Joint Memo for Proposed Bankruptcy Law Reform:

Solutions to Preserve Homeownership

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By

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The Center for Responsible Lending conducted a study of over six million subprime home mortgage loans, and projected that 2.2 million Americans with loans originated between 1998 and 2006 have lost or will lose their homes to foreclosure.[1] This calculation is conservative: It assumes that approximately 20% of subprime mortgage loans originated in 2006 will end in the loss of the home to foreclosure;[2] a recent Lehman Brothers study put the number at 30%.[3] The largest proportion of these losses have yet to come.[4] Without intervention, a staggering loss of homeownership is inevitable.

To help avert a foreclosure crisis, we propose an amendment to the Bankruptcy Code to empower bankruptcy courts to modify home mortgage loans as they can virtually every other kind of secured and unsecured debt. Our proposal does not seek to revisit the 2005 amendments to the Code. Rather, it seeks to remedy an anomaly created by a provision in the 1978 Bankruptcy Code, which singles out home mortgage lenders for special protection and makes the home mortgage on the primary residence virtually the only debt the court cannot modify and the home the only asset it cannot protect. The 1978 provision also denies low wealth and middle income consumers protections available to family farmers, corporations, and consumers wealthy enough to own two homes.

Our proposal would remedy this anomaly in Chapter 13 and provide a comparable solution in Chapter 7 by, generally, permitting bankruptcy courts to write down the debt to the market value of the home and restructure the mortgage.

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1 Center For Responsible Lending, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners* ("*Losing Ground*") (Dec. 2006) at 16, Table 6, available at HREF="http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31217189"§ MACROBUTTON HtmlResAnchor http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31217189; Center For Responsible Lending, *Subprime Lending: A Net Drain on Homeownership*, CRL Issue Paper No. 14 ("*Net Drain on Home Ownership*") (Mar. 27, 2007) at 3, Table 2, available at http://www.responsiblelending.org/pdfs/Net-Losership-3-26.pdf (updating the findings of *Losing Ground* to reflect data for the fourth quarter of 2006).

2 *Losing Ground*, at 11.

3 Lehman Brothers, *Mortgage Finance Industry Overview* (Dec. 22, 2006) at 1.

4 *Losing Ground* at 16, Table 6 (showing that close to 500,000 homes with1998-2006 vintage loans were lost to foreclosure as of May 2005).

It bears note that this is neither a radical nor an unprecedented change; long after the 1978 provision was enacted, many courts interpreted the Bankruptcy Code to allow the reduction of the loan balance to the market value of the home. This continued until 1993, when the Supreme Court interpreted the statutory language to preclude this result.[5]

More importantly, the solutions proposed here will enable families to save their homes while providing mortgage lenders with at least the value they would obtain through foreclosure; after all, a foreclosure sale can only recover the market value of the home, and foreclosure is an expensive procedure. The lender will be protected by recovering at least as much as it would from a foreclosure sale, while the borrower will be spared the loss of the home, and communities will be spared the deleterious effects of neighborhood foreclosures.

Recently, Credit Suisse's Fixed Income Research group issued a report stating that there would be an increase in foreclosure filings (and corresponding investor losses) as the Bankruptcy Code currently bars any realistic option of filing for consumer bankruptcy. Credit Suisse concluded that: "the bottom line is that new bankruptcy law appears to be harming mortgage borrowers, and for investors, this should result in rising losses."[6]

The reason for this is that the current law leaves very few options available to the vast majority of subprime borrowers who are currently stuck in so-called "exploding ARM loans" – that is, 2/28 hybrid adjustable rate mortgages, whose rates rise sharply two years after origination, resulting in massive and frequently unaffordable payment increases.[7] The current law limits the options of such borrowers to the following:

- <u>Continue to make payments on the loan at the higher rate.</u> Few can successfully continue in their loans because the debt-to-income ratios were unsustainably high even at the introductory "teaser" rates – often 50% to 55% of monthly income. For many borrowers, the increased payment will approach or exceed their total net monthly income after the interest rate adjustment.

- <u>Sell the house.</u> For many borrowers, selling their house is not a solution because the loans were underwritten with such high loan-to-value ratios that with the slow-down (or reversal) of home price appreciation, possible appraisal fraud, and the equity-stripping common to these loans, the sale would not net sufficient proceeds to cover the outstanding debt and any applicable prepayment penalties, which are included in over two-thirds of subprime loans. In some real estate markets it will not be possible to sell.

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[5] Nobleman v. American Savings Bank, 508 U.S. 324 (1993).

[6] Credit Suisse, *Subprime HEAT Update* (March 8, 2007) at 12, 9.

