Testimony of

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Testimony of Michael D. Calhoun Center for Responsible Lending

Before the U.S. Senate Judiciary Committee

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

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Good morning Chairman Leahy, Ranking Member Specter, Senator Durbin and other members of the Committee. Thank you for holding this hearing on judicial loan modifications and for inviting me to testify.

Introduction

I serve as president of the Center For Responsible Lending (CRL), (www.responsiblelending.org), a not-for-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of Self-Help (W\vw.self-help.org), a nonprofit community development financial institution that consists of a credit union and a non-profit loan fund.

For close to thirty years, Self-Help has focused on creating ownership opportunities for low¬wealth families, primarily through fmancing home loans to low-income and minority families who otherwise might not have been able to get home loans. In total, Self-Help has provided over $5 billion of financing to 55,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across America.!

With the constant barrage of statistics and staggering dollar figures that have become commonplace during this financial crisis, it is easy to become numb to the depth and scope of the financial pain American families are experiencing today. However, the numbers paint a picture we cannot ignor~. Using recent data from the Mortgage Bankers Association, we calculate that foreclosures on all types of mortgages are occurring at an annual rate of 2.3 million.2 On subprime mortgages alone, the "spillover" costs are massive. At least 40 million homes¬households where, for the most part, people have paid their mortgages on time every month-are suffering a decrease in their property values of $352 billion.3 And these figures only consider spillover for subprime foreclosures, let alone prime and Alt A, which will drive the losses much higher. These losses, in turn, are infiltrating nearly every part of American life, from police and fire protection to community resources for education.

The most pressing need today is to help homeowners stay in their homes and, by extension, support their neighbors' property values and the financial system as a whole, since financial institutions will not survive if their mortgage-related portfolios continue to fail. As we have become accustomed to hearing about the losses stemming from foreclosures,4 we also hear on a regular basis that the foreclosure epidemic is being addressed through the voluntary efforts of servicers and lenders. Notwithstanding these efforts and results published by HOPE NOW,s the foreclosure problem is getting worse, not better. In fact, the voluntary efforts have typically raised a distressed family's mortgage payment instead of lowering it, resulting only in a temporary fix with a high probability offailure.6

We have been encouraged by more recently proposed streamlined modification programs that include systematic affordability thresholds to better ensure sustainability. We have urged the Treasury Department to promptly implement a streamlined program using its authority under the Troubled Asset Repurchase Program (TARP).7 In particular, we have recommended that Treasury adopt the FDIC's proposed loan modification guarantee program and provide guarantees to modifications from servicers with streamlined affordable modification protocols based on the FDIC/IndyMac model under the authority provided by Section 109 of the Emergency Economic Stabilization Act (EESA).8 However, even a well-designed streamlined program has its limitations. While a strong step in the right direction if implemented, certain aspects of a streamlined program are potentially problematic, and it may not be able to reach sufficient numbers of loans held in private label securities.

Given the challenges of even the most promising voluntary efforts, something more is needed: a mechanism (l) to maximize the effectiveness of existing and proposed voluntary efforts by inducing lenders and investors to make sustainable modifications; and (2) to serve as a last resort for those homeowners who could afford market rate loans but who will fall through the cracks of voluntary programs when the servicer either cannot or will not modify. The most efficient and cost-effective way to accomplish this is to lift the ban on judicial modification of primary residence mortgages so that a court can provide an economically rational solution when the investors or servicers do not. Working through the existing infrastructure of the bankruptcy court system, the solution could take effect immediately, leveraging the expertise of the bankruptcy courts. And the plan would be implemented at no cost to the taxpayer.

Judicial loan modifications will provide a strong incentive for servicers and investors to make voluntary programs work, since they will have clear authority to avoid judicial modifications by offering their own workout solutions outside of bankruptcy.

Bankruptcy courts already modify loans for all manner of other debts, including,mortgages on vacation homes and investment properties. They should be permitted to do so for a homeowner's primary residence, which is typically the asset most critical to a family's financial and physical security.

