Response to written questions by

Hon. Thomas B. Bennett
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before the
Senate Committee on the Judiciary

"The Looming Foreclosure Crisis: How To Help Families Save Their Homes"

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Chairman Leahy, Presiding Member Durbin, Ranking Member Specter, and Members of the Committee, I am responding to the written questions received by me on December 18, 2007, from Chairman Leahy. I have received two sets of questions relating to my written testimony of December 5th and my oral testimony given during the December 5, 2007, hearing held by the Senate Committee on the Judiciary. The two sets of questions are composed of six submitted by Senator Durbin and another three by Senator Sessions. All of these questions are addressed in this response..

Before addressing the substance of the questions, I want to once again preface my remarks with a caution regarding the status in which I reply. My earlier written testimony and oral testimony of December 5, 2007, set forth my views and not those suggested by others. The same is true with respect to these responses to written questions. Likewise, I appeared at the December 5th hearing held by the Senate Committee on the Judiciary in my individual capacity and not as the representative, member, or officer of a group or an organization. Once more, this applies to these written responses.

I. Responses to Questions from Senator Richard J. Durbin to the Honorable Thomas B. Bennett

Question 1(a). Are you aware that an overwhelming proportion of the adjustable rate mortgages originated in the last few years does not permit reductions in the interest rate?

Question 1(b). How does your criticism apply given this current market?

Response to Questions 1(a) and 1(b). My criticism regarding this aspect of S. 2136 remains unaltered. This arises from the fact that having floor interest rates in adjustable rate mortgages is nothing new to the last few years. It has existed for many years. The existence of such floors limiting the downward adjustment of interest rates was taken into account by me for purposes of my testimony.

I want to point out that your question indicates that the important point of my testimony on this aspect of S. 2136 may have been missed. It was and is that the proposed alteration of mortgage loan terms by the language of the bill coupled with that of existing language of the provisions governing what is to be included in a Chapter 13 plan mandates that adjustable rate loans secured by one's principal residence be converted to fixed rate obligations. Since S. 2136's ambit is not limited to loans made within the last few year--it applies to ALL unpaid adjustable rate loans secured by a debtor's principal residence made at any time--it will encompass adjustable rate loans with no interest rate floor along with both (1) those with a floor which is below what would be the rate set by S. 2136's calculation as a fixed one and (2) those with a floor which may be above the converted to fixed rate determined under S. 2136. Thus and in a declining interest rate environment, those who file a Chapter 13 bankruptcy case with adjustable rate mortgages with no interest rate floor or a floor rate below that which the rate S. 2136 requires to be the fixed rate will have an interest rate which in future months and years may be higher than the one such a borrower would otherwise have had to pay but for the requirements imposed by this bill. The one group for which the rate could potentially be lower is that composed of mortgage secured loan transactions where the floor rate is above what would be the rate set using S. 2136's fixed rate setting mechanism. However for this to occur, the application of S. 2136 needs to happen in advance of a market adjustment to the selected indexing rate specified in S. 2136 which if great enough could result in S. 2136 not lowering the rate which would have been charged under the adjustable rate regime. This rather complex discussion of some of the various permutations on what will occur should S. 2136 be enacted in its present form overshadows my major testimony points regarding this portion of S. 2136 to which I need to return.

The primary significance of my earlier testimony regarding this aspect of S. 2136 is that what the bill does for some is the opposite of what I perceive to be the intention of the bill. Instead of helping all, it could for some increase the interest rate above what it would have been in the future when compared to the adjustable rate that would have been set under the loan documents. Furthermore, it highlights further why I said that the task facing the Committee's Members is a complex one requiring greater information of sufficient quality being taken into account before enactment of such legislation. Lastly, it poignantly illustrates the problem of using only verbal analysis of a complex universe of fact and law variations without use of at least some of the readily available quantitative methodologies.

Question 2. Do you agree that a wholesale solution is warranted in this marketplace?

Response to Question 2. This question arises from a portion of the written testimony of Professor Scarberry which you quote in part that "...a wholesale solution may be necessary if any effective legislation action is to be taken." I am not certain what the Professor refers to as a "wholesale solution." If the wholesale solution is a reference to his belief that the solution should not be limited to being within the confines of the Bankruptcy Code, I agree that any legislative action should not require one to file bankruptcy to obtain assistance. The reasons I gave were stated during my oral testimony of December 5th when I expressed my position that there are at least two subsets of those who may need assistance to avoid foreclosure. One is those who are in such a dire financial situation in an overall sense that they would of necessity have to file for bankruptcy protection regardless of the status of an adjustable rate mortgage secured loan. The second is composed of borrowers whose only reason for being forced to file for bankruptcy protection is the already adjusted upward interest rate or pending upward adjustment for an adjustable rate mortgage secured loan. These individuals are those who are able to afford to pay all living expenses and other obligations including the adjustable rate mortgage loan at its present interest rate or the one which existed before it adjusted. My position was and is why is the filing of bankruptcy for all such borrowers required as the sole means to obtain whatever assistance may be accorded adjustable rate mortgage loan borrowers with the concomitant increase in costs and complexities incurred by the filing of a bankruptcy case when it is not legally necessary? I believe such a requirement should not be imposed on such borrowers and that the contemplated goal can be accomplished, if desirable, in a broader setting than just those who file a bankruptcy case. To the extent that this is what Professor Scarberry refers to as a "wholesale solution," I agree with him.

