The Heritage Foundation

February 26, 2011

Dear Senator Leahy,

It was my pleasure to testify before your Committee at its February 1, 2011, hearing on "foreclosure mediation programs" in bankruptcy courts. These programs raise important questions with respect to the vitality and recovery of the housing market and with respect to the proper enforcement of property rights and the rule of law. The Committee deserves credit for inviting witnesses to present a balanced view of these programs, their promises, and their pitfalls.

My primary purpose in writing today, however, is to respond to the thoughtful written questions submitted by Senators Sessions and Grassley which you sent to me by letter dated February 9, 2011. I will present each question, in italics, as it was provided to me. My responses are in roman text.

<u>QUESTIONS FOR THE RECORD FROM SENATOR JEFF SESSIONS</u>

1. At the hearing, you testified:

> *It's troubling in this context that several bankruptcy courts have candidly discussed their loss mitigation programs in the context of the absence of their authority to order changes to the terms of loan agreements securing debtors' primary residences. The implication is that, although bankruptcy judges are without power to cram down a mortgage securing a debtor's principal residence, they may, through requiring direct participation of high-ranking officials, heavy-handedly enforcing the good faith requirements in placing the burden on servicers and lenders to show cause why a modification cannot be reached, effectively achieve the same results. In this way, loss mitigation programs can coerce creditors who are repeat players and recognize the necessity of remaining on good terms with bankruptcy courts to make concession that compromise their rights.*

Later in the hearing, Senator Whitehouse asked Judge Drain "is cram down a part of your program?" In response to Senator Whitehouse's question, Judge Drain testified "absolutely not."

If I understand your testimony, you were not arguing that this proposal gives judges the legal authority to order cram downs of home mortgages. Rather, you *were testifying merely that these programs could give courts the authority to pressure creditors to submit to cram downs. Is that correct?*

Yes, it is clear that the effect of bankruptcy court "loss mitigation programs" ("LMPs") will be, in many cases, to pressure creditors to write off some portion of their legal claim on the estate, whether by reducing the principal amount of the loan or waiving certain fees, penalties, or other charges to which they have a legal right.

Judge Drain's response that his court's LMP does not involve "cram down" was correct but incomplete. "Cram down" is a term of art in bankruptcy practice that refers to splitting a secured claim into secured and unsecured portions based on the value of the security; typically, the unsecured portion of the claim is discharged. The effect is to reduce the principal amount of the loan to the value of the underlying asset, thereby reducing indebtedness and loan payments. This occurs at the immediate expense of the lender,[1] who is forced to write-down the value of the loan notwithstanding his contract and property rights under law. Long-term, cram downs are at the expense of borrowers, who face reduced access to credit, higher required down payments, higher interest rates, and other changed terms that increase the cost and difficulty of borrowing. It is for these reasons principally that Congress has barred bankruptcy courts from cramming down mortgages secured by debtors' primary residences.

Yet all of the same negative consequences may result from legal actions that are similar to, but fall short of, cram down, and that is one of the risks presented by mandatory LMPs. Without ordering a cram down or ordering a lender to reduce the principal value of a loan, a bankruptcy court may still, under the guise of mediation, coerce principal reductions and other loan modifications that compromise lenders' lawful rights. This pressure may be overt, such as suggesting a specific modification—for example, one in line with the modifications completed under the HAMP program. It may also be subtle or procedural in nature, such as the judge hinting that the court would look favorably upon a modification, questioning the lender's "good faith" when it declines to propose a modification, or requiring the lender to incur legal expenses and delay during the mediation process. Lenders are repeat players in bankruptcy courts and place great value in remaining in the good graces of those courts and their judges. For that reason, even subtle cues by the court may suffice to coerce a lender to abandon, in part, its substantive rights. The result is to reduce the anticipated value of mortgage loans, increase the risk of loss on such loans, and increase the transactional expenses associated with mortgage lending. In a dynamic market, such as that for mortgage lending, loan criteria will tighten, borrowing costs will increase, and overall lending will fall. So while the cause of these things is not, strictly speaking, "cram down," both the general mechanism (coercing creditors to abandon some portion of their legal rights) and the results are identical.

