Congressional Testimony

Coercing Mortgage Modifications in Bankruptcy Courts: Unlikely Benefits, Certain Risks

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My name is Andrew Grossman. I am a Visiting Legal Fellow in the Center for Legal and Judicial Studies at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

The Committee is to be commended for holding this hearing today to consider the promises and pitfalls of approving bankruptcy courts' loss mitigation programs. These programs are a recent innovation, and while there is some anecdotal evidence on their operations, there has yet to be the kind of formal study or statistical evidence that could drive sound policymaking with respect to them. This hearing, then, is a step in the direction of marshaling evidence, raising awareness, and gaining a better understanding of what these programs are, how they work in practice, and whether they achieve their goals in a way that furthers the greater common good.

As to that question, whether loss mitigation programs are, in the broadest possible sense, successful, I offer no firm opinion today because I do not believe that anyone, at this time, could say with any degree of certainty that these programs are or are not having a positive impact on our housing market, on homeowners in distress, or on the bankruptcy process in those districts that have such programs in place.

There are, however, good reasons to doubt that loss mitigation programs are making a positive contribution. First, it is difficult to pinpoint what additional benefit these programs provide over the myriad of programs that already exist to aid responsible homeowners who find themselves in financial distress. Second, it seems unlikely that these programs, which offer no additional financial incentives to mortgage lenders or servicers, would succeed where programs that offer generous incentives to make reasonable modifications, as well as subsidies to compensate lenders for reducing monthly mortgage payments, have failed. Third, there is a real cost to any interventions that delay ultimate resolution of a mortgage claim or increase legal uncertainty, as an open-ended mandate to negotiate in "good faith" necessarily does. Fourth, there is a question of rights and fundamental fairness when a creditor is forced to "show cause" as to why it has been unable to reach an agreement to reduce the value of its claim or otherwise cede its legal rights. Fifth, there is the question of harm to the debtor, whose "fresh start" coming out of bankruptcy may be delayed or compromised. Indeed, some individuals may even file for bankruptcy, with all of the attendant injury to an individual's creditworthiness and reputation, in the false hope of getting a better deal than may realistically be possible. Sixth is the real risk that further hurdles to resolving defaulted mortgages will delay the bottoming out of the housing market, at great cost to the economy. Seventh and finally, like all policies that create hurdles to enforcing creditors' rights, loss mitigation programs may cause lenders to demand larger risk premiums, in the form of higher interest rates, or to undertake other risk minimization strategies, such as still-greater down payments, that will have the effect of restricting access to credit—an especially damaging result at a time when the market continues to flounder.

It is for very similar reasons that Congress rejected attempts to allow bankruptcy courts to "cramdown" mortgage holders' secured claims on debtors' principal residences. Loss mitigation programs, as they have been structured by several bankruptcy courts,

resemble nothing so much as "cramdown lite," in that the bankruptcy court may effectively coerce the mortgage holder to abandon a portion of its secured claim. This process is, without question, more gentle than the "cramdown" proposals that Congress considered and rejected, but the two policies, "cramdown" and "loss mitigation," are close cousins.

Accordingly, Congress should be wary of giving its blessing to a policy that bears so many risks and offers only ill-defined rewards, and it certainly should not do so at a time when there is no reliable evidence to guide its decision. Instead, Congress should focus on targeted policy interventions that address tangible problems and help to speed the recovery of the housing market, to the benefit of all Americans.

BACKGROUND

Four years after home prices first began to tumble, they have yet to recover, and the housing market remains weak. According to many experts, the primary cause of this persistent weakness is the inability of the market to reach equilibrium—that is, for home prices to bottom out. This problem is both economic and legal in its origins. The economic aspect is price stickiness, or the unwillingness of homeowners, mortgage lenders, and sellers to mark down properties to prevailing market values. Legal uncertainty also plays a large role. Delays in the foreclosure process, due to a variety of causes, have left many properties trapped in a legal limbo, in which their owners, who may be unable to afford mortgage payments, remain in their homes for months or years while mortgage-holders attempt to take possession of the homes and put them on the market. The result is a pent-up supply of temporarily unmarketable homes that depresses prices across the market, prolonging the housing crisis.

Before the market can recover, this backlog of homes in limbo will have to be addressed. Many are proceeding, albeit very slowly, through the foreclosure process, which in many jurisdictions now takes a year or more and imposes great transaction costs on all participants. Others are resolved through alternative legal arrangements, such as short sales and deed-in-lieu-of-foreclosure arrangements, which promise greater speed at far lesser expense.