However and as written the question references a "...wholesale solution...in this marketplace" which contains a nuance which I believe Professor Scarberry may not have contemplated. The question adds to the quote extracted from the Professor's written testimony "...in this marketplace." It is unclear what "...this marketplace" references. It appears to mean some market for adjustable rate mortgages and not the credit market in its totality. To the extent that this is what is meant, I was very careful in my prior written and oral testimony to avoid discussing whether such a market exists from an economist's point of view. This is because it gets into a broader discussion which has been debated in the economic literature for awhile as to whether what economists call sub-markets for goods and services exist and should be evaluated separate and apart from what is the market, here the market for credit. Regardless of the referenced market, I do not believe that legislative action should be taken which causes greater uncertainty in the market and increases risks to lenders/owners of credit instruments, or parts thereof, constituting what are called adjustable rate mortgages which would impose total costs greater than the value of the perceived total benefits. If this is the type of "wholesale solution...warranted in this marketplace," I do not agree with the question as drafted which, I believe, is broader than the solution mentioned by Professor Scarberry.

Question 3. Do you believe that voluntary loan modifications agreed to by lenders and homeowners outside of bankruptcy lead to higher interest rates and less available credit?

Response to Question 3. My earlier written and oral testimony regarding the impact of S. 2136 and S. 2133 were made in the context of proposed legislation specifying at least to some degree what is to occur. Based on the two bill's texts, it is clear that there will be an impact on the credit market which when one holds all other variables constant allows one to assess each's repercussion. As I testified, S. 2136 will have an effect which would tend to cause a shift in the supply of credit to a level less than it otherwise would have been without its enactment and that this shift when isolated from other market forces would cause an <u>increase in the cost of credit higher than</u> <u>it would otherwise have been.</u> I also pointed out in my oral testimony that there are assertions contained in some of the written testimony presented in support of S. 2136 that no such effect will occur which are premised on a supposed historical review of interest rates and supplies of credit encompassing all of the myriad of variables affecting each and not just the effect of legislation. As I have stated earlier, this is like comparing an apple to an orange and saying that they are the same. The reason is that the correct comparison is what the supply of credit and the cost of credit <u>would have otherwise been but for the legislation.</u> It is not what was the actual market supply or what was the actual market rate of interest. This incorrect analysis proffered by some who testified in support of S. 2136 will hide what the result of such legislation actually will be by covering up the true costs imposed by S. 2136. The true costs are hidden by such an incorrect analysis by the effects of the other, unrelated forces which act on supply, demand, and prices.

Furthermore and to clarify this point, I discussed that the supply of credit could increase or decrease after the legislation and the cost of credit could increase or decrease following legislation due to factors unrelated to the legislation. Therefore and to assess the result of this legislation on both the supply and cost of credit, one needs to isolate the effect of all of the unrelated factors to assess what the legislation did to the supply and cost of credit. From this context, the analysis is whether an increase in the supply of credit and/or the cost of credit following legislation would have been a greater increase in the supply and/or a lower increase in its cost without the legislation. Similarly, the study should be if the legislation had not been enacted would a decrease in the supply of credit and/or decrease in the cost of credit have been less of a decrease in supply and/or more of a decrease in credit's cost. Not studying in this fashion what will be wrought by an enacted S. 2136 allows other factors such as a shift in the demand for credit to cover up the truth of what S. 2136 or other such legislation would do.

The point of putting in this response some of what is only in my oral testimony of December 5th is that Question 3 gives no parameters from which to assess what would occur by voluntary loan modification agreements made between a lender and homeowner outside bankruptcy. This makes it impossible to fully respond to the question. This remains true even if I assume–which I believe to be a correct one–that what is referenced is adjustable rate mortgage loans. There is one thing that I can state regarding a voluntary agreement between a lender and borrower. It is that the degree of uncertainty created by S. 2136 regarding, among other things, but not limited to, alteration of the term of the mortgage, its principal balance, and the interest rate is less when within the scope of a negotiation between the parties to the contract(s). Thus, it creates less risk in any restructuring of the loan transaction than one where third parties unrelated to the transaction have input and, indeed, control over the outcome as S. 2136 specifies. The voluntary agreement scenario is also one without the costs imposed by the bankruptcy system. The third parties I refer to are judges who have discretion to decide the value of the property, extend the term of repayment, and set interest rates to name a few of the variables. The other third parties are the lawyers, experts, and others with the ability to become involved in the valuation, term, and interest rate adjustments contemplated by S. 2136. The uncertainty and increase in risk associated with this third party participation in S. 2136's restructuring of adjustable rate mortgage transactions is heightened when one recognizes the vagaries of valuation of properties and the setting of interest rates in a court context governed by S. 2136's framework.