[7] Through the second quarter of 2006, hybrid ARMs made up 81 percent of the subprime loans that were packaged as investment securities. That figure is up from 64 percent in 2002. (*Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs*, p. 2 Fitch Ratings Credit Policy (August 21, 2006))

- Refinance into another loan. The refinancing option is now largely unavailable, both because many borrowers lack sufficient equity to support a refinancing, and because many of the lenders that extended these loans are themselves filing for bankruptcy.[8]

- Negotiate with the lender for a loan modification, workout or loss-mitigation program. Working with their present servicer is often difficult because the loans are now held in trusts by many investors, presenting impediments, both legal and economic, to such agreements. Moreover, under current tax law, where it is necessary to reduce the principal balance of the loan, this reduction may constitute taxable income to the borrower. A significant advantage of bankruptcy is that there is no income tax liability for reductions of a loan balance that occur in the course of a bankruptcy case.[9]

- Lose the home to foreclosure. Unless the law is changed to permit borrowers to save their homes in bankruptcy, for many borrowers, foreclosure will be the only option. This is a result that entails financial disaster, and for some number of borrowers, loss of all family wealth and even homelessness.

Bankruptcy is an option of last resort for families in acute financial distress and on the verge of economic collapse. For a staggering number of families today, the precipitating event will be a catastrophic rate increase on an inappropriate and predatory mortgage loan. A solution such as the one we propose in this memo, that prevents the loss of the home through foreclosure while assuring lenders at least the value they could obtain through a foreclosure sale, is a public policy win.

Brief Overview of How Bankruptcy Works

Bankruptcy enables troubled debtors to seek relief from their debts. Typically, a debtor files for bankruptcy to forestall foreclosure, repossession or other debt collection litigation. Consumer bankruptcy functions as a form of social safety net, providing an equitable distribution of resources among creditors, and enabling debtors to get a fresh start. Generally, individual debtors can choose between filing under Chapter 7 and Chapter 13. Chapter 7 contemplates the liquidation of the debtor's non-exempt assets for the benefit of creditors, and the release of the debtor from further liability on most unsecured debts. In Chapter 13, the debtor establishes a plan for repaying a portion of

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8 *See e.g.*, Gretchen Morgenson, *Crisis Looms in Market for Mortgages* , The New York Times (Mar. 11, 2007).

9 In general, a creditor's write-down of a borrower's loan balance as part of a loss mitigation or loan restructuring is considered "income" under the tax code. Hence, a borrower who benefits from a loan modification of this sort may face the uncertainty of a potential tax assessment a year or so later, once again putting the home in jeopardy. The tax code has a specific income exclusion for loan reductions in a bankruptcy action. Section 108 of the Tax Code sets forth the tax consequences of a discharge of indebtedness. It contains two key exclusions: A debt forgiveness/discharge is not income if it occurs in a Title 11 case (ie a bankruptcy case), or when the borrower is insolvent (see 26 USC sec. 108(a)(1)). Subsection108(d)(3) defines insolvent as where "the excess of liabilities over the fair market value of assets."

her debts out of future earnings over a three to five year period, after which, most unsecured debts are discharged.

The problem with Chapter 7 is that, absent the lender's acquiescence, it does not permit the borrower to keep the house if there has been a default before the case is filed. Moreover, the 2005 amendments to the Bankruptcy Code make it more difficult and costly for borrowers to file Chapter 7 cases. This brings us to the problem with Chapter 13.

As currently drafted, Chapter 13 singles out home mortgage lenders for special protection that makes the home mortgage virtually the only debt that the court cannot modify and therefore the home the only asset it cannot protect. As the home is typically the largest and most important asset a family has, and the home mortgage loan is the family's largest single debt, the exclusion of the principal residence from modification prevents bankruptcy protection from reaching where it is needed most.

The way Chapter 13 works is that the secured and unsecured debts are divided into two separate classes, and within each class, all creditors are treated the same. Most secured debts (e.g., most cars, furniture) are preferred over unsecured debts (credit cards, installment debt), and are paid in full to the extent of the value of the collateral. For example, if a borrower owns an older car valued at $2,000, and the car secures a $4,000 loan, the first $2,000 of the debt is secured, and the rest is put into the class of unsecured debts, and paid pro rata along with the unsecured creditors.

The relevant provision is found at 11 USC §1322(b)(2), which empowers the court to "modify the rights of holders of secured claims, *other than a claim secured only by a security interest in real property that is the debtor's principal residence*, or of unsecured claims…" (emphasis supplied). "Modification" can entail reducing part of the principal balance, reducing the interest rate, or extending or altering the repayment schedule. The ability to modify the debt is possible for virtually every type of debt except for the mortgage on the borrower's primary residence.[10] One might expect that the home would be the most protected asset because it is the most fundamental, as reflected in the policy considerations that have led to state homestead exemptions, but the opposite is the case in the current federal bankruptcy law.