Still others leave limbo by means of mortgage modifications, which often involve a reduction in mortgage principle, reduction in interest rate, and extension of the term of the mortgage. Taken together, these modifications can, in some instances, reduce monthly payments to a level that is affordable to the borrower, while reducing the mortgage lender's expected loss. In general, modification benefits both the lender and the borrower if it results in a payment stream with a risk-adjusted net present value that is greater than the proceeds the lender could expect were it to foreclose, net of the expenses of doing so and then marketing the home. Of course, modification is a possibility only where the borrower can afford to make those modified payments. In many cases, modification would be pointless, because the payments would still be unaffordable, and indeed, many modifications fail for that precise reason. But where the payments can be made, successful modifications are win-win: both the borrower and the lender achieve

benefits above and beyond those possible under the old, unaffordable mortgage. It is for this reason that, in the absence of significant transaction costs, modifications need not be coerced—since both stand to benefit, both should, theoretically, be willing to negotiate a deal.

Unfortunately, all of life is marked by transaction costs, and they have proven to be especially great and stubborn in the relationships between mortgage lenders, servicers, and borrowers, stymieing the possibility of achieving win-win modifications. The result is, in some instances, an impasse: though, based on the numbers, a modification is possible, the parties are unable to reach any agreement. Both sides lose out.

Fortunately, such impasses have become far rarer due to initiatives by mortgage lenders and servicers, as well as, to a much lesser extent, those by the federal government. These come in two varieties. The first are those that function by simply streamlining the negotiation and modification process. The second take an additional step of subsidizing beneficial modifications to overcome even significant transaction costs and to achieve modifications that, absent subsidies, would be one-sided in favor of the borrower.

The most prominent of the first type of program is HOPE NOW, a coalition effort by the nation's largest mortgage lenders and servicers and a variety of community organizations that provide counseling to distressed homeowners. HOPE NOW, which is in its fifth year of operation, provides a point of initial contact for borrowers facing the risk of default and foreclosure to participate in proprietary modification programs offered by their lender or servicer. From January through November 2010, HOPE NOW participants completed approximately 1.65 million permanent mortgage modifications, against about one million foreclosures over the same period. On both a numerical and proportional basis, this represents an enormous increase in modification activity over even 2009, which also saw substantial growth in modifications. The vast majority of these modifications occur outside of the federal government's Home Affordable Modification Program (HAMP), which is described further below. An additional 1.5 million or more borrowers in 2010 received other relief through HOPE NOW to avoid foreclosure, such as temporary forbearance and negotiated short sales.

Given the subject of today's hearing, it is worth describing HOPE NOW's outreach efforts. The coalition holds dozen of outreach events in distressed housing markets each year, at which counselors, servicer representatives, and information are available. Each month, its members send a quarter-million notices describing the program to delinquent borrowers. It operates a free hotline which borrowers can use to reach counselors 24 hours a day, seven days a week. That hotline receives, on average, more than 5,500 calls per day. It also operates a website that documents its various activities, provides tools for homeowners to evaluate different modification and other options, and provides contact information for all of its participants. A separate website allows borrowers to compile a modification application online, with assistance from counselors, and then submit the completed application directly to the mortgage servicer for expedited consideration.

The most prominent of the subsidy-providing programs is HAMP, which was launched in early 2009. HAMP provides "incentive payments" to mortgage servicers and

lenders to reduce monthly payments of borrowers who are in default or at risk of default. HAMP operates with respect to mortgage payments as a proportion of the borrower's monthly gross income. The lender is responsible for reducing payments to 38 percent of monthly income, as necessary, and then the lender and government split the expense of reducing payments to the program's target of 31 percent of monthly income. To achieve these reductions, the interest rate is reduced to as low as 2 percent; the term is extended up to 40 years from the modification date; and the lender may forbear some amount of principle until the property is sold or the payoff date of the loan. Lenders are not required to forgive principle to achieve the 31-percent target, though they may do so. The modified terms, with reduced payments, are imposed on a trial basis, during which the borrower must make at least three payments. After three payments, the modification may be made permanent. Failure to complete the trial payments, however, leaves the borrower liable for all payments due under the original mortgage.

HAMP offers a variety of subsidies to servicers and lenders to undertake the modification process and reduce monthly payments. As described above, the government will cover, in part, the cost of reducing payments, effectively increasing the borrower's ability to pay under the modified terms. In this way, HAMP facilitates modifications that would otherwise be impossible because they would require the lender to take a loss, relative to the foreclosure value of the property. The HAMP process is also replete with "incentives" for servicers and lenders: $1,000 for each permanent modification; an additional $500 where the borrower was current but at risk of defaulting at the time of the modification; an additional $1,500 where the borrower was current but at risk of defaulting at the time of the modification and the monthly payment was reduced by at least 6 percent; and "home price decline protection" payments for declines in the value of the home that secures the mortgage. Borrowers are also eligible for "pay for performance" subsidies of up to $5,000 total to reduce the principal balance. All of these payments are made out of a $23 billion allocation of TARP funds.