This greater risk and uncertainty is caused by various factors. One is that in a court context there frequently are competing valuations made by so-called experts to non-expert judges and similarly varying so-called expert testimony on what the risk premium should be for a bankrupt borrower again presented to a non-expert judge. What happens is conflicting methodologies and approaches are adopted by judges for what and how a property should be valued and what the proper interest rate should be. That this will occur if S. 2136 is enacted as currently drafted is demonstrated by what has happened in a similar context for the valuation of other properties in consumer and business bankruptcy cases for vehicles and other personal and real properties. This is also the case for the setting of interest rates. Furthermore, the continuation of variation in how to value and what to use as value along with the appropriate interest rate to be used will continue even after a ruling by the Supreme Court of the United States on the valuation and interest rate issues. To see that this will be the result, one only need review the reported case law on vehicle valuation and interest rate setting after the Supreme Court and other appellate courts set the so-called valuation and interest rate standards and methodologies: frequently lower courts deviate from what they are to be which is sometimes to the advantage of a consumer, sometimes to his or her disadvantage, and sometimes to the benefit or harm to a lender/owner of a debt obligation.

The upshot is continued uncertainty and an increased risk of loss as the result of such third party intervention when it is done without more rigid and market based standards which do not give a varying degree of discretion to third parties to a transaction. When analyzed by holding the other variables constant, the upshot of this portion of the uncertainty and increased risk created by S. 2136 compared to a voluntarily negotiated modification is that S. 2136 in its present formulation will have greater tendency to cause a decrease in the supply of credit and an increase in its cost beyond **what would otherwise have been the state of each if S. 2136 had not been enacted as currently drafted.**

Question 4. Do you agree with these statements? The statements referenced are a quote from (1) a spokesperson for JPMorgan Chase that “It is always in the best interest of the servicer, the borrower, and the investors if we can modify a loan because foreclosure means there’s no chance the investor is going to recoup their money” and (2) Treasury Secretary Paulson that “Avoiding preventable foreclosures...is in the interest of all homeowners.”

Response to Question 4. Since both quotes are presented to me without reference to the whole of what was said, it is not possible for me to give an absolute yes or no regarding whether I agree or disagree with what was said in the context each statement was made. However, both quotes are presented in the form of being absolutes which hold true for all parties to a mortgage secured loan transaction. As such and if the actual context presented by the question is that these absolutes are always accurate, I disagree with both. The reason regarding the JPMorgan Chase quote is that what is in the interest of an investor to recoup money is not necessarily in the best interest of the other parties including the borrower. The value of what is expended by a borrower to enable an investor to recoup his/her/its investment may be less than the value of an alternative use of the borrower's resources. There are many instances when it makes sense--economic and otherwise--for a borrower to allow a foreclosure than to continue to pay a debt. Each is when in economic terminology the value or utility of keeping the home is less than the utility of an available alternative use for these resources. Likewise, the quote of a portion of Treasury Secretary Paulson's statement is not as quoted always correct. There are instances when a borrower may have an alternative which has a higher value to the borrower than retaining a home. In such an instance, a foreclosure makes economic sense to a borrower. For example in areas where housing prices are decreasing rapidly and are likely to continue to do so, retaining a home even after a borrower files bankruptcy to utilize, if enacted, S. 2136 to write down the secured portion of a debt and to fix the interest rate would still leave the borrower paying for a home worth potentially far less than what is owed after the S. 2136 secured amount write down. This could be the accurate state of affairs even if the Chapter 13 plan pays 0% for unsecured claims. In such declining home value market, that some borrowers would and should allow a foreclosure of her/his/their home is even more the case in jurisdictions which do not allow the collection of deficiency balances following a foreclosure.

Question 5(a). Are you arguing that those with the "training appropriate for the mission" are the mortgage industry bankers?

Question 5(b). If so, is it your belief that these professionals have managed the housing market well over the past five years?

Question 5(c). In any case, is it not precisely the role of the civil courts to adjudicate disputes in which two parties with some knowledge of a given situation cannot agree on the appropriate course of future action?

Question 5(d). More specifically, do you believe that bankruptcy courts should exist at all, or should the car lenders handle disputes in the auto market, commercial property investors handle disputes in the real estate market, etc.?