2. *At the hearing, Judge Drain testified that, in the Bankruptcy Courts for the Southern District of New York, "this entire program is voluntary." As I read the orders establishing the New York program, a judge has the authority to order a debtor or creditor to attend mediation prior to allowing foreclosure on the*

[1] For brevity's sake, I use "lender" to refer to mortgage lenders, mortgage investors, and mortgage servicers.

mortgage. A judge may even order a debtor or creditor to attend such mediation after an objection to the request for mediation has been filed, if the court overrules that objection. Indeed, Judge Drain testified that there were 15 cases in which a party had been ordered into mediation over his objection.

a. Is an order of a Bankruptcy Court requiring a party to a mortgage agreement to attend mediation enforceable through contempt proceedings?

b. If an action is taken in compliance with a court order, would you characterize that action as "voluntary?"

Judge Drain was incorrect to state that his court's "entire program is voluntary," because the program is, by its own terms, mandatory. The Loss Mitigation Program Procedures adopted by the United States Bankruptcy Court for the Southern District of New York on December 29, 2010, provide that, while a lender may object to the court's entry of a loss mitigation order, the court may nonetheless enter its order over that objection. *See* § V. The entry of this order alters the lender's right to lift the automatic stay and foreclose on the property, *see* § VI.C.2, and requires that the lender "shall negotiate in good faith," § VII.A. Not only is this burden stated in mandatory terms, but the LMP Procedures also expressly state, "A party that fails to participate in loss mitigation in good faith may be subject to sanctions." *Id*. Even absent sanctions and the possibility of contempt proceedings, it would be incorrect to deem LMP participation "voluntary" because the LMP Procedures speak in expressly mandatory terms.

A party which fails to comply with an LMP order may also be subject to civil or possibly criminal contempt. A bankruptcy court has the power to hold parties in contempt of court for failure to follow its directives. *See* Fed. R. Bankr. P. 9020; *Brown v. Ramsay* (*In re Ragar)*, 3 F.3d 1174 (8th Cir. 1993) (criminal contempt); Clifford J. White III, Civil and Criminal Contempt in Bankruptcy Court, *USA Bulletin*, Vol. 47, No. 4 (August 1999), *available at* http://www.justice.gov/ust/eo/public_affairs/articles/docs/contempt.htm. Participation is therefore by no means "voluntary."

3. One of the reasons Judge Drain characterized his program as non-coercive was that creditors have the ability to object to a request for mandatory mediation. You expressed some doubts about whether the ability to object to mediation was a meaningful safeguard, testifying that the programs could place the burden on the lender to show that a successful settlement cannot be reached.

a. Between the debtor and the creditor, who, in your opinion, has the most accurate and complete information concerning the debtor's financial condition?

Especially in the current market, the ability to achieve a successful loan modification depends almost entirely on the debtor's willingness and ability to pay. For that reason, an accurate statement of the debtor's finances is essential. Forming a complete picture of a debtor's finances can require extensive documentation, involving all of the debtor's sources of income, assets, liabilities, and cost of living expenses. A lender, in general, will have no more than a piece or two of this puzzle—for example, details on loans that may be in its own portfolio. The borrower, however, has the whole puzzle, or at least the ability to assemble it. For that reason—and in addition to the damage it does to their legal rights—lenders are poorly positioned to bear the burden of demonstrating that successful modification is impossible or even unlikely.