Congress provided this solution during the farm crisis of the 1980s, when it enacted the Family Farmer Bankruptcy Act of 1986 to help distressed farmers avoid foreclosure, including on their primary residence. At that time, family farmers were facing declines in property values and unaffordable mortgages, and the bill did for them what court-supervised loan modifications would do for ordinary homeowners facing the same issues.

Consider one homeowner, Candace Weaver, a schoolteacher from Wilmington, North Carolina. Ms. Weaver refinanced her mortgage in 2005 to meet financial obligations after her husband had a heart attack. She received what seemed like a reasonable if pricey loan at 8.9% from a lender named BNC Mortgage. She was not told that two years later, the rate on her loan (a 2/28 ARM) would jump to 11.9%. She could barely afford this higher payment, and after being diagnosed with kidney cancer requiring surgery, she could not make the payment the month of the surgery. Before surgery, she called her servicer to say she would not be able to make her payment that month. The servicer said it couldn't help her until she was delinquent. After her surgery, and after becoming delinquent, Ms. Weaver called again. This time, the servicer said it couldn't help her until she was in foreclosure. Once foreclosure was commenced, the servicer offered her a repayment plan that required her to make the monthly payments at 11.9% and make up any payments she had missed. This was obviously not achievable for her. Yet, even though she could afford a market rate loan, she cannot have her debt restructured.

By contrast, consider Lehman Brothers. Lehman Brothers earned hundreds of millions of dollars in fees purchasing and securitizing the very type of loan aggressively marketed to Ms. Weaver. In the process, it leveraged itself 30 to 1, causing its own failure and harming the entire global financial system. Lehman Bros, in fact, owned BNC, the very same lender that may cost Ms. Weaver her home. The Wall Street Journal investigated BNC and found widespread falsification of tax forms, forging of signatures, and otherwise ignoring of underwriters' warnings.9 Lehman Brothers, of course, filed Chapter 11 bankruptcy in September. It can have its debts restructured -but Ms. Weaver cannot.

Or consider AIG. Less than two months ago, the Federal Reserve loaned it an $85 billion lifeline when the company appeared on the brink of collapse. Since then, AIG has incurred larger than the then-projected losses on its credit default swap contracts-the profitability of which always essentially rested on an irresponsible bet that doomed-to-fail subprime mortgages wouldn't ultimately fail. Last week, the Fed responded to AIG's continued woes by writing down the $85 billion debt to $60 billion, lowering the interest rate, and extending the repayment term from two to five years.10 Certainly borrowers, for whom the difference between keeping their home or losing it is often only hundreds of dollars per month, should be afforded the opportunity for a reasonable, modest modification. This would not only help individuals, but is crucial to preventing the downward spiral in housing prices that continues to weaken the entire economy.

The cost of lifting the ban on court-supervised modification is worth noting again. To date, the government has spent or committed well over a trillion dollars bailing out the financial industry with no slowdown in foreclosures to show for it. II It has spent only pocket change-if that-to help keep homeowners in their homes. Lifting the ban on court-supervised modifications wouldn't cost the Us. Treasury a dollar. And it would help keep approximately 600,000 families in their homes, helping to stabilize the broader economy as a result. 12

In this testimony, I will focus on the following points:

1. Abusive lending practices, driven by Wall Street's appetite for them, caused this foreclosure crisis.

II. Foreclosures are occurring at staggering rates, and they are only projected to get

worse.

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In this testimony, I will focus on the following points:

1. Abusive lending practices, driven by Wall Street's appetite for them, caused this foreclosure crisis.

II. Foreclosures are occurring at staggering rates, and they are only projected to get

worse.

III. Voluntary, loan-by-Ioan modification efforts are not effectively stemming the tide of foreclosures due to structural, legal, and financial obstacles.

IV. While proposed streamlined modification efforts hold promise, lifting the ban on

court-supervised modification is crucial to the success of any voluntary effort for at least two reasons. Primarily, availability of court-supervised modifications will provide incentive for investors to modify loans because homeowners will have the ability to obtain reasonable modifications when lenders and servicers do not provide them. In addition, homeowners who can afford market-rate loans but whose servicers cannot or will not modify their loans should have an avenue of last resort to remain their homes-benefiting not only themselves but their neighbors, their communities, and the economy as a whole.