Response to Questions 5(a), 5(b), 5(c), and 5(d). I have never argued, nor have I hinted that the professionals with the knowledge and training appropriate for the mission--here to work on the adjustable interest rate mortgage loan foreclosure matters--should be what the question refers to as “mortgage industry bankers.” The point of my earlier testimony and what I urged was for the Senate Committee on the Judiciary to obtain greater assistance from the various professionals who have extensive information regarding the problems presented by what S. 2133 and S. 2136 desire to address along with the requisite kind and quality of training and education in the relevant fields beyond legal training which is singularly lacking in requiring and giving lawyers and judges any sufficient degree and quantity of training for the development of the manner and means to address what is referred to by the Committee as “the looming foreclosure crisis.” These individuals would of necessity be from varying backgrounds and disciplines and could include people employed by those who made mortgage secured loans, but would not and should not be limited to such people. Question 5(b) does not require a response because it assumes that question 5(a) represents my view on the personnel who should be utilized to assist in the development of any legislation to address the “looming foreclosure crisis.” Question 5(a) does not represent my view on who should be further utilized to present a thorough, well thought out approach which does the least harm in the relevant market(s) and to the least individuals and entities.

Both questions 5(c) and 5(d) misapprehend what my written and oral testimony set forth. The import and my criticism of S. 2136 is in part that it is flawed by its design made on the assumption that the historical version of one lender and one creditor holding the debt obligation is the status of the lender-borrower relationship for all adjustable rate mortgage loans to which S. 2136 would have application. Because of this assumption, S. 2136 makes what is to happen in a bankruptcy case apply without full appreciation of and apprehension regarding what will happen, among various things, to the various owners of many of what makes up 100% of a significant number of mortgages: various and potentially numerous streams of payments of principal and interest over differing periods of time for what may be subdivisions of portions of up to a thirty year period. It also overlooks who owns these subparts of what make up the total mortgage obligation of many mortgage secured debts and assumes that it is one lender. In fact, the ownership is far more diverse and includes not just a mortgage company, bank, savings and loan, but also individuals and other entities unrelated to the underlying home loan transaction. The scope of ownership includes pension and retirement trusts and plans, IRAs, money market funds and other places where individuals hold their savings and other assets. Perhaps even more troublesome is that these mortgage secured transactions are not know to be, for want of a better term, indirectly the basis on which a money market fund or other investment vehicle is valued and which will cause losses in value greater than otherwise might occur if legislation does not fully take into account how to minimize disruption of the market system.

I cannot overstate how potentially more damaging to others passage of a bill could be which does not take into greater consideration these and numerous issues and factors which go beyond just what it may do to the credit market. Incomplete further analysis of the scope and quality necessary may increase the costs of what S. 2136 contemplates to occur which will be borne in significant part by the American public. One of the factors that I will not repeat here because I discuss it in response to Senator Sessions’ first question is that S. 2136 and to a lesser degree S. 2133 are NOT without cost to the American public. Quite the contrary, there are costs of a potential magnitude which could exceed the aggregate benefit accorded to what has been estimated by some of the Committee's witnesses as borrowers for 600,000 mortgage secured principal residence debts.

A principle espoused by me that questions 5(c) and 5(d) evidence has been missed is that S. 2136 could be drafted in a fashion that lessens the risks and uncertainty that the current version will create in the market by modifications which do what other disciplines have done: utilize standards developed by experts who are not being paid to foster one side's or another's position and which are formulated outside a court setting. An example is how the interest rate adjustment is to be done. These individuals would not, without more guidance, do what S. 2136 does in section 101(a)(3) which is to set a base rate which is the average interest rate for thirty year conventional mortgages published by the Federal Reserve which, if one investigates further, is in reality the average rate for such mortgages calculated by FHLMC based on mortgage loans with a loan-to-value ratio of 80% and then leave to litigation what the bankrupt's risk premium above this base rate should be. Instead, a potentially better base rate could be used along with risk specific standards which, at the least, narrow what would be court determined variations in the adjustment to the base rate. Other possibilities exist which could lessen the degree of risk and uncertainty in the setting of the interest rate. This process may yet require court adjudications, but will make it less frequent with smaller variations from an appropriate interest rate. Having given this explanation by use of an example, it is obvious what my answer is to question 5(c) and that question 5(d) is based on a distortion of what I have testified to in writing and orally. I have never testified or even suggested, let alone intimated, that bankruptcy courts should not exist or that a particular type of lender or investor handle disputes with a borrower. In a nutshell version, what I have been saying is that S. 2136 invites disputes which do not need to exist and if modified could create less risk and uncertainty in the market to the benefit of all. This is why I do not believe what is suggested by question 5(d) and, instead, believe that the question is regrettably premised on a misapprehension of what I have said.

Question 6(a). Do the same difficulties [determining who would lose if mortgages were to be modified in bankruptcy] exist when loan servicers attempt to voluntarily work out loan changes with at-risk homeowners?

Question 6(b). If so, is that a strong argument for allowing these changes to be made within the context of bankruptcy, since often it is too difficult outside of the court to sort out who must approve of each modification?