The home mortgage exception was enacted in 1978, a time when home mortgages were nearly all fixed-interest rate instruments with low loan-to-value ratios and were rarely themselves the source of a family's financial distress. The mortgage market has shifted considerably since 1978. Subprime lending in the last six years has increased significantly, primarily in the form of "exploding ARMs," where monthly payments increase by 40% after year two even if interest rates in the economy remain constant.

[10] In 2005, the bankruptcy law was amended to treat some recent purchase money loans for automobiles in a similar fashion, but the dollar figures for such loans pale in comparison to the amount of a home loan and, depending on fair market value, the amount of equity associated with the residence. Moreover, such loans can still be modified with respect to interest rate and payment amounts.

These loans have relied on property appreciation, and in many cases appraisal fraud, and have left many borrowers with payments that they cannot afford and mortgages larger than the value of their homes. If the borrowers cannot restructure these debts, then they can neither save their home nor get back on their feet financially.

For years, bankruptcy courts found ways around the provision's harsh result by finding exceptions to the blanket prohibition on modifying home mortgage loans – by, for example, finding that the exemption applies only to extent that the outstanding loan balance does not exceed of the value of the home, or, because the rationale for the home mortgage exception was the need to incent home mortgage lending to facilitate home purchases, finding that it only applies to purchase money lending and not refinances. These "fixes" ended with the 1993 Supreme Court case of *Nobleman v. American Savings Bank*, 508 U.S. 324 (1993), in which the Court held that bankruptcy courts must apply section 1322(b) according to its express, literal terms. The practical effect of the current bankruptcy law is that borrowers stuck in unaffordable home loans must cure their defaults and, in addition, make monthly payments onthe loans according to their terms or lose their homes. No other creditor—in personal bankruptcy or business bankruptcy—can leave a borrower in such a position.

Not only is this policy unwise; it is unjust. Because the home mortgage exception applies only to primary residences, borrowers wealthy enough to own two homes can obtain relief from the mortgage on their vacation or investment home, thereby retaining at least one shelter for their family. Nor does the exception apply to the homes of family farmers, who file under Chapter 12, or to commercial real estate owned by businesses filing under Chapter 11.[11] The law thus deprives mostly low-wealth and middle class families of protections available to all other debtors.

Proposed Bankruptcy Code Amendments

The following is the package of necessary changes to the Bankruptcy Code – five to chapter 13 and one to chapter 7 – to help borrowers currently stranded in 2/28s:

<u>Changes to Chapter 13:</u>

1. <u>Strip-down.</u> Chapter 13 precludes bankruptcy courts from stripping down the mortgage loan principal balance to the value of the loan. As a consequence, the borrower is unable to refinance to another loan, to pay the loan off by selling the house without continuing to owe money to the lender, or to build equity for the family.

[11] The family farm Chapter 12 corollary to section 1322(b)(2), found at 11 USC § 1222(b)(2), provides the bankruptcy court with power to "modify the rights of holders of secured claims, or of holders of unsecured claims…" Similarly, the corresponding provision of Chapter 11, found at 11 U.S.C. § 1123(b)(5), contains language identical to that in section 1322(b)(2), reaffirming the exemption for loans secured by the debtor's primary residence, but imposing no corresponding exemption for a company's principle place of business or any other property.

- Solution: Eliminate the prohibition on modifying loans secured by mortgages on the debtor's primary residence. 11 USC § 1322(b)(2) should be modified as follows:

  1322 Contents of plan

  . . . .

  (b) Subject to subsections (a) and (c) of this section, the plan may –

  (2) modify the rights of holders of secured claims, ~~other than a claim secured only by a security interest in real property that is the debtor's principal residence,~~ or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims;

2. Reamortization. Chapter 13 requires that secured creditors be paid the value of their allowed secured claim within three to five years. Thus, even if section 1322 is changed as suggested above and the court is able to modify the loan in bankruptcy, this requirement would preclude most borrowers from benefiting from the change because with an amortization period of three to five years, the monthly payments even on a stripped-down loan will be too high for borrowers to afford. The Bankruptcy Code imposes no such requirement on family farmers who file under Chapter 12.

   - Solution: Add a new section 1322(b)(11) (and renumber current 1322(b)(11) as (b)(12)), tracking the language that currently makes this possible for family farmers under Chapter 12, which states:

     "(11) provide for payment of allowed secured claims secured by the debtor's principal residence consistent with section 1325(a)(5) of this title, over a period of up to 30 years from the date of the petition, except that payment of interest accruing after the date of filing of the petition on such claims shall be calculated at a fixed annual percentage rate in an amount equal to half of one percentage point greater than the most recently published annual yield on conventional mortgages published by the Board of Governors of the Federal Reserve System, as published in statistical release H.15 or any publication that may supersede it, as of the applicable time set forth in 12 C.F.R. 226.32(a)(1)(i).; and"

   - In addition, add at the beginning of section 1325(a)(5): "except as otherwise provided by section 1322(b) of this title."