I. Abusive lending practices, driven by Wall Street's appetite for them, caused this foreclosure crisis.

The flood of foreclosures we see today goes beyond the typical foreclosures of years past, which were precipitated by catastrophic and unforeseen events such as job loss, divorce, illness or death. The current foreclosure crisis is characterized by losses triggered by the unsustainability of the mortgage itself, even without any changes in the families' situation, and even where the family qualified for, but was not offered, a loan that would have been sustainable.

From 2000 to 2005, only 16% of subprime mortgages being securitized were relatively straightforward fixed-rate mortgages. In contrast, 40% were 30-year ARMs, 17% were interest-only loans, 19% were 40-year ARMs, and 8% were balloon 10ans.13 The three particularly tricky aspects of the subprime ARMs made during this period are the following: first, the rate jumps up, often sharply, at the end of the initial period, and often without regard to whether interest rates in the economy stay the same or even decline; second, lenders typically made these loans with the understanding that the borrower could not afford the rate increase, and would have to refinance before the rate reset; and third, refinancing before reset entails the payment of a steep prepayment penalty-typically equaling three to four percent of the loan balance. 14

The number of subprime loans made without full documentation of income climbed from 26% of subprime mortgages in 2000 to 44% in 2005,15 while a staggering 9 out of 10 Alt-A option ARMs made in 2005 were without full documentation.16 Failure to escrow for taxes and insurance was yet one more way families were fooled into thinking they could afford what were in fact unsustainable loans, occurring mainly in the subprime market, 17 and contributing to higher rates of foreclosure. 18

When Federal regulators finally proposed to require lenders to underwrite loans to the fully-indexed, fully-amortizing payment schedule that would apply after expiration of initial rates, interest-only periods, and negative amortization, the response from industry was telling. In fact, at the time, Countrywide estimated that 70% of their recent borrowers would be unable to meet this common-sense standard.19 Industry's response represented an admission that they had been making unsustainable loans that would eventually result in unaffordable payments.

Wall Street's appetite for risky loans incentivized mortgage brokers and lenders to aggressively market highly risky exploding ARM loans instead of the sustainable loans for which borrowers qualified.zo As Alan Greenspan told Newsweek, "The big demand was not so much on the part of the borrowers as it was on the part of the suppliers who were giving loans which really most people couldn't afford. We

~reated something which was unsustainable. And it eventually broke. If it weren't for securitization, the subprime loan market would have been very significantly less than it is in size."Zl

Loan originators-particularly independent mortgage brokers-specialized in steering customers to higher-rate loans than those for which they qualified, particularly minority borrowers. They also loaded up the loans with risky features, including prepayment penalties, and encouraged borrowers to take out "no doc" loans even when those borrowers had easy access to, and often provided, their W-2s.

A key driver of the upselling is a practice known as yield-spread premiums (YSPs), in which lenders pay independent brokers special bonuses if they place a customer into a higher-rate loan than that for which the customer qualifies. Generally, the maximum bonus also required the broker to sell the borrower a prepayment penalty to lock in the higher rate. Like other broker fees, the YSPs are paid to the broker upon settlement of the loan, so the broker has no interest in the performance of that loan thereafter?Z

Market participants readily admit that they were motivated by the increased profits offered by Wall Street in return for risky loans. After filing for bankruptcy, the CEO of one mortgage lender explained it this way to the New York Times, "The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans," he said. "What would you do?"z3

This upselling resulted in a huge percentage of borrowers paying more for their loans than they should have. A study for the Wall Street Journal found that of the subprime loans originated in 2006 that were packaged into securities and sold to investors, 61 % "went to people with credit scores high enough to often qualify for conventional [i.e., prime] loans with far better terms."Z4 And even those borrowers who did not qualify for prime loans could have received sustainable, thirty-year fixed-rate loans, for at most 50 to 80 basis Ps0ints above the "teaser rate" on the unsustainable exploding ARM loans they were given. 5 Had these borrowers received the sustainable loans they qualified for, we would not be facing the foreclosure crisis we are in today.

