Testimony of

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Mr. Chairman and members of the Committee, thank you for inviting me here to testify before you today. My name is Henry J. Sommer and I am an attorney specializing in bankruptcy and consumer law matters. For over 33 years, I have represented families and individuals in Philadelphia who have sought my help for serious debt problems, often involving mortgage foreclosure. I am the President of the National Association of Consumer Bankruptcy Attorneys (NACBA), an organization of attorneys who represent consumers in bankruptcy. Our members, numbering over 2700, represent a large proportion of the individuals who file bankruptcy cases in the United States Bankruptcy Courts. I am also Co-Editor in Chief of Collier on Bankruptcy, I have had the honor of testifying several times before this Committee over the past 25 years, and I am a former member of the Judicial Conference's Advisory Committee on Bankruptcy Rules and the Federal Reserve Board's Consumer Advisory Council.

It is now quite clear that our country is facing approximately two million home mortgage foreclosures over the next few years. While there may have been some doubt about this when I first testified about this issue in the House last April, the dimensions of the problem are now becoming evident to almost everyone. These foreclosures are already having widespread effects in neighborhoods across America, as well as in the financial markets, and those effects will get much worse in the months to come. Not only will millions of people lose their homes, but other homes in the vicinity will decline in value as a result of nearby foreclosures, causing a significant loss in wealth to most American homeowners.

It is also clear that it is within the power of Congress to prevent hundreds of thousands of these foreclosures, and the ripple effect they will have throughout the economy. Senator Durbin's Helping Families Save Their Homes in Bankruptcy Act (S.2136), which would make modest changes to the Bankruptcy Code to treat home mortgage debts more like all other secured debts, could save as many as 600,000 families from losing their homes. Allowing homeowners to file chapter 13 plans that modify their mortgage debts and reduce their payments would utilize an existing, efficient, well-established, and predictable template to prevent foreclosures, and it would not require the use of government funds to bail out either homeowners or lenders. No other legislative proposal has the potential to save nearly as many homes.

The basic principle underlying the bill -- that liens are reduced to the extent they exceed the value of the collateral and the payment terms are modified to reflect a fair rate of interest -- is popularly known as "cramdown". The concept is one of longstanding use and importance in bankruptcy law, and has applied for decades to almost every other kind of asset in chapter 11 (commercial real estate and all other assets), chapter 12 (all assets, real and personal), and chapter 13 (almost all assets, including second homes, multifamily homes, and commercial property, but not a debtor's principal residence.) Essentially, it simply permits the debtor to "buy back" an asset from a creditor's lien at the current market value anyone else would pay for it, and pay that amount over time with a fair rate of interest. Moreover, the unsecured portion of the debt remains as an unsecured claim in the bankruptcy case.

This principle is fundamental to the way that bankruptcy laws reflect economic reality and provide an orderly system for resolving the rights of debtors and creditors. Among creditors, it is unfair to pay a secured creditor more than the value of its collateral at the expense of unsecured creditors. And making bankruptcy more difficult for debtors does not mean they will pay debts they cannot afford to pay. If cramdown is not permitted for debtors who cannot pay their mortgages, debtors and creditors have several other alternatives, none of which is more favorable to the mortgage creditor:

(1) Foreclosure, in which the creditor would receive liquidation value which is usually much less than current market value (some sources estimate that a foreclosing creditor receives an average of 60% of market value after all foreclosure costs);
(2) Short sale, in which the debtor sells the home privately and pays the creditor what it would receive in cramdown (usually, minus a realtor's commission and other costs of sale);
(3) Deed in lieu of foreclosure, in which the creditor receives the home, worth only the cramdown amount, and must pay the costs of maintaining and selling the property;
(4) Voluntary modification, which lenders rarely agree to, in which an arrangement similar to cramdown results.

In light of the fact that cramdown is at least as favorable to a creditor as foreclosure, it is not surprising that the price and availability of mortgages were not affected over the years when four circuits permitted cramdown of home mortgages in chapter 13 prior to the Supreme Court ruling otherwise. Indeed, prior to the Supreme Court's Dewsnup decision, many courts permitted cramdown of undersecured liens in chapter 7. Also, chapter 13 debtors still have the ability to cram down mortgages on investment properties, commercial real estate, vacation homes, and two and three family homes, with no resulting difference in credit cost or availability of such loans.

The fundamental underlying fact in these cases is that bankruptcy does not cause a loss to the creditor. The debtor's inability to pay, combined with inability to refinance or sell the asset and pay off the loan, has caused the loss. The loss already exists, as a matter of economic reality, whether or not the creditor has recognized it on its books. Bankruptcy, whether in a corporate chapter 11 case or an individual's chapter 13 case, recognizes that reality and moves forward from there to restructure the debtor's finances according to rules designed to rehabilitate the debtor financially and share the pain fairly.