3. Interest rate and terms. Chapter 13 precludes bankruptcy courts from reducing the interest rate or converting a loan from an adjustable rate to a fixed rate loan to make it affordable and sustainable.

   - The amendment to 11 USC § 1322(b)(2)) described in paragraph 1 above will enable the court to reduce the rate or convert to a fixed rate, sustainable loan.

The language in paragraph 2 above will provide direction to the court to make the loan fixed rate and add a risk premium to the average 30 year fixed rate in the market. This 50 basis point risk premium is the same as the annual FHA premium.

4. <u>Final pay-off of outstanding balance.</u> The Code requires that payments to secured creditors under a consumer's Chapter 13 plan be made in "equal monthly payments" (11 USC § 1325(a)(5)(B)(iii)). Some courts have construed this language to prohibit a plan that would permit the debtor to pay off the claim of a home secured lender by making a final balloon payment for the balance owed with the proceeds of a refinancing at the end of the plan. The Code thus precludes the most likely basis on which most debtors could repay their mortgage loans.

    - <u>Solution:</u> Amend Chapter 13 (11 USC § 1325(a)(5)(B)(iii)) to make clear that the "equal monthly payments" requirement does not apply to the repayment schedule for home mortgage loans. The section should be revised as follows:

        § 1325. Confirmation of plan
        ". . .
        (iii) if <u>the holder of the claim is secured by personal property</u> --
        (I) property to be distributed pursuant to this subsection is in the form of periodic payments, such payments shall be in equal monthly amounts; and
        (II) ~~the holder of the claim is secured by personal property,~~ the amount of such payments shall not be less than an amount sufficient to provide to the holder of such claim adequate protection during the period of the plan;"

5. <u>Barriers to bankruptcy filing.</u> The 2005 Bankruptcy Code amendments added a requirement that debtors undergo credit counseling before filing for bankruptcy. This causes a delay that borrowers facing bankruptcy cannot afford, and could make these proposed amendments meaningless for the borrowers who need them most. Since home loans could not be modified when the counseling requirement was added, it's clear that the requirement was not intended to prohibit debtors from responding to imminent foreclosure.

    - <u>Solution</u>: Waive the counseling requirement where a foreclosure proceeding has been commenced against the debtor's home by adding a new section 11 USC § 109(h)(5), which states:
        "(5) The requirements of paragraph (1) shall not apply with respect to a debtor who submits to the court a certification that the holder of a claim secured by the debtor's principal residence has initiated a judicial or nonjudicial foreclosure on the debtor's principal residence."

Changes to Chapter 7

1. Redemption of property. Chapter 7 permits borrowers to "redeem" personal property by paying the lender the fair value of the property, and thereby extinguishing the debt that the property secures, but it does not permit the debtor to similarly "redeem" the home.

   - Solution: Amend 11 USC § 722 to include the underlined text below:

     > An individual debtor may, whether or not the debtor has waived the right to redeem under this section, redeem <u>the debtor's principal residence</u> or tangible personal property intended primarily for personal, family, or household use, from a lien securing a dischargeable consumer debt, if such property is exempted under section 522 of this title or has been abandoned under section 554 of this title, by paying the holder of such lien the amount of the allowed secured claim of such holder that is secured by such lien <u>or the liquidation value of such property, whichever is less</u>, in full at the time of redemption.

In addition to the foregoing essential changes, the following independent changes – one for chapter 13 alone, and five for both chapter 13 and chapter 7 – would provide important protections to bankruptcy debtors:

Additional Changes to Chapter 13:

1. Excessive Fees: Mortgage companies frequently charge unauthorized or excessive fees to debtors in Chapter 13, sometimes failing to disclose the fees until the debtor is no longer in bankruptcy having successfully completed the Chapter 13 case, or seeks to pay off the mortgage balance, thus further impeding the debtor's effort to stabilize financially.

   - Solution: add a new section 1322(c)(3), which states:

     > "No fees, expenses, or charges shall be added during or after the bankruptcy case to any secured debt provided for by the plan based upon any occurrence during the bankruptcy case unless such fees or charges are approved, as reasonable, lawful, and provided for by the underlying contract, by the bankruptcy court after notice and a hearing. Such fees, expenses or charges shall only be added to the secured claim to the extent that the secured debt is secured by property the value of which is greater than the amount of such claim. The failure of a party to obtain such approval shall be deemed a waiver of any claim for such fees, expenses or

charges for all purposes, and any attempt to collect them shall be deemed a violation of section 524(i) of this title."