II. Foreclosure figures are mind-boggling, and they're getting worse.

A year ago, some mortgage lenders still insisted that the number of coming foreclosures would be too small to have a significant impact on the economy overall.z6 No one makes that claim today. Today, with foreclosures at an all-time high and projected to go higher,27 the "worst case is not a recession but a housing depression."z8 According to Credit Suisse, at least two million American families are expected to lose their homes to foreclosures on subprime loans, most of them by the end of 2009-and this is in addition to the 700,000 homes already in foreclosure or owned post-foreclosure by the mortgagee.29 According to industry projections, all told (taking account of subprime, "Alt-A" and prime foreclosures), 6.5 million homes-that's one in eight homes with outstanding mortgages-will be lost to foreclosure over the next five years.30

Introductory periods on both subprime and nontraditional loans are expiring in astounding numbers, and it's only projected to get worse. Principal loan value on .securitized loans scheduled to reset in September 2008 was a little over $20 billion, including $15 billion of subprime and approximately $1 billion of Alt A. Subprime resets are scheduled to decrease steadily between now and mid-2009 and trickle to near zero by late 2010 (with a couple of upticks in mid 2010 and 2011), but since these loans are ARMs, every six months the rates on the loans will change, and resets will potentially rise if currently very low short-term indexes do.3! And we have not even seen the tip ofthe Alt A iceberg. Total scheduled resets skyrocket in 2010 and 2011, reaching about $27.5 billion per month in late 2010 and peaking at $30 billion per month in mid-20 11. Approximately half of that $30 billion is attributable to Alt A.

The decline in housing values, only precipitated by the foreclosures themselves, is leaving millions of homeowners underwater on their mortgages-increasing the likelihood of foreclosures still, in circular fashion. Currently, thirty percent of families holding recent subprime mortgages owe more on their mortgage than their home is worth.32 These families are at higher risk of foreclosure because this "negative equity" precludes the homeowner from selling, refinancing or getting a home equity loan or other mechanism for weathering short-term financial difficulty.33 Regulators and economists are increasingly cautioning that loan balance reductions may be needed to avoid unnecessary foreclosures.34 Federal Reserve Chairman Ben Bemanke has noted: "In this environment, principal reductions that restore some equity for the homeowner may be a relatively more effective means of avoiding delinquency and foreclosure.

The negative effects of foreclosures are not confined to the families who lose their homes. Forty million neighbors of families who face subprime foreclosures-those who are paying their mortgages on time-will see their property values decline as a result by $352 billion. And these are just the effects of subprime foreclosures; foreclosures on prime and Alt-A loans will push the losses much higher. Other ripple effects include a reduced tax base, increased crime, further downward pressure on housing prices, and loss of jobs in the industry. Federal Reserve Chairman Ben Bemanke recently noted, "At the level of the individual community, increases in foreclosed-upon and vacant properties tend to reduce house prices in the local area, affecting other homeowners and municipal tax bases. At the national level, the rise in expected foreclosures could add significantly to the inventory of vacant unsold homes-already at more than 2 million units at the end of 2007-putting further pressure on house prices and housing construction.,,36

Not surprisingly, this cycle of foreclosures is also having a dramatic impact on homeownership rates and, by extension, the ability to build wealth, for millions of families. Robert Shiller recently noted that the meltdown and resulting crisis has erased any gains in the homeownership rate made since 2001, and the rate stands to fall further yet.3?

III. Current voluntary modification efforts have failed to stem the tide of foreclosures.

For over a year, Congress and the Administration have urged lenders to modify troubled mortgage loans where a reasonable modification would be affordable for the homeowner, would avoid foreclosure, and would lead to a recovery for the lender that is as good as or better than what could be recovered at a foreclosure sale. Despite the loss mitigation encouragement by HOPE NOW, the federal banking agencies, and state agencies, the voluntary efforts undertaken thus far by lenders, servicers and investors have failed to stem the tide of foreclosures. Moreover, servicers still face significant obstacles in making modifications.