I understand that industry lobbyists have been arguing that such legislation is unnecessary because 1) lenders will solve the problem through voluntary modifications and 2) the legislation would cause interest rates to increase dramatically. As I will discuss, neither of these arguments has merit. But I must first point out that these arguments contradict each other. The bankruptcy legislation would allow courts to impose terms similar to those that would be needed to save homes in voluntary modifications. If lenders were actually granting such modifications to homeowners who need them, those homeowners would not need to file chapter 13 cases to obtain those terms. In addition, the resulting modified loans would have the same economic effect that they would have if a bankruptcy court imposed the modifications. It makes no sense to argue that the same types of modifications, on the same loans, would have totally different effects on the mortgage market.

But the truth is that voluntary modifications are not being made in any significant numbers. Although there have been many press announcements by lenders and regulators that such modifications will be granted, our experience in the field, as well as press reports, reveal that this is not happening in many cases. When I testified in the House eight months ago, a witness representing the industry testified that such efforts were well under way, yet months later it was reported by Moody's that modifications were being granted in only 1% of subprime mortgage cases. And not all "modifications" even saved the family's home; some lenders count as successful modifications resolutions such as "short sales" in which the borrower sells the home and the lender forgives the remaining debt.

Industry representatives claim that borrowers are just not responding to their offers of help, but borrower after borrower, as well as many housing counselors and attorneys trying to negotiate with lenders, report that when they do call they are subjected to endless phone chains, constant changes in the people they are dealing with, enormous paperwork requests, and ultimately denial of necessary modifications. To the extent modifications are being offered, many are inadequate, such as delaying an interest reset for a year or two, or increasing the negative amortization of the loan, which would simply push the problem into the future.

So far, the primary responses to the problem have been to beef up government and nonprofit resources for counseling debtors and negotiating with lenders. But if lenders are unwilling to offer significant modifications, no amount of resources put into those programs will prevent the massive wave of impending foreclosures. In a dramatic example, it was recently reported that when state housing finance agencies sought to help borrowers by asking lenders to modify loans so the agencies could then refinance them, they had no success because lenders would not make the modifications. If mortgage companies will not modify loans even when they will receive an immediate payoff through refinancing, they certainly will not modify them in cases where they will be paid over a long period of time. In short, the problem is not that borrowers are spurning the lenders' generous offers of help. It is that the public relations efforts about mortgage modification have not been matched by real, concrete action. It defies logic that borrowers would not respond to meaningful offers to help them save their homes if such offers were actually being made.

And it is not surprising that modifications are not happening on a large scale. In some cases, modifications are flatly prohibited or severely restricted by the mortgage pooling and servicing agreements, so servicers do not even have discretion to grant them. Even when they are not prohibited, obtaining a loan modification is difficult for many reasons:

? Who owns the loan? It is important to realize that most borrowers will be negotiating with a servicer of their loan rather than with their original lender or with the trust that actually owns the loan. People facing foreclosure in previous mortgage crises had the advantage of being able to go to their local bank or savings and loan to negotiate directly with the entity that made the loan, serviced it, and held the economic interest; since the lender faced significant losses from foreclosure, a win-win modification could often be worked out. The world has changed, however. Many borrowers and even their servicers simply cannot locate the holders of the mortgage to negotiate with, or there are multiple owners who all would have to agree to modification; the loans have been sliced and diced so many times that all of the owners cannot be found and brought into the process.

? Fear of investor lawsuits. The servicer has obligations to the investors who have purchased the mortgage-backed securities through pooling and servicing contracts, and the interests of these investors conflict. Servicers are hesitant to modify the loans because they are concerned that it will impact different tranches of the security differently, and thereby raise the risk of investor lawsuits when one or more tranche inevitably loses income. This phenomenon is known as "tranche warfare". For example, a modification that defers loss will favor the residual holder if the excess yield account is released, but will hurt senior bondholders. The legally safest course for the servicer is clearly foreclosure.

? Servicers are overwhelmed and are simply not set up to negotiate modifications. The magnitude of the crisis has been too much for many servicing operations to effectively respond. Hundreds of thousands of borrowers are asking for relief from organizations that have traditionally had a collections mentality of trying to foreclose as quickly as possible. They know how to foreclose, and the foreclosure process has been increasingly automated to maximize the fees the servicers receive. These servicers are not disposed to postponing foreclosure or equipped to handle case-by-case negotiations. What happens most often is that, at best, the servicer goes through the motions of looking into modification, while the foreclosure proceeds full speed ahead. Only when the foreclosure sale is imminent does the borrower realize that no modification will be forthcoming. Further, many of these servicers are affiliated with lenders who are themselves going bankrupt or facing severe financial stress, and therefore are cutting back just as the demands are increasing significantly.