Additional Changes Applicable to Both Chapters 7 and 13

1. Maintain Debtors' Legal Claims: Consumers are sometimes inadvertently deprived of the legal claims they have against predatory lenders or others because they are not aware that such claims are considered "assets of the estate" and so do not list them among their scheduled assets when the bankruptcy case is filed.

    - Solution: Add a new section 554(e) which provides:

        "(e) In any action in State or Federal court with respect to a claim or defense asserted by an individual debtor in such action that was not scheduled as property under section 521(a)(1), the trustee shall be allowed a reasonable time to request joinder or substitution as the real party in interest. If the trustee does not request joinder or substitution in such action, the debtor may proceed as the real party in interest and no such action shall be dismissed on the ground that it is not prosecuted in the name of the real party in interest or on the ground that the debtor's claims were not properly scheduled in a case under this title."

2. Mandatory Arbitration: Mandatory arbitration clauses are found in many consumer contracts, including home mortgages. The enforcement of these arbitration agreements under the Federal Arbitration Act is often in direct conflict with the goal of bankruptcy jurisdiction to have one centralized forum for the prompt resolution of disputes affecting the bankruptcy estate. In order to protect homeowners, both Fannie Mae and Freddie Mac have prohibited the use of arbitration clauses in home loans they purchase.

    - Solution: Prohibit the enforcement of arbitration clauses found in consumer contracts in bankruptcy proceedings by adding a new provision as follows:

        "28 U.C.C. § 1334, Bankruptcy cases and proceedings

        No written agreement for arbitration subject to the Federal Arbitration Act, 9 U.S.C. § 1 et seq., shall be enforceable in any civil proceeding arising under title 11, or arising in or related to a case under title 11, in a case filed by an individual debtor whose debts are primarily consumer debts."

3. Homestead Exemption for the Elderly: A significant number of debtors facing foreclosure are elderly and have nonexempt equity in their properties because of low homestead exemptions in some states. They cannot save their homes under Chapter 13 because current law requires paying the value of their nonexempt equity to unsecured creditors. They cannot get Chapter 7 relief because Chapter 7 would cause them to lose their homes.

- Solution: Enact a homestead floor for the elderly, by adding adding a new 522(b)(3)(D) and amending 522(d)(1) as follows:

  "522(b)(3)(D): If the debtor, as of the date of the filing of the petition, is 55 years old or older, the debtor's aggregate interest, not to exceed $ 75,000 in value, in real property or personal property that the debtor or a dependent of the debtor uses as a residence, or in a cooperative that owns property that the debtor or a dependent of the debtor uses as a residence."

  Section 522(d)(1) would be amended to read:

  "The debtor's aggregate interest, not to exceed $ 20,200 in value or, if the debtor is 55 years of age or older $75,000 in value, in real property or personal property that the debtor or a dependent of the debtor uses as a residence, in a cooperative that owns property that the debtor or a dependent of the debtor uses as a residence, or in a burial plot for the debtor or a dependent of the debtor."

4. Preservation of rights. The Code was amended in 2005 to protect consumers from the loss of their claims due to bankruptcy court sales of loan portfolios "free and clear" of those claims to third party purchasers. However, the new provision, section 363(o), may not extend to transfers of portfolios pursuant to a chapter 11 plan.

   - Solution: Language added as a new section 1129(a)(17) would prevent the evasion of the intent of section 363(o) through this device:

     "1129(a)(17): If the plan results in the transfer to a person of any interest in a consumer credit transaction that is subject to the Truth in Lending Act or any interest in a consumer credit contract (as defined in section 433.1 of title 16 of the Code of Federal Regulations (January 1, 2004), as amended from time to time) then such person shall remain subject to all claims and defenses that are related to such consumer credit transaction or such consumer credit contract, to the same extent as such person would be subject to such claims and defenses of the consumer had such interest been purchased at a sale under applicable nonbankruptcy law."

5. Consumer Protection Violations: A final possible amendment would be Senator Durbin's amendment that obtained significant support in the debate on the 2005 Act, disallowing claims in which lenders had violated consumer protection laws.

   "Section 502(b) of title 11, United States Code, is amended--

   (1) in paragraph (8), by striking ``or'' at the end:
   (2) in paragraph (9), by striking the period at the end and inserting ";or" and

(3) by adding at the end the following:
"(10) the claim is based on a secured debt, if the creditor has failed to comply with any applicable requirement under section (c), (d), (e), (f), (g), (h), or (i) of section 129 of the Truth in Lending Act (15 U.S.C. §1639), sections 226.32 and 226.34 of Regulation Z (12 C.F.R. §§ 226.32 and 226.34) or any applicable state constitution, law or regulation that was in force at the time such debt was incurred".