HAMP participation is mandatory for servicers of loans owned or guaranteed by Fannie Mae or Freddie Mac. Borrowers who submit complete applications for HAMP modifications must be evaluated for eligibility, and their servicers are obliged, in certain instances, to complete modifications pursuant to the program's terms.

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. Over 575,000 trial modifications have been converted into permanent modifications, and about one-tenth of those subsequently failed.

HAMP has failed to live up to expectations, particularly the Obama Administration's stated goal of achieving three to four million mortgage modifications under the program. Far fewer homeowners than forecast have proven eligible for the program; in many cases, even with hefty reductions in monthly payments, the home remains fundamentally unaffordable. Worse, many homeowners lured into the program have been thrown into foreclosure after they failed to make trial payments and then became liable for the total delinquency on their mortgage during the trial period. HAMP has shown that, even with major subsidies, there may not be a large pool of mortgages that can be reasonably modified so as to keep at-risk homeowners in their homes. It has

also demonstrated the sometimes severe consequences of holding out false hope to homeowners burdened by excessive mortgage debt.

HOPE NOW and HAMP are just two of the myriad programs that facilitate foreclosure alternatives. Other programs target second liens, mortgages insured or guaranteed by the Federal Housing Administration or other federal agencies, borrowers who are temporarily unemployed, and homeowners in the regions hardest hit by the housing crisis.

Nearly all of these efforts are of recent origin, and they represent a fundamental reworking of the mortgage modification landscape. Whereas previously, modification was a process that involved only two parties directly—the servicer and the borrower—and was often ad-hoc, arbitrarily offered, or even unavailable, now it is a permanent feature of the housing market, with regularized procedures.

It is in this context that several bankruptcy courts have created an additional avenue for mortgage modification that they call "loss mitigation." Under these programs, which are implemented through standing orders of the court, a mortgage lender must participate in a negotiation process with the debtor to settle the mortgage claim by means other than foreclosure. During this process, the automatic stay is extended (the creditor is also barred from seeking a lift of the stay), the debtor retains possession of the home, and the parties provide periodic updates to the court on the status of the settlement negotiations.

Though these programs differ in their terms, they share several features intended to push the parties toward settlement. First, a party objecting to the loss mitigation process, or seeking to terminate it, must provide the court with "specific reasons why loss mitigation would not be successful." *In re Sosa*, No. 10-11702 (Br. R.I. Jan. 28, 2011). Second, the creditor must be represented by an individual with full decision-making authority to enter into a loan modification or take other settlement action. Third, the parties must negotiate in "good faith" and are subject to sanction for failure to do so. Fourth, when the period allotted for loss mitigation negotiation has run its course without agreement, any party (though probably the debtor) may seek an extension to continue negotiations, and a party (probably the creditor) opposing the extension must, again, show cause as to why an extension would be inappropriate.

Taken together, these features effectively place the burden on the lender to demonstrate why the debtor is not eligible for relief from foreclosure in order to proceed with a properly proven secured claim. This represents a reversal of normal bankruptcy practices regarding secured debt, in which proof of claim alone suffices.

ANALYSIS: FAULTY PREMISES

As should be apparent, bankruptcy courts' loss mitigation programs do not exist in a vacuum, but enter a field crowded with modification programs. How loss mitigation interacts with those other programs, as well as the complicated features of the housing market, is unclear from the limited amount of experience with loss mitigation in the

bankruptcy courts. But there is good reason to believe that these programs are duplicative of preexisting alternatives, are unlikely to provide much or any relief to most debtors unless operated in a coercive manner, may injure some debtors, and may prolong the housing crisis.

As an initial matter, it is useful to identify the premise on which support of these programs rests: that, in a large number of cases, it is possible to reach a mutually beneficial negotiated settlement—especially a mortgage modification—if the debtor and lender are merely made to confer.

This is, however, a questionable premise. As experience with HAMP has shown, the low-hanging fruit is gone. Modifications that are obviously win-win have been done, through programs such as HOPE NOW, often well prior to any bankruptcy filing. They are off the table. 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, either have been evaluated for HAMP eligibility, or could be at any time, without any action by the bankruptcy court. And modifications that fall 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. So there is no good reason to believe that, absent coercion, loss mitigation during the bankruptcy process will cause deals to emerge that were previously unavailable. To believe otherwise 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.