? Piggyback seconds. The most intractable problem is the fact that a third to a half of 2006 subprime borrowers took out piggyback second mortgages on their home at the same time as they took out their first mortgage. In these cases, the holder of the first mortgage has no incentive to provide modifications that would free up borrower resources to make payments on the second mortgage. At the same time, the holder of the second mortgage has no incentive to support an effective modification, which would likely cause it to face a 100% loss. The holder of the second is better off waiting to see if a borrower can make a few payments before foreclosure. Beyond the inherent economic conflict, dealing with two servicers is a negotiating challenge that most borrowers cannot surmount.

With respect to the contention that the legislation would raise interest rates by one to two percent on all mortgages, there is simply no basis for this conclusion. The argument that consumers' costs will rise, and that credit will be less available, is made every time consumer protection legislation is proposed and it has never proved to be true. For example, after the 1978 Bankruptcy Reform Act, which significantly expanded debtors' rights, consumer credit continued to grow dramatically and did not become more expensive. After the 2005 bankruptcy bill, which restricted debtors' rights, credit did not become less expensive. The fact is that legislation such as this has no measurable impact because the debts which are discharged in bankruptcy are overwhelmingly debts that would not be paid in any event. Bankruptcy laws are not the cause of the loss; the debtors' inability to pay is the cause of the loss. In the current mortgage situation, as I discussed previously, the lenders will take a loss, perhaps a greater loss, even if this bankruptcy legislation is not enacted.

Moreover, the arguments made by the lenders do not make sense as a matter of simple arithmetic. Even if it were not true that the losses have already occurred, and would not be caused by bankruptcy legislation, even if lenders did not already account for the risk of default in their mortgage rates, and even if they continued to make the same kinds of loans in the future that created this catastrophe, the amount of interest rate increase they are predicting is 10 to 20 times the amount that could possibly occur.

Industry lobbyists have also argued that enactment of legislation like S.2136 would bring uncertainty to the financial markets. Like the losses that they claim will be brought about by the legislation, that uncertainty already exists. It would be hard to imagine how this bill could bring even a small fraction of the uncertainty the lenders themselves have caused. No one knows how many mortgages will be modified to prevent foreclosures, or what the terms of those modifications would be, to the extent they occur. If anything, allowing modification in chapter 13 will foster more certainty and stability because it will create a predictable template for dealing with defaulted mortgages, based on long-recognized bankruptcy principles that will permit a large number of families to avoid foreclosure and the more unpredictable losses foreclosure will cause.

I also hope Congress will remember that those who are making these projections are the same people who not long ago told Congress that there were no problems with abuses or excesses in subprime mortgage lending that needed regulatory or statutory action.

The people who now say they are so concerned about risk are the same people who saw no problems when it was repeatedly pointed out they were giving loans without even determining whether borrowers could pay those loans and, in fact, were offended by the idea they should be required to determine whether a borrower could repay the loan.

In other words, these are the people who created this mess and are now suffering billions of dollars of losses, not because of any bankruptcy laws, but rather because of their poor predictive abilities. It is hard to understand why Congress should listen to predictions about the mortgage market from those who have been so wrong, rather than from those who predicted that the current crisis would happen.

The industry has also argued that the legislation will help speculators and that it will be used by those who do not need it. But S.2136 will not help speculators, because it only applies to a debtor's principal residence. Ironically, under current law, investors can already modify the loans on the properties they buy.

S. 2136 also will not help those who bought a more expensive house than they could, even with a reasonable mortgage, afford. The existing feasibility standard for confirmation of a chapter 13 plan will prevent such debtors from obtaining relief under this bill.

The mortgage modification remedy in S.2136 will not be used where it is not needed; there are strict eligibility requirements based on the stringent means test expense formula, based on IRS collection standards, enacted in the 2005 bankruptcy legislation. If debtors can pay their living expenses as determined by those standards, and still have enough money remaining to cure their mortgage defaults under the standard chapter 13 methods, they will not be eligible for modification. And, in our experience people do not file bankruptcy unless they have no alternative. (Some will not do so even then.)

S.2136 also will not allow judges to simply reduce mortgage amounts and interest rates without any standards. Supreme Court precedents guide bankruptcy courts in both valuation and setting of interest rates, and S.2136 itself sets standards that incorporate those precedents. Loans would not be reduced below a property's fair market value (more than the lender would receive in foreclosure) and interest rates would not be reduced below conventional rates, usually increased by an adjustment for risk.

S.2136 will help the many families who refinanced their homes with predatory mortgages, often because they were deceived into refinancing an affordable mortgage into one they could not afford, especially the many families who, in fact, qualified for better terms. And it will help their neighbors, whose homes will not lose value because of foreclosures on their block, as well as their mayors and local governments, who will not suffer a precipitous loss in their property tax base

In conclusion, Congress has an opportunity to prevent hundreds of thousands of families from losing their homes, if it acts soon. Providing resolution in such cases is more likely to rationalize and stabilize the market, rather than destabilize it.