Impact of Proposed Amendment on a Typical Case

A typical case would involve a debtor who refinanced her mortgage to pay credit card debts or to pay for home improvements. Such debtors are enticed by promises of interest rates lower than credit cards, tax deductibility of interest, and lower payments, generally at a teaser rate that is good for two years, but are not informed that the monthly payment does not include the escrow of taxes or insurance. In order to obtain the mortgage, she was required to refinance her existing mortgage, which was a fixed rate, amortizing loan with full escrows at about the same rate as the teaser rate, but a much lower rate than the rate would be adjusted to after two years. When the two-year adjustment came around, the debtor's payments increased by 40%. Because she could not afford the increased payments and because real estate values were beginning to stagnate or fall, the debtor could not solve the problem by refinancing or selling her house. She fell behind, and is facing foreclosure. See Appendix 1 for statistics demonstrating that this is a widespread case.

A recent example provided by a bankruptcy attorney of this unfortunately typical situation is a man who has been in a chapter 13 plan with the lawyer since October of 2005. His plan payments have gone up twice due to rate adjustments on his subprime hybrid ARM loan. He is a 77-year old, African-American widower on social security, and has contemplated just giving up his house as it is becoming more and more unaffordable and is consuming most of his limited income. Since he has no place to move to, he has decide to try to stick with the chapter 13 for now, but if his monthly mortgage payments continue to increase, he will eventually end up losing his home.

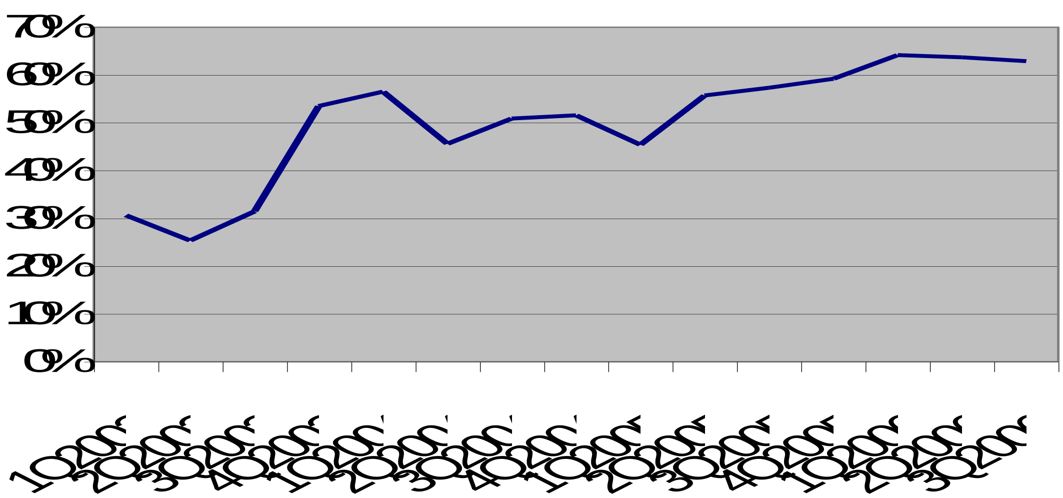
The traditional chapter 13 remedy for foreclosures, which has helped many in the years since chapter 13 was enacted in 1978, is to propose a plan to cure a default over a reasonable period of time (usually three to five years) and maintain current payments. This remedy works well for families that have fallen behind on their mortgage payments because of medical problems or unemployment, and can now resume payments. But it requires the family to be able to pay the current payments, plus pay a bit more toward the arrears each month. For families facing payment shock and payments they cannot afford because they were qualified for the loan based on a lower teaser rate (if ability to pay was even considered), such a plan is unworkable. Even if they are earning the same amount as when they got the mortgage, they cannot afford the current payments, much less anything toward arrears.

Under our proposed change in the bankruptcy law, the debtor's mortgage could be reamortized for 30 years at a lower fixed rate that would be affordable. The payments would be lower, because the rate would be lower than the adjusted subprime rate, and the debtor would not have to make additional payments toward arrears. The proposal would allow debtors to obtain the kind of loan modifications that can be obtained from some lenders (often with enormous difficulty, paperwork, and negotiation) and would not be dependent on the lender's whim, or the requirements of securitization trust documents that sometimes prohibit such modifications. In our example, the debtor would be able to obtain a modification to something like the market rate she had before the refinancing, which she could afford.