> *b.* *Most debtors file bankruptcy only once in their life, whereas most servicers manage many mortgages within a bankruptcy court's jurisdiction. Do you think that fact may have some effect on the willingness of servicers to object to debtors' requests for referral to mediation? Please explain your answer.*

As described above, mortgage lenders are "repeat players" in the bankruptcy process. While an individual may file for bankruptcy only once or several times in his or her life—and indeed, the law contains provisions to discourage or bar repeat filings—a mortgage lender with a portfolio of home loans may reasonably expect to come to bankruptcy court as a creditor with some frequency, especially at a time when the economy remains weak and unemployment high. Accordingly, mortgage lenders, like all repeat players to litigation, recognize the value of remaining in judges' good graces. This may manifest itself in any number of ways, from going along with mediation orders even when they are unlikely to result in a successful modification to proposing modifications that compromise their rights and to which they would not otherwise voluntarily accede. In such a situation, coercion may be subtle, but from the point of view of the lender, still quite tangible.

> *c.* *Judge Drain responded to your concern by pointing out that motions to lift the stay are not automatically granted. Would it be fair to say that, in consumer cases, the stay is usually lifted if the amount owed on the mortgage exceeds the fair market value of the home?*

While a bankruptcy court has a duty to consider all motions and responses in opposition fairly against the requirements of the law—with the result that few motions are "automatically" granted—in many circumstances the automatic stay is lifted in response to requests by mortgage lenders in bankruptcy, especially where the debtor has little or no equity in the home. At the very least, LSMs greatly increase the burden on the lender to lift the automatic stay and may categorically bar such relief for an arbitrary period of time, thereby compromising the lender's rights under law.

4. *At the hearing, you also expressed the concern that mandatory mediation programs might give bankruptcy judges the de facto ability to modify mortgages on primary residences. Judge Drain testified at the hearing that, under mandatory mediation programs, judges "may not impose an outcome on the parties, either directly or by, for example, refusing to relieve them of the loss mitigation procedures until they reach an agreement. We are there to enforce the deadlines imposed by the order and to resolve complaints that a party is acting arbitrarily, capriciously or otherwise to the detriment of good faith negotiation."*

a. *Under Senator Whitehouse's bill, S. 222, is there any specific provision that would limit the bankruptcy judge to the role Judge Drain describes?*

No, S. 222, by giving bankruptcy courts carte blanche to enact LMPs, does not limit in any way their discretion or prevent them from using such programs to coerce modifications that the parties would not, on a purely voluntary basis, enter into.

b. *Mr. Rao testified that "under the Rhode Island and New York loss mitigation programs, the servicer who wishes to terminate the program must state those reasons clearly in a request to the court." Based on your experience as a litigator, do you think it is likely that servicers will not wish to make such an explanation in open court or in publicly-available court filings?*

Lenders may find such filings to be problematic for several reasons. First and foremost, under the loan agreement and generally applicable law, the lender has no legal obligation to make such a showing to achieve relief from the bankruptcy court. In this way, LMPs effectively alter the terms of the loan agreement, placing a burden on the lender that was not part of the bargain thatit struck with the debtor. Understandably, lenders would not wish to shoulder this expense. Second, in some instances, the showing described by Mr. Rao may require lenders to divulge proprietary materials—for example, the precise manner in which they evaluate loans for modification. This would become, in general, part of the public record, and thereby available to competitors. This information would also be available to attorneys who might solicit other homeowners in the area whose homes are subject to mortgages held by the lender. In this way, homeowners could abuse the bankruptcy process to achieve mortgage modifications that are unnecessary, such as write-offs of loan principal where the homeowner is able to make the current mortgage payments. Lenders who balk at making such modifications may be subject to sanctions for "bad faith"—after all, their internal modification procedures would be a matter of public record. The result would be "modification mills," widespread write-downs on loans, further contraction in mortgage lending, and further harm to the housing market.

c. *Is there a defined, universally accepted legal standard by which bankruptcy judges will evaluate servicer behavior to determine if the servicer is "acting arbitrarily, capriciously or otherwise to the detriment of good faith negotiation?" If not, would you characterize that determination as being a discretionary one with the court?*

With respect to negotiations over mortgage modifications, there is no single, clear standard for "good faith" participation. For that reason, such a determination is largely at the discretion of the bankruptcy court and would be difficult or impossible to overturn on appeal—keeping in mind that such determinations are extremely unlikely to be appealed.

