitive to bankruptcy modification risk. All existing empirical evidence, however, indicates that these assumptions are incorrect. Mortgage markets are indifferent to bankruptcy modification risk. 46

A. All Empirical Evidence Indicates that Mortgage Markets Are Indifferent to Bankruptcy Modification Except at Margins

There is a simple way to test for market sensitivity to bankruptcy modification: compare mortgage interest and insurance rates on property types for which the mortgages may currently be modified in bankruptcy with the rates on properties on which the mortgages may not be modified in bankruptcy. Courts have interpreted the Bankruptcy Code's mortgage anti-modification provision to apply only to single-family principal residence

mortgages.⁴⁷ Thus, single-family principal residence mortgages may not be modified in bankruptcy; all other mortgages may be modified in bankruptcy. One would expect that if the market were sensitive to bankruptcy modification, there would be a risk premium for mortgages on the types of property that can currently be modified in bankruptcy—mortgages on vacation homes, multifamily homes, and investment properties—and that this premium would not exist for single-family owner-occupied principal residence mortgages, which cannot be modified.

In an article forthcoming in the *Wisconsin Law Review*,⁴⁸ I tested this hypothesis using three different pricing measures in mortgage markets: effective mortgage interest rates (annual percentage rates or APRs), private mortgage insurance rates, and secondary mortgage market pricing from Fannie Mae and Freddie Mac. In each market I examined rate variation by property type in order to isolate the expected risk premium for bankruptcy modification risk on non-single-family owner-occupied properties. All three measures indicate that mortgage markets are indifferen~ to bankruptcy modification risk, at least in terms of pricing; ⁴⁹ the variation in rates in each market does not track with bankruptcy modification risk.

In a companion article-in-progress, coauthored with Joshua Goodman of Columbia University, I test the impact of permitting cramdown historically in the period before 1993, when it was permitted in many judicial districts. This historical evidence shows scant evidence of market sensitivity. Historically, in a very different mortgage market, we only detect a 12 basis point average impact on interest rates from cramdown, and no impact on credit availability. Current market data, however, suggest no impact whatsoever from any ability to modify mortgages in bankruptcy. Taken together, the evidence in these articles suggests that permitting modification of mortgages in bankruptcy would have no overall impact on mortgage costs or availability, except at the margins. Marginal, high-risk borrowers might find credit slightly more expensive, but all available evidence indicates that there will be no impact on creditworthy borrowers.

These empirical findings comport with economic theory. If foreclosure losses are greater than bankruptcy modification losses, the market will not price against bankruptcy modification. Evidence from a variety of historical and contemporary sources indicates that lenders' losses from bankruptcy modification would be less than from foreclosure. Indeed, by definition a lender cannot do worse in bankruptcy than in foreclosure; bankruptcy law provides that a secured lender must receive at least what the lender would receive in foreclosure, namely the value of the collateral. ⁵⁰

B. The Mortgage Bankers Association's Claim Regarding the Impact of Bankruptcy Modification Is Patently False and Disprovable

The Mortgage Bankers Association (MBA) has claimed that permitting modification of mortgages in bankruptcy will result in an effective 200 basis point increase in interest rates on single-family owner-occupied properties ("principal residences,.").⁵¹ The MBA figure has varied over the course of the MBA's lobbying effort against bankruptcy reform, shrinking by a quarter to 150 basis points in more recent lobbying materials. The MBA's methodology for

calculating the figure has also changed. 52 Regardless of size or calculation, the MBA figure is patently false and is the result of a cherry-picked comparison.

The MBA figure is derived from a comparison of the current interest rate spread between mortgages on single-family principal residences and on investor properties. 53 The MBA reasons that because single-family principal residence mortgages cannot be modified in bankruptcy while investor property mortgages can, then the entire difference in mortgage prices for these property types is attributable to bankruptcy modification risk for the investor properties.

The MBA's claim is demonstrably false. First, the MBA engages in questionable calculations of the price spread. It includes not only the current additional interest rate premium for investor properties of 37.5 basis points, but also amortizes the higher down payments and points generally required on investor properties in order to achieve the 200 (or 150) basis point figure. 54

Even accepting the MBA's inflated numbers, however, the idea that the entire spread in mortgage rates between single-family owner-occupied properties and investor properties being due to bankruptcy modification risk is preposterous. 5

The MBA then cherry-picks its evidence to support its lobbying position. The MBA could have also compared interest rates spreads between mortgages on single-family owner occupied properties and mortgages on other property types that can currently be modified in bankruptcy-mortgages on multifamily properties or vacation homes. As it turns out, there is no rate spread; conforming mortgages on vacation homes and multifamily properties are currently priced the same as single-family principal residences. Only investor property mortgages are priced higher. The same holds true for private mortgage insurance premiums; there is no additional premium for multifamily properties at any of the seven major private mortgage insurers, even though multifamily property mortgages can be modified in bankruptcy. The pattern also holds true for Fannie Mae and Freddie Mac delivery fees-Fannie and Freddie do not demand discounts that track the difference in bankruptcy modification risk. This means higher interest rates on investor properties must be attributed to non-bankruptcy risk factors entailed in lending against an investor property.