Scope of the Crisis – Potential Legislative Impact

In the United States, the proportion of mortgages entering foreclosure has climbed steadily since 1980, with 847,000 new foreclosures filed in 2005.[1] In 2006, lenders reported 354,554 new foreclosure filings for the fourth quarter alone, 47.5 percent higher than the fourth quarter of 2005.[2] In the past 18 months, there have been frequent stories in the media about risky lending practices and surges in loan defaults, especially in the subprime market.[3]

Subprime Foreclosure Starts as a Percent of Total Conventional Foreclosure Starts



Source: MBA National Delinquency Surveys

The graph above shows that foreclosure filings on subprime mortgages now account for over 60 percent of new conventional foreclosure filings reported in the MBA National Delinquency Survey (A “conventional” loan is one that is not insured or guaranteed by a government agency). This fact is striking given that only 23 percent of current originations are subprime, and subprime mortgages account for only 13 percent of all outstanding mortgages.

CRL forecasts that 2.2 million Americans with 1998-2006 vintage loans either have lost or will lose their homes in foreclosure.[12] The vast proportion of these losses have yet to occur. Absent some legislation to stem the tide of foreclosures, the impact will be devastating, not only for the families who lose their homes, but on the broader communities as well. The spillover effects on neighborhood and the wealth of other families will be substantial; according to the Woodstock Institute, families lose 1.44% of their house value for every foreclosure that occurs on their block. Thus, all families with $150,000 houses who live on a black with 3 foreclosures will lose $6,500 of their wealth.

There are no other policy changes that we can think of that could save these families their homes, avoid spreading losses to communities, and spare investors the losses associated with foreclosure sales, at no additional appropriated cost to the government.

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[12] *Losing Ground*, at 16, Table 6; *see also Net Drain on Homeownership*, at 3, Table 2 (updating the findings of *Losing Ground* to reflect data for the fourth quarter of 2006).

Appendix 1

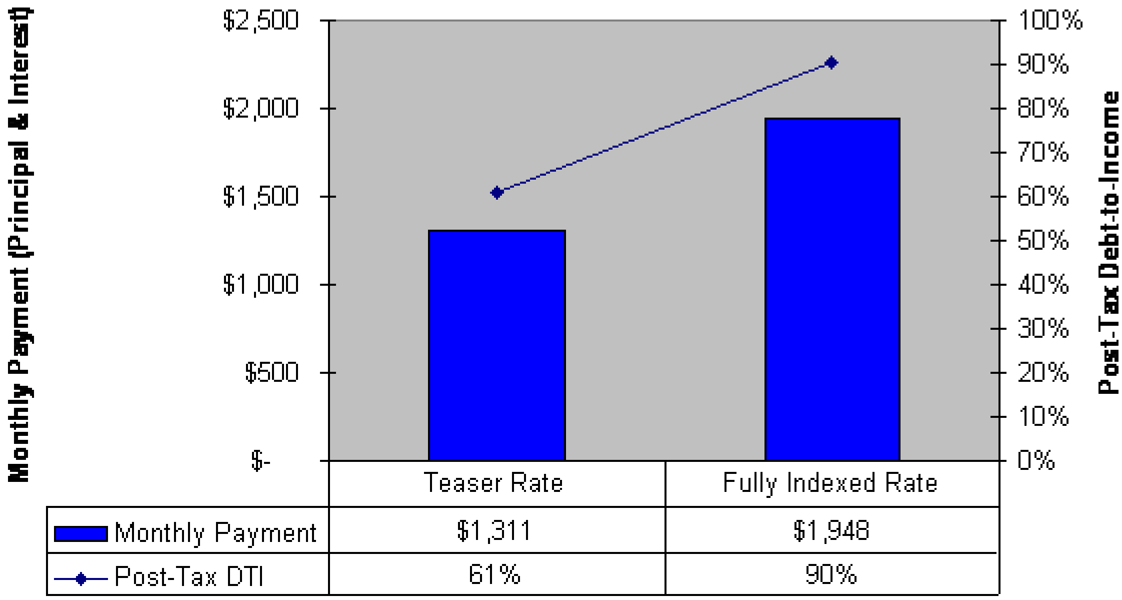
Rate Reset Problem of 2/28 "Exploding" ARMs

Subprime lenders are routinely marketing the highest-risk loans to the most vulnerable families and those who already struggle with debt. Because the subprime market is intended to serve borrowers who have credit problems, one might expect the industry to offer loan products that do not amplify the risk of failure. In fact, the opposite is true. Lenders seek to attract borrowers by offering loans that start with deceptively low monthly payments, even though those payments are certain to increase. As a result, many subprime loans can cause "payment shock," meaning that the homeowner's monthly payment can quickly skyrocket to an unaffordable level.