5. *Senator Whitehouse commented at the hearing that mandatory mediation programs "have important benefits even for servicers. Bankruptcy courts have the power to clear title questions that have been raised by faulty paperwork with respect to mortgages." Do bankruptcy courts obtain that power through the*

establishment of mediation programs, or is that a power that bankruptcy courts have irrespective of such programs?

Loss Mitigation Programs, as they have been implemented to date, provide bankruptcy courts with no additional legal authority to resolve title defects. Indeed, such programs, implemented through standing orders, could not confer on the court any additional authority. Nor would S. 222, as introduced, provide any such additional authority. If LMPs have benefits to lenders—which is a doubtful proposition—resolving title defects is certainty not among them.

QUESTIONS FOR THE RECORD FROM SENATOR CHARLES GRASSLEY

1. *One of the concerns with the loss modification programs ("LMPs") being run by bankruptcy courts is that they could potentially produce a de facto moratorium on foreclosures, which could have an adverse impact on our already suffering economy and housing market.*

   Please elaborate on the potential damage to the housing market and credit systems if LMPs produced a de facto moratorium on foreclosures? More specifically, what is the potential damage to the housing market and credits systems if the average time for all foreclosures is increased by any significant amount of time, for example, six months to one year?

While it is unlikely that LMPs would produce a moratorium, they do inevitably delay the foreclosure process, which has many of the same effects as a moratorium. However, passage of S. 222 could, in fact, result in temporary regional moratoriums due to the uncertainty that it would inject into the foreclosure process, especially as bankruptcy courts move to adopt and revise LMPs.

Even temporary foreclosure moratoriums of this sort would be enormously damaging to the housing market and mortgage lending. First, a moratorium would delay the bottoming out of the housing market by keeping a large inventory of homes of the market for the duration of the moratorium, with the expectation that these homes would be put on the market later. Second, a moratorium would directly impose large costs on mortgage lenders, who would be unable to enforce their legal rights for the duration of the moratorium. Third, a moratorium could increase mortgage defaults by driving the prices of many homes further underwater and by reducing the disincentive to default—the threat of imminent foreclosure. Fourth, depending on its duration, a moratorium could harm or even cause the failure of many community banks and credit unions that have significant mortgage holdings in their communities. Fifth, a moratorium would impose costs on taxpayers through Fannie Mae and Freddie Mac. Sixth and finally is the potentially permanent damage that would be done to credit markets by demonstrating to lenders that the federal government is willing to upset settled contractual rights for short-term political gain. If investor confidence were damaged in this way, the cost of borrowing could rise across the economy, and particularly for mortgage loans. This would, in the end, injure all Americans who depend on credit. For these reasons, even a temporary foreclosure moratorium caused by widespread adoption of LMPs would have extremely negative consequences for the U.S. economy.

2. *According to some supporters of the bankruptcy court loss modification programs, one of the purported benefits of the programs is that they allow the servicers of mortgages to enter into modifications below the guidelines established by the ultimate holders of the mortgages. In other words, a greater amount of the debt will be written off or deferred than would otherwise be possible under the programs run by the federal government or private institutions. There is a perception that the entry of a court order requiring mandatory mediation and an order approving a settlement that results from the mediation, gives servicers some immunity or "cover" to violate contractual and fiduciary obligations. However, the ultimate holder of the overwhelming number of mortgages, one way or another, is the federal government via Freddie Mac and Fannie Mae. So really the ultimate holders of these mortgages are American taxpayers.*

    (a) *Should courts be helping mortgage servicers violate their contractual and fiduciary obligations to taxpayers or any other third parties?*

The rule of law includes the enforcement of lawful contractual rights and obligations. When courts arbitrarily modify contractual rights—or, equivalently, decline to enforce lawful contractual rights—to the benefit of one party and detriment of another, the rule of law is undermined. This is inconsistent with the generally accepted role of the courts, which is to uphold and faithfully apply the law.

