Testimony of

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TESTIMONY OF SCOTT A. STENGEL BEFORE THE

SENATE JUDICIARY COMMITTEE

Hearing on

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

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Mr. Chairman, Ranking Member Specter, and Members of the Committee, I am grateful for your invitation to testify today on the role that bankruptcy laws should play in the current housing crisis.

I am a partner in the Washington, DC, office of Orrick, Herrington & Sutcliffe LLP, and a significant part of my practice is devoted to advising participants in the capital markets on the application of bankruptcy and other insolvency laws. I appreciate the opportunity to share with you this morning some observations from that perspective and to assist the Committee in understanding the impact that proposed legislation might have on the mortgage-finance market. I am speaking only for myself today and not on behalf of my law firm or my clients.

At the outset, I want to express my gratitude to the Members of this Committee and to the other officials at federal, State, and local levels who have worked so tirelessly to address the economic challenges facing our nation. Speaking just as a citizen, I am heartened by the leadership that has been exhibited and am confident that, when honest policy debates are coupled with a collaborative spirit, constructive solutions can emerge.

In the last seven months, however, a dizzying array of legislative and regulatory initiatives has been adopted that represents a staggering level of federal intervention in our economy and a dramatic shift in many longstanding government policies. From my perspective as a lawyer advising market participants, I can say that much in these programs is still being digested and, in some cases, deciphered. Yet, what has become clear is that each one is rippling through the financial markets and the broader economy and is influencing the behavior of both businesses and consumers in ways that no doubt were intended and in other ways that may have been unforeseen. This butterfly effect, in my view, should not be overlooked or underestimated as changes in the bankruptcy laws are considered and, in the current environment, counsels in favor of especially careful deliberation.

Among the most pressing issues that I continue to perceive in the capital markets is uncertainty in pricing risk. Before the present credit and liquidity crises, this process was facilitated by credit rating agencies independently assessing the probability of default on a security and assigning a corresponding rating. In the last year, however, questions have been raised about the degree of comfort that can be taken from such a rating, and the resulting uncertainty has sparked a flight of capital especially among investors who relied heavily on credit ratings to make judgments on pricing. This has resulted in liquidity becoming increasingly scarce and market volatility skyrocketing, which in turn have fueled a vicious cycle in which the overall tolerance for uncertainty has declined sharply.

From the standpoint of the capital markets, therefore, the time would seem ripe for policies that are designed to provide greater clarity and stability on issues that factor into investment decisions and associated risk assessments. A prominent example is the impact of bankruptcy and other insolvency laws on the rights of creditors. An inordinate degree of uncertainty attends the application of these laws generally, not only because they have a more debtor-friendly orientation than their counterparts in other countries but also because they are administered by courts that continue to claim broad powers in equity. This lack of predictability can generate material risk premiums for liquidity from the capital markets, which ultimately must be passed through to borrowers in the form of higher interest rates or other charges if credit can be extended at all.

In the same vein, this would seem an inopportune time to propose initiatives that could increase uncertainty among investors in pricing the risks associated with capital-markets transactions. This includes, I fear, any legislation authorizing bankruptcy courts to "strip down" or otherwise modify the principal and interest that are due on a loan secured by a debtor's principal residence. The prohibition against such forced modifications in bankruptcy is three decades old and, contrary to arguments that have been advanced by some scholars, has little to do with the kinds of mortgage-loan products that were offered when the Bankruptcy Code of 1978 was originally enacted. Rather, its purpose has always been to foster a liquid and efficient mortgage-finance market, which is needed now more than ever.

I wholeheartedly agree that the rising tide of foreclosures must be stemmed in order to stabilize the housing market and, even more, to alleviate the increasingly unsustainable burdens on families across the country. But I am equally convinced that a change to the bankruptcy laws is not the answer. Instead - with Fannie Mae and Freddie Mac in conservatorship and with promising financial products like covered bonds on the horizon - I respectfully recommend that the Congress consider a more holistic approach to reinvigorating our system of mortgage finance and that, as part of this framework, a comprehensive protocol for voluntary loan modifications be established that includes meaningful incentives to participate.

I would be pleased to answer any questions that Members of the Committee may have.