A. The number of modifications is inadequate.

Seriously delinquent loans are at a record high for both subprime and prime loans,38 and all available data have consistently indicated that (1) continuing foreclosures far outpace total loss mitigation efforts, and (2) only a small share of loss mitigation efforts result in true loan modifications that are likely to result in sustainable loans.39

In October, Credit Suisse reported that only 3.5 percent of delinquent subprime loans received modifications in August 2008.40 Similarly, the most recent report from the State Foreclosure Working Group of Attorneys General and Banking Commissioners (which covers 13 servicers, 57% of the subprime market, and 4.6 million subprime loans) confirms that progress in stopping foreclosures is "profoundly disappointing.,,41 Their data indicate that nearly eight out often seriously delinquent homeowners are not on track for any loss mitigation outcome, up from seven out often from their last report.42 Even the homeowners who receive some kind of loss mitigation are increasingly losing their house through a short sale or deed-in-lieu rather than keeping the home through a loan modification or workout.43

What's more, when modifications and other workouts are made, they are frequently temporary or unsustainable, leading to re-default and placing homeowners and financial institutions in an even worse economic position than when they started. Data through September 2008 indicate that the large majority of HOPE NOW efforts rely on repayment plans,44 which typically require financially burdened households to add previously unpaid debt to their current mortgage payments. Not surprisingly, we now see very high rates ofre-default on loan modifications, primarily because most loan modifications or workouts do not fundamentally change the unsustainable terms of the mortgage to make the loan affordable to borrowers over the long term.

According to Credit Suisse, when interest rates or principal are reduced, the re-default rate is less than half of those for these other modifications.45

The most recently implemented government effort to induce voluntary loan modifications is not off to a very promising start. The FHA's Hope for Homeowners program has experienced underwhelming interest from lenders, receiving less than 100 applications during its first month of operation and lowering its estimate of how many homeowners it will help during its first year to 13,30046-out of 2.3 million projected foreclosures. .

B. Numerous legal and structural obstacles stand in the way o/modifications.

A recent Federal Reserve Staff Working Paper identifies a number of obstacles that limit the scale ofmodifications.47 These obstacles help explain why voluntary loss mitigation cannot keep up with demand.

? Investor Concerns: Servicers may shy away from modifications for fear of investor lawsuits.48 While most Pooling and Servicing Agreements (PSAs) provide adequate authority to modify loans, these modifications may cause disproportionate harm to certain tranches of securities over other classes. Investors are also particularly concerned about re-default risk, where their short term losses from modifications will be compounded by future foreclosure costs, which will increase as housing prices continue to fall, if the borrower cannot sustain payments under the modified terms. In addition, when servicing securitized loans, some PSAs limit what servicers can do by way of modification. For example, some limit the number or percentage of loans in a pool that can be modified.49

? Second Liens: Additional liens on a property pose a structural obstacle that is often impossible for servicers of the first lien to overcome. Between one-third and one-half of the homes purchased in 2006 with subprime mortgages have second mortgages,50 and many more homeowners have open home equity lines of credit secured by their home. The holder of the first mortgage will not generally want to provide modifications that would simply free up homeowner resources to make payments on a formerly worthless junior lien, nor to modify a loan where there is a second mortgage in default. But as Credit Suisse reports, "it is often difficult, if not impossible, to force a second-lien holder to take the pain prior to a first-lien holder when it comes to modifications," thereby dooming the effort. 51

\- Servicer Incentives: The way servicers are compensated by lenders creates a bias for moving forward with foreclosure rather than engaging in foreclosure prevention. Servicers are often not paid for modifications but are reimbursed for foreclosure costS.52 The Federal Reserve concludes, "Loan loss mitigation is labor intensive and thus raises servicing costs, which in turn make it more likely that a servicer would forego loss mitigation and fursue foreclosure even if the investor would be better off if foreclosure were avoided." 3