    (b) *If not, what are the economic and policy ramifications?*

The consequences are those I identified above in response to Senator Sessions's first question. Particularly serious would be the blow to investor confidence, which could effect lending throughout the economy.

    (c) *Under the Bankruptcy Code, when a principal residence is involved, is it the proper function of a bankruptcy judge to "re-write" the mortgage and/or the contract between the servicer and the ultimate holder of the mortgage, as is suggested by supporters of the loss mitigation programs?*

No. As discussed above, Congress has, for good reasons, declined to give bankruptcy courts the authority to alter the terms of mortgages securing debtors' principal residences. When a bankruptcy court attempts to achieve such a result in an indirect manner, such as through a LMP, it risks the negative consequences that Congress sought to avoid in denying courts that power.

3. *At the conclusion of its January 28, 2011 decision overruling the challenge to its loss mitigation program, the Rhode Island Bankruptcy Court stated that the program "was conceived as a case management tool designed to encourage the resolution of differences between residential mortgage lenders and their borrowers, and to provide a way for them to access the various federal housing programs available outside of*

bankruptcy, such as the Home Affordable Modification Program (HAMP)." The decision further maintains that "[t]he Loss Mitigation Program is intended to start a dialogue, giving the parties nothing more than the opportunity to discuss their respective positions."

Similarly, during the hearing before the Committee, multiple supporters of the programs repeatedly indicated that the most beneficial aspect of the programs was that they provided borrowers the first chance to communicate with a fully authorized representative of the lender.

However, given the extremely negative credit implications that flow from filing for bankruptcy, it would appear to be a very high price to pay to receive the most beneficial aspect of the loss mitigation programs.

Generally, what are the negative ramifications of a homeowner's filing bankruptcy and how do you evaluate the claim that these programs should be expanded in order to provide homeowners with the programs' most beneficial aspect? In other words, do the negative consequences of filing bankruptcy outweigh what is described as the biggest benefit of participating in a loss mitigation program run by a bankruptcy court?

As to whether the negative ramifications of filing for bankruptcy outweigh the potential benefits of LMP participation for an individual that would otherwise not file for bankruptcy, the answer is almost certainly yes.

Filing for Chapter 13 bankruptcy is an expensive and disruptive process. While the total fees for filing are only about $300, guideline attorney's fees range from about $2,500 to $5,000 in simple cases, depending on the district; in complex cases, the fee can be much higher.

In addition, filings are included on credit reports immediately upon filing and remain there for seven years. Thus, Chapter 13 bankruptcy damages credit scores and impairs access to credit for a significant period of time.

Many Chapter 13 bankruptcies fail; that is, the filer never obtains a discharge of his debts. Nearly 20 percent of Chapter 13 cases fail before the court has confirmed the filer's plan. Another 55 percent fail between confirmation and discharge because the filer has been unable to carry out his plan. This means that only one-third of all Chapter 13 filers complete the process successfully and get the fresh start that bankruptcy promises. The rest—two-thirds of all filers—pay court fees, pay attorney's fees, pay fees to the bankruptcy trustee, invest time and money to restructure their financial affairs, and then wind up with nothing more than temporary relief. It is therefore not surprising that a substantial number of Chapter 13 filers—nearly one-third—go on to file for bankruptcy again.

These statistics suggest that holding out the promise of significant relief from mortgage debt to encourage more individuals to file for Chapter 13 bankruptcy is bad policy. At best, Chapter 13 would serve only to delay foreclosures in most case where the home is at risk while imposing enormous costs on those who are already financially vulnerable and losing their access to credit.