There are many non-bankruptcy risk factors that explain the pricing spread on mortgages between investment properties and single-family owner occupied properties.

The higher interest rates and points required on investor properties are explained by higher default rates on investor properties, the greater likelihood of investor properties being non-recourse, and the more limited secondary market for investor property mortgages. Investor properties have inherently greater default risk in part because an investor has the additional rent or mortgage expense that an owner-occupier does not. Investor properties also carry a variety of tenant risks-vacancy, nonpayment, and damage. Because investor properties mortgages are often financed through rental payments, tenant risk adds to the default risk. There are myriad risk factors for investor properties that single-family owner-occupied properties do not have. The MBA, of all organizations, should recognize that most, if not all,

of the price spread between investor property mortgages and single-family owner-occupied mortgages is due to factors other than bankruptcy modification risk. Yet the MBA contends that the entire price-spread is due to differences in bankruptcy modification risk. If the MBA revealed a non-cherry-picked comparison in its lobbying materials, its spurious 150 or 200 basis point claim would fall apart.

Based on my empirical analysis of a wide variety of mortgage market data, 56 there IS statistically a zero percent chance that the MBA's 150 or 200 basis point claim is correct. All empirical and market observational data indicates that that MBA's claim of an effective 150-200 basis point increase from allowing strip-down is simply groundless. At best the MBA's figure is a wild and irresponsible guess; at worse it is a deliberately concocted falsehood.

Contrary to the MBA's spurious claims, all empirical evidence indicates that there is unlikely to be anything more than a de minimis effect on interest rates as a result of permitting bankruptcy modification.

IV. BANKRUPTCY MODIFICATION DOES NOT CREATE A MORAL HAZARD

One of the major objections voiced against permitting modification of mortgages in Chapter 13 bankruptcy is that it will create a moral hazard and that consumers will be tempted to go out and gamble on unaffordable loans because they can always discharge their debt in bankruptcy. This view reflects a fundamental misunderstanding of the bankruptcy process and of the problem created by foreclosures.

A. Bankruptcy Imposes Significant Costs on Debtors

Permitting modification of mortgages in Chapter 13 bankruptcies will not create a moral hazard problem. Chapter 13 is not a "drive-by" process. In order to receive a discharge in Chapter 13, a debtor must live on a court-supervised means-tested budget for 3 or 5 years. 57 Having to get the court and the United States Trustee to sign off on the reasonableness of daily expenses creates a powerful disincentive against filing for bankruptcy unless the filing is absolutely necessary. Moreover, Chapter 13 insists on full repayment of certain debts, including allowed secured claims, domestic support obligations, and tax liabilities. 58 A below-median-income debtor who does not repay creditors in full can only receive a Chapter 13 discharge once every six years; an above-median-income debtor who does not repay creditors in full can only receive a Chapter 13 discharge once every ten years. 59 This means that the minimum time between repeat Chapter 13 filings is longer than the time a foreclosure stays on a credit report.

Debtors are also unlikely to receive a windfall from Chapter 13 modification. Cramdown would only result in the debtor having zero equity in the property, not positive equity. Given the large transaction costs to a sale, debtors are unlikely to sell their properties for anything beyond a de minimis profit absent a remarkable recovery of the housing market.

B. Wealthy Debtors Are Ineligible for Chapter 13 Bankruptcy

It is also important to recognize that permitting modification of mortgages in Chapter 13 bankruptcy will not result in wealthy or spendthrift debtors receiving unmerited relief. For starters, Chapter 13 bankruptcy is not available to debtors with huge debt burdens. To file for Chapter 13, an individual must have less than \$250,000 in noncontingent, liquidated, unsecured debts and less than \$750,000 in noncontingent, liquidated secured debts.⁶⁰ This means that a homeowner with a million dollar mortgage cannot avail himself of Chapter 13. Instead, if that homeowner wishes to keep his mansion, he must file for Chapter 11 bankruptcy. While there is a parallel antimodification provision in Chapter 11,⁶¹ adopted after the Supreme Court's 1993 *Nabelman* (banning cram down of principal residence mortgages in Chapter 13) in the 1994 amendments to the Bankruptcy Code, there has been no legislation proposed to remove it.⁶²