Response to Questions 6(a) and 6(b). Part of my written and oral testimony was to point out the structural change caused by what I called alteration of the traditional mortgage loan ownership of the entire principal and interest due over the live of a loan from one or a few individuals/entities into a commodity which is broken into numerous repayment streams of principal and interest, among other items. My discussion was and remains how S. 2136 for principal and interest and to a lesser degree S. 2133 for interest and other charges plus principal if agreed to by the borrower and owner(s) of the repayment streams do not take into account the ownership situation for many of the adjustable rate loans which each would affect. My testimony was not that these factors would not exist outside of a bankruptcy case, nor that the difficulties these present when compared to the historical one borrower-one lender model would not exist outside a bankruptcy case. The major focus of my testimony is that S. 2136 and S. 2133 disregard the implications of this structural change in ownership and assume that the usual mode of dealing with secured loans in a consumer bankruptcy case in Chapter 13 are up to the challenges these complexities present without causing significantly more risk and uncertainty in the credit market for an extended period of time–undoubtedly years–until, if ever, a means and procedure with sufficient certainty in approach and application by third parties is in place. What I have and continue to urge is that more consideration and analysis of what is involved with these types of loans occur and that a better framework should be developed for handling of the various issues. I additionally suggest this could be done by legislation that does not by its placement in the Bankruptcy Code, of necessity, require one to file a bankruptcy case to be able to use its provisions. This framework should be developed with the assistance of what I previously testified were those equally bright and capable professionals who are not lawyers and judges. This framework should be in some respects more explicit leaving for some matters less discretion to hundreds of judges and thousands of lawyers and litigants. If done better, it could create valuation, term extension, and interest rate methodologies with less risk and more certainty and consistency of outcome which would have less of an impact on the credit market and the cost of credit.

At least some of the same difficulties exist with modifications of the sort contemplated by S. 2136 should they be done within a bankruptcy case or outside a bankruptcy case. However, S. 2136 imposes what I view as an insufficient structural model on how to modify adjustable rate mortgages which by its model causes more and potentially greater "difficulties" that do not now exist outside bankruptcy. This is partly due to having the legislation placed within the Bankruptcy Code and some of what its current statutory provisions require. This is highlighted by recognition that any legislation achieving what S. 2136 desires to be done enacted outside the context of the Bankruptcy Code may still be utilized by those who initiate a bankruptcy case. This means that I do not agree that the question 6(b) proffered contention that bankruptcy is the way, and the only way, to achieve, if at all possible, what S. 2136 desires to occur to "...sort out who must approve each modification..." I would also like to mention that I have not read or heard any testimony regarding the extent to which the contractual provisions governing modification of the principal and interest portions of the mortgages may already exist for some mortgage secured ownership vehicles which specify the when, how and by whom such changes may be made. That the scope of the when, how, and by whom is not detailed to a sufficient degree by some or many does not mean that this is the case for all. A consequential question raised by the existence of the category of mortgage ownership vehicles with the necessary degree of specificity for these matters is whether those in this grouping should be treated the same as those which are not? As with other issues, consideration should also be given to this factor.

II. Responses to Questions from Senator Jeff Sessions to the Honorable Thomas B. Bennett

Question 1. There are numerous references to the unintended consequences and potentially negative effects of the proposed legislation (S. 2133 and S. 2136). You urged Congress to be careful in considering these reforms, explaining that there are too many unknown variables and that we do [not] yet know whether problems in the home mortgage industry are simply a symptom of a larger problem. One unintended consequence of the proposed legislation, mentioned several times by several of the witnesses, will be on the cost of loans–interest rates will likely increase and the supply of credit will likely decrease.

a. Do you believe that the overall costs of loans to borrowers will increase?
b. Will this likely be true for all adjustable rate mortgages, including those that are not sub-prime?
c. Will this likely be true for all fixed rate mortgages, including those that are not sub-prime?
d. Will the small benefit to the subset of borrowers that will "benefit" from passage of S. 2133 or S. 2136 be offset by the harm to the larger overall group of borrowers?
e. Will the subset of borrowers affected by the passage of S. 2133 or S. 2136 also experience some likely harm(s)? Please explain.