- Limited Servicer Staff and Technology: With few but welcome recent exceptions, servicers have continued to process loan modifications in a labor-intensive, case-by-case review. While they have added staff and enhanced systems, the lack of transparent, standardized formulas has limited the number of modifications that have been produced.54

IV. The key to inducing voluntary modifications is the availability of court-supervised modifications.

The most promising voluntary program proposed to date is the FDIC's proposal that Treasury use its T ARP authority under Section 109 of EESA to guarantee 50% of investor losses on loans modified under streamlined affordable modification protocols.55 This program, which would tap up to $50 billion-or 7o/0-0fthe total $700 billion authorized by EESA, has the potential to facilitate modification of three million loans. We have urged Treasury to implement it immediately, and we hope Congress will urge or require Treasury to do the same.

However, we are also keenly aware that even a well-designed voluntary program is still voluntary and will not be 100 percent effective. Certain aspects of a streamlined program are potentially problematic, and it may not be able to reach sufficient numbers of loans held in private label securities. So despite what voluntary programs are implemented, an additional mechanism is critical for two reasons-to induce voluntary modifications and to provide a critical backstop for borrowers who could afford market-rate loans but are not assisted by voluntary efforts.

A. The primary goal of lifting the ban on court-supervised modifications is to induce voluntary modifications.

We estimate that lifting the ban on judicial modification of mortgages on principal residences could help approximately 600,000 families at risk of foreclosure remain in their homes56-not because 600,000 families would file for bankruptcy, but because knowing that homeowners who aren't offered conforming modifications have the option to file for bankruptcy will induce servicers to voluntarily modify loans, allowing homeowners to keep their homes.

The mediocre results of voluntary efforts so far have demonstrated that servicers and investors often need every reasonable incentive possible to be encouraged to modify loans. If investors know that homeowners who can afford market-rate mortgages will ultimately receive modifications whether or not they are offered voluntary ones, they will have every incentive to authorize voluntary modifications and servicers will have the assurance that they are acting in the investors' best interests by administrating them. In addition, bankruptcy judges, who are extremely skilled at debt workouts, could help develop modification templates that could be used by servicers outside of the bankruptcy court context.5

The Family Farmer Bankruptcy Act of 1986 provides an informative precedent, demonstrating how the availability of bankruptcy would increase voluntary modifications. That legislation enacted what is now Chapter 12 of the Bankruptcy Code for the specific and express purpose of permitting bankruptcy judges to modify mortgages on family farms, including primary residences located on these farms, permitting adjustment of interest rates and the adjustment of secured principal balance to the fair market value of the property. The allowance of court-supervised modifications induced more voluntary modifications outside of bankruptcy because everyone knew the alternative. After being extended several times, the Family Farmer Bankruptcy Act was made a permanent part of the Bankruptcy Code in 2005. In addition, as Richard Levin, Vice Chair of the National Bankruptcy Conference, has said, the success of Chapter 12 has actually led to a decrease in its use. As lenders and borrowers have come to understand how the law operates, they are increasingly able to reach agreements on their own, without intervention by the courts.58

B. Court-supervised modifications also provide a last resort to homeowners whose servicers won't modify their loans, even though they can afford a market-rate loan.

Even if a streamlined voluntary program is implemented, a significant number of troubled _ homeowners who could sustain a mortgage on economically rational terms will nonetheless be forced into foreclosure because the loan servicer cannot or will not agree to modify the loan. Often this result will be to the clear detriment of investors as a whole. In such cases, what is needed as a last alternative to foreclosure is a mechanism that enables a court to break the deadlock and provide an economically rational solution that avoids foreclosure and nets the lender at least as much as would be recovered through a foreclosure sale.

C. The proposed plan to lift the ban on court-supervised modifications is narrowly tailored to prevent borrower windfall and minimize the downside for lenders¬and it comes at no cost to the taxpayer.

Currently, judicial modification of loans is available for owners of commercial real estate and yachts, as well as subprime lenders like New Century or investment banks like Lehman Bros., but is denied to families whose most important asset is the home they live in. In fact, current law makes a mortgage on a primary residence the only debt that bankruptcy courts are not permitted to modify in Chapter 13 payment plans. Removing this exclusion would help homeowners (but not speculators) who are committed to staying in their homes, without bailing out investors and without imposing costs on the taxpayers.