Moreover, LMPs may undermine more promising approaches to preventing foreclosures. The bulk of outstanding mortgages are controlled or owned by Fannie Mae and Freddie Mac, private banks, and portfolio lenders, all of which have the power to renegotiate mortgages and face strong incentives to do so to preserve the value of homes. By holding out a false hope of major modifications, LMPs may undermine their efforts by eliminating homeowners' incentives to accept modification offers, even ones that are targeted to their situation and less disruptive than bankruptcy is likely to be. In this way, LMPs may only delay foreclosures while blocking more promising alternatives that better protect consumers' financial security.

4. *Some supporters of the loss mitigation programs maintain that the programs can produce better modifications than those under HAMP or private/proprietary programs. How is that possible? What direct or indirect forces or factors would produce a better modifications resulting from the bankruptcy court programs?*

HAMP, of course, relies on government subsidies to encourage lenders to alter mortgages to reduce monthly payments. This allows the parties to complete modifications that fall slightly outside the band of mutual benefit, due to the borrower's inability to make payments that would provide the lender a reasonable stream of payments. Modifications that fall farther outside of that band—that is, where even HAMP subsidies are insufficient to enable the parties to make a deal—are likely to be unworkable; a fair payment to the lender is likely to be more than the borrower can afford to pay.

Therefore, the contention that LMPs could result in more aggressive modifications than under HAMP implies that the bankruptcy court overseeing the LMP is able to wield some additional tool or power that is unavailable in HAMP. One such tool that could be used to further reduce monthly payments is money—simply provide more subsidies. But LMPs do not provide additional money. The only other possible tool is coercion—that is, pushing lenders to accept deals that they would, in a purely voluntary circumstance, reject as disadvantageous. To believe that LMPs do not rely on coercion to achieve such results would be to expect a free lunch: without putting any additional money on the table, bankruptcy courts can somehow bridge the gap between a borrower's ability to pay and what the lender is willing to accept.

5. *No law prevents lenders and borrowers from negotiating to modify a mortgage, before or after a borrower files bankruptcy. Under the Bankruptcy Code, the deadlines governing the adjudication of a motion for relief from the automatic stay can be extended by the mutual agreement of the parties. Moreover, during the hearing, there was testimony that there have been only a limited number of objections to cases being referred to the loss mitigation program in the Southern District of New York.*

So, what, if anything, does the "mandatory" nature of the loss modification programs run by bankruptcy courts really add? Based on the statements made at the hearing by supporters of the programs, shouldn't a voluntary program produce the same results? And if so, why is any legislation needed?

What the mandatory nature of LMPs adds to the programs is subtle coercion, as described above. This, supporters seem to believe, will be enough to result in modifications that would otherwise be unachievable. To the extent that those who support LMPs dispute this point, they necessarily accept that a voluntary mediation program would achieve the same results as a mandatory LMP. And, to be sure, voluntary mediation is a valuable service that reduces litigation expenses and helps resolve disputes in an expedient and often amiable manner. No additional legislation is needed for parties to a bankruptcy proceeding to participate in voluntary mediation.

6. *A few days prior to the hearing, a bill, S.222, the "Limiting Investor and Homeowner Loss in Foreclosure Act of 2010," was introduced. Do you believe that the proposed legislation should be enacted? Why or why not?*

Though I take no position on S. 222, the policies underlying it are troubling and should give any Member of Congress pause. As described in my written testimony, the bill appears designed to authorize and encourage bankruptcy courts to adopt mandatory LMPs that serve to coerce lenders to agree to loan modifications that they would not accept voluntarily. Further, these programs, even when they do not result in such modifications, burden the exercise of lenders' lawful contractual rights. These programs threaten many severe and negative consequences, which I describe in my written testimony and elsewhere in these answers. S. 222 is a bill that would slow recovery of the housing market and housing prices, while making it more difficult for responsible families to obtain mortgage loans in the future. A Congress that does not share those goals and that seeks to speed recovery and expand homeownership would not enact S. 222.