Response to Question 1(a), 1(b), 1(c), 1(d), and 1(e). Initially, my testimony has been consistently that the cost of credit will be higher and its supply less than **each otherwise would have been should S. 2133 or S. 2136 be enacted.** It has not been that the cost of credit would necessarily increase or decrease or that the supply of credit would increase or decrease. The reason for this distinction is that there are numerous variables which interplay to cause the cost and supply of credit to move from where each is at a given point in time. Although the cost of credit, the interest rate, may go up or down following enactment of either bill and the supply of credit may increase or decrease after adoption of what is in either bill, the proper method to determine the impact of such legislation on the cost of credit and its supply is to fix the other variables and analyze in isolation the effect of the legislation. Because and to the extent that each bill, although arguably S. 2133 to a lesser degree, causes a greater degree of uncertainty in the market meaning increased risk, this as a non-price factor would cause a leftward shift in the supply of credit from where it otherwise would be and with a given demand for credit remaining where it was before the shift, the price of credit would increase at equilibrium. In the credit market, this is what one would usually expect to be the case when increased risk is associated with lending. There should be at least one caveat to this and it is one which involves a demand curve which has a portion or portions which are or are near being inelastic. However, there has been no evidence presented that this is the case for the demand for credit and it is not likely that such a state exists for purposes of what is being discussed with respect to S. 2133 and S.2136.

Given this somewhat technical response, an example will facilitate discussion of what would normally be expected to happen. If following enactment of either of these bills the relevant rate of interest goes down to 4% or up to 10%, the question is what the rate of interest would have been without enactment of the legislation. It may be that had the legislation not been enacted that the interest rate would have been 3.8%, not 4% should it go down or 9.8% and not 10% should it increase. Thus, the cost of the legislation given all other factors being held constant would be an interest rate which is higher by 2/10ths of one percent in each instance. This represents an additional 2/10ths of one percent which would be potentially paid by new entrants into the credit market, for example first time home buyers, those refinancing exiting obligations, and those with adjustable rate mortgage loans not within the purview of S. 2133 or S. 2136. Thus, the answer to questions 1(a) and 1(b) is that there would be an increase in the interest rate **above what it otherwise would be for borrowers** which would be true for all adjustable rate mortgages, not just for those to sub-prime borrowers. With respect to question 1(c), this will be true, too, for fixed rate loans made following enactment of such legislation for some period of time. The reality is contrary to what some said at the December 5, 2007, hearing: there is a cost to enactment of S. 2136 and to a lesser degree S. 2133. These costs which may be significant and will be borne by not just the lenders/owners of existing adjustable rate mortgage payment streams, but by other American consumers in the market for credit. This is a factor of importance which needs more analysis before one enacts legislation of the sort contemplated by S. 2133 and S. 2136. What should be of potentially greater moment to the supporters of S. 2136 and S. 2133 is the fact that this increase in the cost of credit above what it would have been will be paid by borrowers to some of the very lenders and owners of debts about whom the proponents of these bills complain in potentially an aggregate amount exceeding the value of the benefits argued to be gained from the legislation! The majority of those who will pay what is a hidden cost are the borrowers for whom S.2136 and S. 2133 do not apply!

One would hope that a quantitative review of the costs and benefits of such legislation would be made to ensure that what, in particular, S. 2136 contemplates must occur–principal write downs and interest rate reductions–does not result in aggregate costs which exceed the aggregate benefits. Given the representations that the number of adjustable rate mortgage loan transactions which would be able to benefit from use of S. 2136 is relatively small when compared to the total number of adjustable rate mortgage transactions coupled with the fact that numerous other refinancings and loans will be made in the future, this so-called relatively small number of loans may well receive an aggregate benefit which is far less than the aggregate costs of lost principal, lost interest, bankruptcy case related expenses, losses from further decrease in values of homes during the bankruptcy restructuring process, to list a few, PLUS what may be the greatest of all costs in the aggregate: the increase above what would have been paid in interest by other borrowers seeking mortgage secured loans, refinancing existing mortgage loans, and having a change in adjustable rate mortgage loans outside the application of S. 2136. It is possible that even a small fraction of one percent higher interest rate for borrowers not within the group to be helped by S. 2136 will increase the costs to this non-S. 2136 category of borrowers in a total amount which is greater, maybe much greater, than the total benefit to those S. 2136 hopes to assist. This would be due in large part by the larger number of other borrowers harmed compared to the benefits asserted to be accorded to the 600,000 homeowners estimated by S. 2136's proponents. There has been insufficient attention paid to this problem and I believe the true cost of the legislation should be determined in a more rigorous manner before enactment of either S. 2133 or S. 2136 in their current versions. To date, I have seen no testimony or evidence presented to this Committee in support of these bills which estimates these costs and benefits in any rigorous quantitative manner.

Perhaps more troubling is that the argument that 600,000 loan transactions–homes–would be saved from foreclosure or benefit from S. 2136 overlooks the stark reality of what has and continues to happen in a Chapter 13 case. It is the failure rate in Chapter 13. That is, it is the number of Chapter 13 cases dismissed without obtaining a discharge. The statistic most generally cited is that approximately 67% of Chapter 13 cases are dismissed before completing payments under a plan. I need to state that this number does not control for various factors such as achieving the desired result without the need of a bankruptcy discharge, whether the dismissed case was a debtor's first, fifth, tenth, twelfth or other number of bankruptcy case filed, and for other quantitative issues. Regardless, the point is that the failure rate in Chapter 13 is, as it is in other forms of bankruptcy reorganization, very high. When this failure rate is taken into account, the posited benefits from S. 2136 will be nowhere near what the proponents argue. It will be closer to one third of what is asserted or approximately 198,000 mortgage loan transactions if the 67% dismissal rate is close to accurate. Even if off by some amount, it is clear that the majority of cases will be dismissed before discharge should the historical norm remain unchanged.