The bankruptcy legislation currently proposed is in fact narrower than the Family Farmer legislation in that the current proposal applies only to people who meet a strict means test to establish their inability to make their mortgage payments, whereas the Family Farmer legislation applied to all family farmers. The proposal also provides substantially greater guidance to (i.e., limitations on) bankruptcy judges in setting the new loan terms. These limitations provide greater certainty and protection for lenders, ensuring them control over the homeowner's ability to obtain such relief at all, as a sustainable loan modification offered by the lender will disqualify the homeowner for bankruptcy relief.

Following are several key elements of the proposed plan:

1. Induces voluntary loan modifications. As noted above, voluntary modifications and refinancings are the goal, and we continue to encourage promising streamlined efforts aimed to facilitate them. Regardless of what voluntary plans gain momentum, court-supervised modifications are a critical tool in the toolbox, making any voluntary modification program more likely to succeed. Lenders would hold the keys to the courthouse, and can avoid court-supervised modification through voluntary modification. If the servicer agrees to a sustainable modification, the borrower will not qualify for bankruptcy relief because they will fail the eligibility means test. The American Securitization Forum fast-track modification process enables lenders to modify loans in borrowers' favor even without borrower consent.

The availability of court-supervised loan modifications removes the threat of investor lawsuits-investors would have no reason to sue over a modification if the same or more costly modification could be made by a judge. Moreover, as Lewis Ranieri, founder of Hyperion Equity Funds and generally considered the father of the securitized mortgage market,59 has recently noted, judicial modification is the only way to break through the problem posed by second mortgages.60

2. Narrowly targets families who would otherwise lose their homes and excludes families who do not need assistance. The proposal ensures that loan modifications are available only where the homeowner's income is insufficient, after deducting modest IRS¬approved living expenses, to cover the existing mortgage payments. In addition, there is a good faith requirement that allows courts to exclude anyone who wrongly makes it through existing hurdles. These requirements ensure that judicial modification will only be available for those loans that would otherwise end in foreclosure. In foreclosure, the lender cannot recover any more than the market value of the home and typically recovers far less after a one- to two-year process. Moreover, homeowners' own self-interest will provide strong incentive not to attempt to seek judicial loan modifications except as a very last resort. Filing for bankruptcy looms for seven years on individuals' credit reports, dramatically limiting their access to affordable credit and often affecting their property rental and employment options as well.

3. Limits judicial discretion and downside for lenders. The proposal would require courts to set interest rates at a commercially reasonable rate - the current 30-year conventional fixed rate plus a reasonable "risk premium." Senator Durbin's proposal also provides that the principal balance cannot be reduced below the value of the property and that the term cannot exceed 40 years. It also makes relief available only to those families who have sufficient income to afford their loans as modified; if not, the judge would lack the authority to modify the mortgage terms.

4. Costs the U.S. Treasury nothing. Unlike many plans to reduce foreclosures under consideration, this one comes at no cost to the U.S. Treasury.

5. Helps maintain property values for families who live near homes at risk of foreclosure.

Preventing 600,000 foreclosures translates to saving $89 billion in wealth for families who aren't facing foreclosure, but whose neighbors are.

D. Industry arguments against lifting the ban are not supportable.

Industry typically attempts to justify its opposition to lifting the ban on judicial loan modifications with claims that doing so will increase the cost of credit and cause disruption in the market. Neither claim is tenable.

1. Availability o/judicialloan modifications will not increase the cost of credit.

Several data points demonstrate that lifting the ban on judicial loan modifications will not significantly impact the cost of credit.