There is also little reason to believe that loss mitigation is necessary to overcome informational barriers between borrowers and servicers. Through HOPE NOW and other efforts, at-risk homeowners have access to credible, useful information on seeking modifications, as well as tools that allow them to evaluate their eligibility for different modification programs and approaches. Mortgage servicers have ramped up their modification capabilities significantly over the past two years, as demonstrated by the unprecedented number of modifications being completed through proprietary programs. Most servicers have established modification hotlines for their existing mortgage customers, and some even allow borrowers to apply for modifications online. Not all homeowners may take advantage of these resources, but they do indicate that the time when information on modification was hard to come by, and modification decisions were made slowly through opaque processes, is long gone.

There is a real risk that loss mitigation programs, as they have been structured by the bankruptcy courts, will undercut these more comprehensive and efficient solutions. Both the mortgage industry and the political branches of the federal government have recognized the benefits of channeling at-risk homeowners into comprehensive evaluation and modification programs. Channeling modification requests into existing programs facilitates consistent procedure, expedient review, and consistent application of modification standards. It also serves to connect borrowers with other resources and programs that may prove useful in addressing their indebtedness. Loss mitigation, however, proceeds outside of these programs and does not enjoy these advantages. To

the contrary, it requires servicers and lenders to engage in an ad hoc, semi-adversarial negotiation process. This is expensive in terms of resources and fails to ensure consistent results. To the extent that some homeowners see court-supervised modification as a superior option to simply applying for relief from their servicers and forgo participation in programs such as HOPE NOW, this will prove expensive and broadly counterproductive to avoiding foreclosure for the greatest number of mortgages in the most successful manner possible. Other homeowners may use loss mitigation as an opportunity to "forum shop" for the best possible modification, with the same results.

Loss mitigation also threatens to delay resolution of at-risk mortgages, while imposing significant burdens on both the servicer or lender and borrower. Specifically, all of the loss mitigation programs created to date extend the automatic stay, allowing the homeowner to retain possession of the mortgage-encumbered home while the parties negotiate. It should be no surprise that evaluating ad hoc loan modifications can be a resource-intensive and time-consuming process, and, indeed, Bankruptcy Judge Cecelia Morris of the Southern District of New York has noted that "slowdown" is a common feature of loss mitigation. This delay, while obviously detrimental to lenders, also injures debtors by putting off the date of their "fresh start" following plan confirmation.

The burden on the lender or servicer in terms of personnel can also be considerable because these programs require the direct participation of an individual with full decision-making authority. This prevents the use of local counsel or clerical workers who, in other modification scenarios, would compile the application and perform many initial evaluative steps. On the one hand, this feature of the programs demands an unreasonable misallocation of resources; on the other, it is central to a negotiation process that depends for its success on exerting pressure on mortgage servicers and lenders.

That pressure—and many features of these programs, from the decision-maker requirement to the "good faith" requirement, do act to exert significant pressure on servicers and lenders—suggests that loss mitigation programs may threaten the rights of mortgage holders. This analysis assumes, in the main, that bankruptcy courts' loss mitigation programs will not be successful because they will be unable to achieve results any different from those possible in their absence. If that assumption is relaxed, however, there is the possibility that courts could use loss mitigation procedures to coerce lenders into accepting quite prejudicial modifications. Although bankruptcy judges are without power to "cramdown" a mortgage securing a debtor's principle residence, they may, through requiring the direct participation of high-ranking officials, heavy-handedly enforcing the "good faith" requirement, and placing the burden on servicers and lenders to show cause why a modification was not reached, achieve effectively the same result. In these ways, loss mitigation programs can coerce creditors—repeat players who recognize the necessity of remaining on good terms with bankruptcy courts—to make concessions that compromise their rights.

This would allow some debtors to retain their homes, but it should not be counted as a success. In effect, it would be no different from the "cramdown" proposals for debtors' principal residences that Congress has repeatedly rejected due to the likelihood that they would exacerbate tensions in the housing market.

There is also a real risk that modifications achieved through loss mitigation will ultimately harm the very homeowners they were intended to aid. As with HAMP, homeowners may enter into modifications that ultimately prove unworkable and result in additional financial distress without preserving their home. This is, if anything, a greater risk under loss mitigation programs because of their ad hoc approach to making modifications without any of the safeguards and strict eligibility criteria that are embedded into HAMP or the generous subsidies that serve to reduce payments. Unfortunately, the bankruptcy courts lack the facilities to undertake the kind of data collection that would be necessary to chart the subsequent performance of mortgages modified in loss mitigation proceedings. Not only do we not know whether these modifications are injuring a substantial proportion of those whom they are intended to benefit—which has been the case under HAMP—but we will have no way of knowing that even in the future.