Joined with this statistic is the fact that under current bankruptcy law dismissal of a case before its successful conclusion undoes all that occurred in the case unless the dismissal order provides otherwise. This is the general import of section 349(b) of the Bankruptcy Code. This means that unless the borrower files another Chapter 13 relatively quickly following the pre-discharge dismissal of an earlier Chapter 13 case, the holder of the adjustable rate mortgage secured loan gets to put the loan back to where it would have been as if no bankruptcy case had been filed. In other words, the entire debt is treated as secured, the interest rate that would have been charged but for S.2133's or S. 2136's application may be charged retroactive to before the filing of the initial Chapter 13, and other additional charges, fees, and expenses permitted under the contracts or applicable law may be imposed as if no bankruptcy case had ever been filed. The result is that the borrower may owe more on the mortgage secured loan than she/he/they would have owed had a Chapter 13 case never been filed..

This happens now in consumer chapter 13 cases dismissed pre-discharge with respect to real property, vehicle, and other secured loans. This puts the borrower in the posture of being potentially in a worse position than she/he/they would have been without filing bankruptcy. Many times, it also makes a second or subsequent case less likely to succeed than the earlier one with the concomitant increase in the likelihood that a foreclosure will ensue.

This sequence of events is made even more likely for some by the BAPCPA enacted amendments to the Bankruptcy Code for debtors who have more than one case filed within a one year period. This is due to the addition to the bankruptcy laws of the requirement of a substantial change in personal or financial circumstances of a debtor in the interval between the dismissal of the prior case and the filing of the new one which must be proven by the debtor to exist by clear and convincing evidence in order to have the automatic stay of section 362(a) of the Bankruptcy Code stop a foreclosure following the filing of a bankruptcy case beyond 29 days under section 362(c)(3)(A) or be put in place where none exists on filing a bankruptcy case which is the third case or more within one year under section 362(c)(4). Essentially and in response to question 1(e), all of this means that some of those borrowers who S. 2133 and S. 2136 are supposedly designed to help may be worse off under the scheme of either S. 2133 or S. 2136. For some of these, having a foreclosure before spending more monies on a home that will ultimately be lost is better in the long run, though a difficult outcome in the short run.

Question 2. Congressional actions in the home mortgage market will have consequences–there will be winners and losers under every proposed policy. Already, lenders are pulling back from loans they would have made earlier due to the uncertainty of the market. Your testimony explained how the effects of the proposed legislation (S. 2133 and S. 2136) will be far in their reach, going well beyond the scope of the bankruptcy courts. In your [oral] testimony to the Committee you stated that there are "two stages of losses" associated with this legislation and the effect it will have on the market. Can you provide more detail as to these stages of loss?

Response to Question 2. In my oral testimony, I was expanding on a point in my written testimony to demonstrate a particular problem with S. 2136 caused by the write down of the secured portion of the unpaid balance of an adjustable rate mortgage loan coupled with the extension of the term of the loan beyond that provided for under the terms of the loan documents and a reduction in the interest rate below the contract rate. S. 2136 purports to allow an adjustable rate mortgage loan's secured status reduced to the market value of the home once a bankruptcy case is filed. This converts the unpaid amount of the loan balance which exceeds the value of the security to an unsecured claim. Assuming that the valuation done within the bankruptcy case matches the true value of the security outside a bankruptcy case, here the debtor's residence, the diminution or loss in value of the secured claim in bankruptcy is the same as the loss that would be incurred outside bankruptcy should the property be sold at the time of valuation in the bankruptcy case. Assuming the accuracy of the valuation done within a bankruptcy case, this is the first loss on the secured claim and the proponents of S. 2136 are right to the extent of this loss being the same in or outside a bankruptcy case assuming the valuation within a bankruptcy case is accurate.

What is the second loss is what S. 2136 does to the written down, now fully secured claim in the bankruptcy case. It takes the fully secured portion of the overall claim and lowers the interest rate and extends the repayment period. This is done without regard to whether the amount of interest using the contract rate as applied to the secured principal balance plus amortization of the secured principal balance over the remaining contracted for life of the loan is fully repayable by a debtor in her/his/their bankruptcy case! The extension of the repayment period for the secured claim is especially longer than under the contracted for term for mortgage secured loans with maturities of less than thirty years, say seven, ten, and twenty year original terms. When one recalls that a number of mortgage secured obligations of the sort S. 2136 would govern in a bankruptcy case have been broken into various streams of principal and interest covering various portions of what makes up the total of payments due under an adjustable rate mortgage, the extension of the term of the mortgage beyond what was contracted for causes a loss to the holders of some of these streams of payments which are more attenuated in time from today to be greater than those with streams of payments closer to today. Indeed and if the extension is long enough and/or the interest rate reduction is great enough, the loss on this portion of what is supposedly a 100% secured claim may approach all of the value of this stream of payment. This is the second loss on what is the supposedly fully secured claim.