C. Permitting Bankruptcy Modification Would Not Benefit Speculators or Vacation Home Purchasers

Bankruptcy modification would not yield a windfall to housing speculators ("flippers") or second home purchasers. A mortgage loan modification in bankruptcy can occur only as part of a plan.³ The automatic stay would likely be lifted on an investment property (or second home) before a plan could be confirmed.⁴ Accordingly, speculators and homeowners intent on keeping their second homes are unlikely to file for bankruptcy to seek mortgage modification in the first place. Permitting bankruptcy modification of primary home mortgages thus steers a true course between extending the right sort of relief and not extending it too broadly.

D. Foreclosure Falls Within the Moral Hazard Exception for "Contagion Fires"

Permitting bankruptcy modification of mortgages in order to prevent inefficient foreclosures also fits into a well-recognized exception to moral hazard, that for "contagion fires." It would create a moral hazard for the fire department to rescue people from fires caused by smoking in bed, yet we rescue in-bed smokers without hesitation, in part because fires can spread and harm third-parties, like neighbors. Foreclosures function like fires, and a rash of foreclosures can destroy property values throughout a neighborhood.

Moral hazard concerns are inapplicable given the immense third-party costs of foreclosures, and the Bankruptcy Code already has powerful antidotes to moral hazard risk. Concerns about more than isolated serial and strategic filings are greatly overstated and unsupported by empirical evidence.

V. POTENTIAL IMPROVEMENTS TO THE BILL

A. Equalize Treatment of Bankruptcies and Foreclosures on Credit Reports

The legislation could be improved by changing section 605(a)(1) of the Fair Credit Reporting Act,⁶⁵ to provide that Title 11 case may not remain on a credit report for more than seven years. Currently Title 11 cases may remain on credit reports for up to ten years, while all other adverse reports, including foreclosures, may remain on credit reports for only up to seven years. The unequal weighting of bankruptcy filings and other defaults on credit reports creates a disincentive for bankruptcy filings and should be changed.

The unequal weighting of foreclosures and bankruptcies on credit reports bears no correlation with lenders' ultimate recovery on their loans. Nor does it provide much protection to potential creditors, as there is only a two-year window under which two Chapter 7 discharges could appear on a credit report,⁶⁶ and serial bankruptcy filers will have sufficient other adverse entries on their credit reports to alert potential creditors of risk. Equalizing the treatment of bankruptcies and other defaults on credit reports would simply lead to bankruptcy being treated as a default on all reported debts, which is exactly what it is.

The Bankruptcy Code already has provisions to address the potential problem of serial bankruptcy filers;⁶⁷ credit reporting is not the place to do so. Bankruptcy is sometimes both the responsible, efficient, and fair course of action, and it should not be disincentivized relative to a non-bankruptcy default. Moreover, leaving bankruptcies on credit reports longer than other types of defaults interferes with the core bankruptcy policy of the fresh start for honest but unfortunate debtors. Bankruptcy filings should be treated like any other default for the purposes of credit reporting. ⁶⁸

Notably, when the FCRA was enacted in 1970, it provided that bankruptcy filings could remain on credit reports for fourteen years, while all other types of adverse entries could only remain on reports for seven years. When Congress passed the Bankruptcy Reform Act of 1978 that created the current Bankruptcy Code, the House bill included" an amendment by Representative McKinney of Connecticut that would have reduced the time bankruptcy remains on a credit report from fourteen to seven years. Representative McKinney noted that "an exhaustive search of the legislative history of [the fourteen year] provision has disclosed no compelling reason for the statute's unforgivingly lengthy memory.,⁶⁹ While Representative Butler noted that "The purpose of the provision was to keep the record open long enough so that creditors could determine whether the individual had filed more than one bankruptcy.,,⁷⁰ this reason is simply inapplicable in the world of modern, instantaneous, computerized credit scoring. Indeed, even at the time, Representative Butler did not think it was reason enough and supported the amendment. Yet the enrolled version of the Bankruptcy Reform Act only reduced the time that bankruptcy remains on credit report from fourteen to ten years,⁷¹ in a compromise between the Senate and House.⁷²

Unfortunately, this compromise creates an imbalance in credit reporting treatment that favors foreclosure to bankruptcy filing. Given that bankruptcy modification of mortgages presents an important potential tool for helping homeowners keep their homes and benefiting all parties at interest-homeowners, lenders, and communities-it is important to amend the FCRA to provide for equal treatment of bankruptcy and foreclosure.