The fact that loss mitigation may drive some homeowners to file for bankruptcy who would otherwise have not done so is also harmful. Bankruptcy is an expensive, disruptive, and potentially damaging process. Most would probably file under Chapter 13. 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, 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 bankruptcy is bad policy. At best, bankruptcy would serve only to delay foreclosures in most cases, while imposing enormous costs on those who are already financially vulnerable and limiting their access to credit.

Loss mitigation programs may also further slow recovery of the housing market by delaying resolution of the statuses of the millions of homes that are presently "underwater" or, for a variety of other reasons, unmarketable. If there is a flood of bankruptcy filings to take advantage of loss mitigation programs, the homes involved will be trapped in legal limbo for months as the bankruptcy cases and negotiations play out in slow motion. Where modifications do occur, they may ultimately fail over a period of months, effectively resetting the clock on foreclosure. In this way, loss mitigation would serve as yet another hurdle to completion of the foreclosure process. Depending on how

many borrowers attempt to take advantage of this alternative, the result could be to slow the inevitable bottoming out of housing prices and delay the market's recovery.

Finally, loss mitigation programs may have an ex ante effect on lending practices, especially within bankruptcy districts where they are employed in a coercive manner. It is unreasonable to expect that lenders would not adjust their up-front terms in response to changes in the law that weaken loan enforcement. Experience and research show that any proposal that has the effect of undermining the certainty of mortgage agreements or imposing losses on mortgage lenders will serve to reduce the availability and increase the cost of mortgage loans. Two responses could be expected. First, lenders would demand higher interest rates and fees as compensation for taking on the added risk of losing money due to the inability to foreclose on a secured interest, as well as the risk of hefty legal and administrative expenses. Second, to guard against coerced modifications that amount, in whole or in part, to "cramdowns," lenders would demand increased down payments from mortgage borrowers. Requiring that borrowers put down enough money to cover potential declines in the value of their homes is the only way to avoid this risk. The result would be to reduce the availability, and increase the cost, of mortgage borrowing.

Recent research confirms this effect. In one study, Karen Pence, a senior economist at the Federal Reserve Board who studies household and real estate finance, determined that state laws that impose costs on lenders (as much as 10 percent of the value of the loan balance) prior to foreclosure reduce the availability of credit for residents of those states. As a result of these laws, families "may pay more for their mortgages, purchase smaller houses, or have difficulty becoming homeowners."[1]

Similarly, economists Emily Lin and Michelle White found that unlimited homestead exemptions, which allow individuals to shelter home equity from creditors in bankruptcy, significantly reduce the availability of mortgages and home-improvement loans.[2]

The result, then, of coerced modifications to mortgages—which would be the only thing that bankruptcy courts could offer that is unavailable outside of bankruptcy—would be to put home lending out of reach of many Americans and to raise the cost of borrowing for those who are able to secure mortgages, further weakening the housing market. This is a perverse result, considering that the long-standing aim of U.S. housing policy has been to encourage homeownership by promoting affordability in the mortgage market.

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[1] Karen Pence, "Foreclosing on Opportunity: State Laws and Mortgage Credit," *Review of Economics and Statistics*, Vol. 88, No. 1 (February 2006), pp. 177–182, at *http://works.bepress.com/cgi/viewcontent.cgi?article=1001&context=karen_pence*.

[2] Emily Y. Lin and Michelle J. White, "Bankruptcy and the Market for Mortgage and Home Improvement Loans," *Journal of Urban Economics*, Vol. 50, No. 1 (2001), pp. 138–162, at *http://econ.ucsd.edu/~miwhite/lw-jue-reprint.pdf*.

CONCLUSION

When an individual is living in a home that he fundamentally cannot afford, there are only bad options, and filing bankruptcy in a last-ditch attempt to keep the home or to stay in it a while longer is among the worst. Encouraging at-risk homeowners to do so would be irresponsible. For that reason, Congress should be very wary of bankruptcy court-based loss mitigation programs that offer few or no options unavailable outside of bankruptcy, while holding out hope for homeowners facing foreclosure. Unless and until there is evidence that these programs can be operated in a manner that (1) does not injure at-risk homeowners, (2) does not compromise creditors' lawful rights, and (3) does not cause undue delay in the foreclosure process, encouraging their proliferation would be unwise.

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