First, decades of experience in which bankruptcy courts have been modifying mortgage loans on family farms in Chapter 12,61 commercial real estate in Chapter 1 1,62 vacation homes and investor properties in Chapter 13,63 demonstrate there were no ill effects on credit in those submarkets. Debt secured by all of these asset types, in addition to credit cards and car loans, are readily securitizable even though they can be modified in bankruptcy.64

Second, from 1978 (when the current Bankruptcy Code was enacted) until 1993 (when the Supreme Court decided Nobleman v. American Savings Bank, 508 U.S. 324 (1993)), many courts across the country believed that bankruptcy judges had the authority to modify home mortgages (by treating them as secured up to the value of the property only). Lending experience during this l5-year period showed that those jurisdictions that permitted principal reductions experienced no adverse effects on the cost or availability of credit, either as compared with jurisdictions that did not permit principal reductions, or as compared with the period after 1993, when principal reductions were no longer permitted.65

Third, and dispositively, the cost of credit and its availability already reflect the risk that some loans will end in the loss of the home to foreclosure. Because the proposal provides for modifications only in those cases where without it the home will be lost to foreclosure, and because modification is economically preferable to the lender/investor than the cost and loss associated with foreclosure, the proposal imposes no additional risk, and hence, no further cost. As noted earlier, the proposal imposes a strict means test that limits relief to those homeowners whose income is insufficient, after deducting modest living expenses allowed by the IRS, to cover their mortgage obligations, and there is a good faith requirement that allows courts to exclude anyone who wrongly makes it through those hurdles. The result of these requirements is that judicial modification will only be available for those loans that would otherwise end in foreclosure. In foreclosure, the lender cannot recover any more than the market value of the home, and typically recovers far less, in a process that typically takes one to two years. Judicial modification guarantees that the lender will recover the value of the property -without the cost or delays of foreclosure.66

2. Availability of judicial loan modifications will not cause further disruptions to a market already disrupted - by the reckless practices of Wall Street and loan originators.

Industry has also claimed that lifting the ban on judicial loan modifications will cause market disruption. In late 2007, Mark Zandi, Chief Economist at Moody's Economy.com, testified before this Committee that there was simply no evidence lending credibility to that position. He noted that other consumer loans already covered under Chapter 13 have well-functioning secondary markets.67 He further noted that the secondary market for non-conforming loans had already "effectively shut down in the wake of the ongoing financial shock, and will only revive after there are major changes to the securitization process." Lifting the ban on judicial modifications, he stated, was "immaterial by comparison.,,68

Today, nearly a year later, it is difficult to imagine a market more disrupted than the current one. Changes in the securitization process now seem even more inevitable, and lifting the ban on judicial modifications seems even more "immaterial by comparison." As we and others have advocated for lifting the ban on judicial loan modifications, industry has said, "Don't intervene in the credit markets." Recently, though, industry has found itself on the doorstep of the u.s. Treasury, begging for intervention-to the tune of over a trillion dollars, courtesy of the U.s. taxpayers. In evaluating the credibility of the positions taken on this proposal, Congress must not lose sight of the reality that the driving force behind this market disruption - the worst since the Great Depression - is a wave of foreclosures showing no sign of slowing down. Nor should it lose sight of the fact that the foreclosures were caused by the reckless practices of Wall Street and loan originators, many of whom are the very same lenders arguing that allowing judges to modify loans on reasonable, sustainable terms will disrupt the market. To the contrary, judicial modification will slow foreclosures and help stabilize it.

Conclusion

The foreclosure crisis will get worse before it gets better, harming neighbors, communities and the economy as a whole. Our economic recovery depends upon stabilizing the housing sector, and this requires urgent measures to stop the flood of foreclosures. Voluntary loan modification efforts are not sufficient. Investors and servicers need greater incentive to agree to voluntary modifications, and court-supervised modification, as history has demonstrated through the Family Farmer legislation, is the mechanism that will offer that incentive. Further, it provides a critical backstop to enable courts to implement economically rational loan modifications where the parties are unwilling or unable to do so. Court-supervised loan modifications will slow foreclosures on a sufficient scale and time frame to have a meaningful impact. Congress should lift the ban on judicial modification of primary residence mortgages in order to help stem the tide of avoidable foreclosures and stabilize the housing market and the broader economy.

We applaud this Committee for its leadership in pursuing this urgently needed relief.