7. *The loss mitigation programs run by bankruptcy courts and HAMP are inextricably intertwined. The failures of HAMP are well documented. According to a March 2010 report prepared by the Office of the Special Inspector General for the Troubled Asset Relief Program, the failures of HAMP are likely because:*

   (1) the Treasury Department has revised the program regulations and guidelines repeatedly since its creation, causing confusion and delay;

   (2) the Treasury Department approved and encouraged the grant of trial modifications without proper documentation of the homeowner's eligibility, resulting in a large number of trial modifications being granted where the homeowner had no hope of saving the mortgage through modification; and

   (3) the Treasury Department has failed to properly advertize and market the program to homeowners.

The Special Inspector General also concluded that a number of design elements of the Home Affordable Modification Program make it unlikely to result in permanent foreclosure avoidance.

Do you agree with the conclusions reached by the Special Inspector General in his March 2010 report?

I do agree with the conclusions reached by the Special Inspector General. HAMP, though well-intentioned, has been a failure and has actually harmed many of the families it was intended to help. At this date, it is extremely unlikely that the program will achieve anything near its goal of three to four million permanent mortgage modifications.

8. *During the hearing, John Rao testified that:*

> *"… -- there are obviously concerns about the lack of transparency with HAMP. But one thing we do know and we have seen from the reports that have been coming out of Treasury is that it proves the point that if you do actually modify the mortgage and give the homeowner an affordable payment, they will pay.* ***The statistics are showing that one year after the program with homeowners who have been on permanent modifications 85 percent of those homeowners are staying on the program****."*
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> *"****The redefault rates on HAMP modifications are considerably lower than any other modifications that have been attempted. And I specifically refer to the proprietary mortgages that services are doing outside of the HAMP program which have redefault rates which are twice as high as HAMP modifications****. And the other final point is even within that category of the -- of homeowners in the -- who are staying on the program the redefault rate when you lower their monthly payment more and often more by -- than 30 percent the redefault rates are even lower. So the lower the monthly -- the more you reduce the monthly payment the more the homeowner will continue to make ongoing payments, which will contribute to investor gains."*

(Emphasis added).

Do you agree with Mr. Rao's testimony? Why or why not?

Mr. Rao's testimony is, at best, highly misleading, but it is also revealing. It is misleading because, in fact, a huge number of HAMP modifications fail. Since its inception, HAMP has facilitated about 1.5 million trial modifications, about half of which have been canceled due to the inability of borrowers to make modified payments or for other reasons. Mr. Rao implies that this is not the case by referring only to the universe of permanent modifications. But the program has been unsuccessful in achieving significant numbers of permanent modifications. Examined as a whole, rather than cherrypicking narrow portions of its work, HAMP is a failure.

But Mr. Rao's testimony serves the useful purpose of revealing his hope for LMPs that they will result in mortgage modifications that achieve reductions even greater than those made under HAMP alone. As described above, such modifications could only be achieved through the application of coercion on lenders. Mr. Rao's testimony very nearly concedes this point.

9. *On January 25, 2011, legislation was introduced in the House of Representatives to terminate HAMP. Do you believe that HAMP should be ended? If so, why? If not, what has to be done to get HAMP to work? And what is the timeframe within which those changes have to be implemented?*

HAMP is a failure and should be ended. I direct the Committee to the comments of my Heritage Foundation colleagues Ronald Utt and David John, whose criticisms of HAMP at the time it was introduced proved unfortunately and eerily prescient. They predicted at the time that most modifications made under HAMP would fail. As they explained, in a weak economy and weak housing market, even significant government interventions and subsidies would not "save" many homeowners. They were right. *See* Ronald Utt, Ph.D. and David John, 12 Problems with the Obama Mortgage Stability Initiative Plan, Heritage Foundation Webmemo No. 2311, February 25, 2009, available at http://www.heritage.org/Research/Reports/2009/02/12-Problems-with-the-Obama-Mortgage-Stability-Initiative-Plan.