B. Permit Mortgage Modification in Chapter 11 Bankruptcies

Any changes made to section 1322(b)(2) of the Bankruptcy Code should also be made to its parallel Chapter 11 provision, 11 U.S.C. § 1123(b)(5).⁷³ Debtors who have too much debt to qualify for Chapter 13 are not particularly sympathetic characters. But for inflated real estate markets like California, there are far from wealthy debtors who have mortgage and

auto loan debt that exceeds \$750,000, making them ineligible for Chapter 13. Making a parallel change in Chapter 11 would have even less impact on creditors, not just because of the relative rarity of individual Chapter 11 filers, but also because in Chapter 11 creditors have the protection of a plan vote and, for undersecured creditors, an 1111 (b) election, which allows them to avoid cramdown.

VI. CONCLUSION

Bankruptcy modification presents the best and most powerful solution to the foreclosure crisis. It presents an impressive list of features:

- Immediate solution
- No cost to taxpayers
- Addresses both negative equity and payment reset shock
- Addresses the contractual and incentive problems created by securitization; cuts servicers out of the modification decision
- Addresses the problem of second lien mortgages
- No moral hazard problem
- No costs for future borrowers
- Screens out speculators
- Forces losses to be shared by lender and borrowers
- Encourages voluntary modifications

In a perfectly functioning market without agency and transaction costs, lenders would be engaged in large-scale modification of defaulted or distressed mortgage loans, as the lenders would prefer a smaller loss from modification than a larger loss from foreclosure.

Voluntarily modification, however, has not been happening on a large scale⁷⁴ for a variety of reasons,⁷⁵ most notably contractual impediments, agency costs, practical impediments, and other transaction costs.

If all distressed mortgages could be modified in bankruptcy, it would provide a method for bypassing the various contractual, agency, and other transactional inefficiencies. Permitting bankruptcy modification would give homeowners the option to force a workout of the mortgage, subject to the limitations provided by the Bankruptcy Code. Moreover, the possibility of a bankruptcy modification would encourage voluntary modifications, as mortgage lenders would prefer to exercise more control over the shape of the modification. An involuntary public system of mortgage modification would actually help foster voluntary, private solutions to the mortgage crisis.

Unlike possible programs for government refinancing or guarantee of distressed mortgages, the bankruptcy system is immediately available to resolve the mortgage crisis. Government refinancing or guarantee plans would take months to implement, during which time foreclosures would continue. In contrast, bankruptcy courts are experienced, up-and-running, and currently overstaffed relative to historic caseloads. Moreover, the bankruptcy automatic stay would immediately halt any foreclosure action in process upon a homeowner's filing of a bankruptcy petition.⁷⁶ And, unlike government guarantees or refinancing, bankruptcy modification of all mortgages would not involve taxpayer dollars.

Bankruptcy modification would not impose costs on future borrowers except at the very margins. A wide range of empirical data show that permitting bankruptcy modification of all mortgages would have little or no impact on mortgage credit cost or availability. Because lenders face smaller losses from bankruptcy modification than from foreclosure, the market will not price against bankruptcy modification.

Bankruptcy modification would also avoid the moral hazard for lenders and borrowers of a bailout. Lenders would incur costs for having made poor lending decisions thru limited recoveries. Borrowers would face the requirement of living for three or five years on a court-supervised budget in which all disposable income goes to creditors, a damaged credit rating, and the inability to file for bankruptcy for a number of years.

Bankruptcy modification also provides an excellent device for sorting out types of mortgage debtors. It can correct the two distinct mortgage problems in the current crisis-payment reset shock from resetting adjustable rate mortgages and negative equity from rapidly depreciating home prices-while preventing speculators and vacation home purchasers from enjoying the benefits of modification. And, by providing an efficient and fair system for restructuring debts and allocating losses, bankruptcy will help stabilize the housing market.

Allowing bankruptcy to serve as a forum for distressed homeowners to restructure their mortgage debts is both the most moderate and the best method for resolving the foreclosure crisis and stabilizing mortgage markets.

Unlike any other proposed response, bankruptcy modification offers immediate relief, solves the market problems created by securitization, addresses both problems of payment reset shock and negative equity, screens out speculators, spreads burdens between borrowers and lenders, and avoids both the costs and moral hazard of a government bailout.

Permitting modification of all mortgages in bankruptcy would thus create a low-cost, effective, fair, and immediately available method for resolving much of the current foreclosure crisis without imposing costs taxpayers, creating a moral hazard for borrowers or lenders, or increasing mortgage credit costs or decreasing mortgage credit availability. As the foreclosure crisis deepens, bankruptcy modification presents the best and least invasive method of stabilizing the housing market and is a crucial step in stabilizing financial markets.