It arises from application of S. 2136 by setting of the repayment term and interest rate for the whole of the mortgage secured loan as if all streams of payment of principal and interest are owned by one person/entity and not by multiple persons/entities. This type of loss is caused by the application of an interest rate which for the total of the unpaid principal plus interest over the extended maturity may be appropriate in the aggregate, but with respect to some of the streams of repayments, especially those near the end of the extended repayment period, is too low by market set standards. What possibly may happen is that those receiving payments from the front end of the stream of repayments of principal or interest may have either a proportionately smaller loss, no loss, or a potential gain above what would have otherwise occurred. This will in some cases be at the expense of those owning a repayments stream later in time. What has happened to what was one long term debt with all payment streams held by one person or entity for up to thirty or more years in duration is that some have been divided into what may be viewed as more akin to short term, intermediate term, and long term repayment streams, among other types of compositions, which in the market usually have different valuations caused by different discount factors or interest rates for each. Unfortunately, this is not how S. 2136 will treat these differing types and terms of repayment streams. They are all lumped into one with no recognition of the differences in risks associated with each. This situation is not contemplated by S. 2136, S. 2133, and the current practice in consumer bankruptcy cases, and its applicable law. As a result, certain of the owners of these attenuated streams of what would have been found for claims allowance under the Bankruptcy Code to be fully secured will be, in reality, not treated as fully secured and, for some, could potentially be made nearly, if not totally, worthless.

Lastly, it is an incomplete comparison to assert that this already happens with vehicle loans and similar personalty loans in a Chapter 13 case. The reason that it is a misleading comparison is that these other sorts of vehicle and personalty secured loans have much shorter maturities than large parts of the streams of repayment of mortgage secured obligations which can be extended under S. 2136 for a term multiple years–tens of years–longer than can vehicle and other personalty secured loans under a Chapter 13 plan and the dollar amount of most of these mortgage debt repayment streams is also much greater than those for the majority of vehicle and other personal property secured loans. This makes any losses on adjustable rate mortgage secured obligations much greater than those for vehicle and similar shorter term secured debt instruments. This is another of those complex problems which should be thought about in greater detail before any version of either S. 2136 or S. 2133 is enacted.

Question 3. Mr. Sommer testified that almost 600,000 homeowners will benefit from the enactment of S. 2136 by filing bankruptcy and being able to keep their homes.

a. In your opinion is this an accurate statement? Will 600,000 homeowners, as a result of this legislation, be able to keep their homes that might otherwise have been lost to foreclosure?

b. Or, are we likely just postponing the majority of home losses for a short time?

Response to Question 3. I have no reason to question that the estimated number of homeowners as calculated by Mr. Zandi was done properly based on the assumptions he used. My belief is that this is where Mr. Sommer may have obtained the 600,000 figure. If Mr. Sommer did a separate calculation, I have no reason to doubt that it was done consistent with the assumptions he used. Whether this number of homeowners will benefit from S. 2136 depends on how one defines "benefit." If it means keeping one's home for a longer time from one day to years longer than one would have kept it had a foreclosure occurred and the estimated number is accurate then the statement is accurate. However, if what is meant is that all of the 600,000 homeowners will not face foreclosure by filing a Chapter 13 bankruptcy case and be able to afford to repay in full the mortgage debt obligation, I do not believe it to be correct. The reasons are set forth in my response to Senator Sessions' question 1. Likewise and for some as I also set forth in my response to Senator Sessions' question 1, the result will only be the postponing of a foreclosure for a period of time which could range from a short to a longer one. Why these are the case is the very high failure rate in all bankruptcy cases, including Chapter 13. Whether less than most of the 600,000 homeowners asserted to be benefitted will prove to be the case remains to be seen, but should the historical rate of discharges granted in Chapter 13 cases remain at or near what it has been, those benefitted by avoiding foreclosure and keeping their home until paid for will be only about a third of the asserted 600,000 homeowners.

III. Conclusion. Mr. Chairman and the other Members of the Committee, I thank you for allowing me to set forth my perspective regarding each of S. 2133 and S. 2136. In summary, I have not argued that nothing should be done. Rather, I have addressed what I believe to be significant deficiencies in each of the bills along with some of what I believe to be each's merits on the hope that greater analysis and consideration will be given to what is being attempted to ensure that the least negative impact and the greatest net benefits, if possible, will be associated with whatever may be enacted. To that end, I am willing to give whatever other assistance which may be requested of me.