Worse than HAMP's ineffectiveness is the harm that it has caused many families. An unsuccessful modification under HAMP can have devastating consequences and actually accelerate home loss. It can also increase indebtedness and lead the way to bankruptcy. In HAMP, the Obama Administration has ignored the admonition *primum non nocereto*: "First, do no harm."

Accordingly, Congress could actually help homeowners by requiring the winding down of the HAMP initiative in a way that does not penalize those who are currently undergoing trial modifications but sets a firm end-date for the program.

10. *In March of last year, Mark Calabria, the Director of Financial Regulation Studies of the CATO Institute, testified before the House Committee on Oversight and Government Reform about why government efforts have not stemmed the foreclosure tide. The CATO Institute is a nonprofit, non-partisan public policy research institute. In his testimony, Mr. Calabria explained that:*

> *"The short answer to why previous federal efforts to stem the current tide of foreclosures have largely failed is that such efforts have grossly misdiagnosed the causes of mortgage defaults. An implicit assumption behind former Treasury Secretary Paulson's HOPE NOW, FDIC Chair Sheila Bair's IndyMac model, and the Obama Administration's current foreclosure efforts is that the current wave of foreclosures is almost exclusively the result of predatory lending practices and 'exploding'*

adjustable rate mortgages, where large payment shocks upon the rate re-set cause mortgage payment to become 'unaffordable.'"

"The simple truth is that the vast majority of mortgage defaults are being driven by the same factors that have always driven mortgage defaults: generally a negative equity position on the part of the homeowner coupled with a life event that results in a substantial shock to their income, most often a job loss or reduction in earnings. Until both *of these components, negative equity and a negative income shock are addressed, foreclosures will remain at highly elevated levels. …"*

"Before discussing specific policy proposals, Congress should bear in mind that as approximately 50 percent of foreclosures are currently driven by job loss, the most significant way to reduce foreclosures is to foster an environment that is conducive to private sector job creation. Accordingly, the worst thing Congress can do is to insert uncertainty into the job market, pushing employers to the sides-lines."

Do you agree with Mr. Calabria's testimony? Why or why not?

I do agree with Mr. Calabria's testimony because he accurately diagnoses a primary cause of the foreclosure crisis. The fundamental problem driving high foreclosure rates is unaffordability, and unaffordability is often caused by job loss and unemployment. In that circumstance, unless the federal government is willing to provide enormous subsidies to homeowners who cannot afford their mortgage payments or whose homes are underwater—subsidies far larger than those available under HAMP—tinkering with existing mortgages will not provide significant benefit.

I also agree with Mr. Calabria's prescription that, to reduce foreclosures, Congress should focus on pro-growth policies and avoid enacting barriers to job creation. Unfortunately, the previous Congress chose the opposite approach, enacting bills such as the misnamed Patient Protection and Affordable Care Act that will raise the cost of hiring, impose financial burdens on businesses and individuals, and result in job loss. To help economic recovery, the Senate would do well to follow the lead of the House of Representatives in passing legislation to repeal the PPACA.

Along similar lines, my Heritage Foundation colleagues James Sherk , Karen Campbell, and John Ligo have identified a series of economic and regulatory reforms to "unleash entrepreneurs to create jobs." *See* James Sherk , Karen Campbell, Ph.D. and John Ligo, A Free Enterprise Prescription: Unleashing Entrepreneurs to Create Jobs, Heritage Foundation CDA Report No. 10-09, December 14, 2010, available at http://www.heritage.org/Research/Reports/2010/12/A-Free-Enterprise-Prescription-Unleashing-Entrepreneurs-to-Create-Jobs. The pro-growth policies that they identify would do far more to help American homeowners than all of the Obama Administration's housing-directed efforts taken together.

Sincerely,

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Visiting Legal Fellow
The Heritage Foundation