Unfortunately, payment shock is not unusual, but represents a typical risk that comes with the overwhelming majority of subprime home loans. Today the dominant type of subprime loan is a hybrid mortgage called a "2/28" that effectively operates as a two-year "balloon" loan.[4] This ARM comes with an initial fixed teaser rate for two years, followed by rate adjustments in six-month increments for the remainder of the term of the loan.[5] Commonly, this interest rate increases by between 1.5 and 3 percentage points at the end of the second year, and such increases are scheduled to occur even if interest rates in the general economy remain constant; in fact, the interest rates on these loans generally can only go up, and can never go down.[6] This type of loan, as well as other similar hybrid ARMs (such as 3/27s) have rightfully earned the name "exploding" ARMs.

An example of the severity of payment shock that can occur on the typical exploding ARM for a $200,000 loan follows:

Subprime Adjustable Rate Mortgage Payment Shock
(No Change in Interest Rates)



For the 2/28 ARM shown in the chart above, CRL is making conservative assumptions that correspond with typical mortgages of this type. To make the example even more conservative, we are assuming no general increase in interest rates, even though rates have increased substantially in the past three years. The example is based on an introductory teaser rate of 6.85 percent and a fully indexed rate of 11.50 percent.[7] The loan amount used in this example was $200,000, and, given the common practice of extending loans where the pre-tax debt-to-income ratio is 50 to 55 percent, we assume that this homeowner had a pre-tax income of $31,452, which equates to a post-tax income of $25,901.

At the end of the introductory rate period, this homeowner's interest rate rose from 6.85 percent to 9.85 percent, and the monthly payments jumped from $1,311 to $1,716, and again six months later to $1,948, an increase of over $600 a month.[8] This would be a large increase for most families, and is a huge burden for a family that already struggles with debt. At $1,948, this leaves only $210/month for all other expenses – including property taxes and hazard insurance, food, utilities, transportation, healthcare, and all other family needs.

Sadly, and all too commonly, this hypothetical homeowner had credit scores that would have qualified him or her for a fixed rate loan at 7.5 percent, which would have translated to monthly payments of $1,398—a challenging debt-load to be sure, but far more sustainable than the $1,948 fully-indexed monthly payment associated with the 2/28 loan illustrated above, a payment that can easily increase as interest rates rise.[9]

One would hope that this type of loan would be offered judiciously. In fact, hybrid ARMs (2/28s and 3/27s) and hybrid interest-only ARMs have become "the main staples of the subprime sector."[10] Through the second quarter of 2006, hybrid ARMs made up 81 percent of the subprime loans that were packaged as investment securities. That figure is up from 64 percent in 2002.[11]

Because of the proliferation of these loans, payment shock for subprime borrowers is a serious and widespread concern. According to an article in the financial press that ran a year ago, homeowners face increased monthly payments on an estimated $600 billion of subprime mortgages that will reset after their two-year teaser rates end.[12] Fitch Ratings calculated that by the end of 2006, payments would have increased on 41 percent of the outstanding subprime loans.[13]

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[1] The rate of new foreclosures as a percent of all loans rose from 0.13 in 1980 to 0.42 in 2005, as reported in the *National Delinquency Survey*, Mortgage Bankers Association. 2005 new foreclosure filings statistic from Realty Trac in *Home Foreclosures on the Rise*, MoneyNews (February 23, 2006) at http://www.newsmax.com/archives/articles/2006/2/23/134928.shtml.

[2] "More Than 1.2 Million Foreclosures Reported in 2006 According to RealtyTrac™ U.S. Foreclosure Market Report (January 25, 2007) http://biz.yahoo.com/prnews/070125/lath048.html?.v=87.

[3] See, e.g., Saskia Scholtes, Michael Mackenzie and David Wighton, "US Subprime Loans Face Trouble," *Financial Times* (December 7, 2006); "Nightmare Mortgages," *Business Week* (September 11, 2006); Vikas Bajaj and Christine Haughney, "Tremors at the Door, *New York Times* (January 26, 2007); Matthew Padilla, "Subprime's Grip Slips," *The Orange County Register* (January 28, 2997); and "Vikas Bajaj "For Some Subprime Borrowers, Few Good Choices," *New York Times* (March 22, 2007).

[4] A balloon loan is one that is not repayable in regular monthly installments, but rather requires repayment of the remaining balance in one large lump sum. While 2/28s are not balloon loans, the impact of higher interest rates at the end of the two-year teaser rate period, resulting in higher monthly payments, may force a borrower to seek refinancing.

[5] *See, e.g. Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs*, p. 2 Fitch Ratings Credit Policy (August 21, 2006).

[6] Here we are describing the 2/28 because it is by far the most common product in the subprime market, but the concerns are the same with the 3/27, which differs only in that the teaser rate remains in effect for three years.

[7] The typical 2/28 rises to 6-month LIBOR (now 5.35 percent) plus an index of 6.5 percent, or almost 12 percent.

[8] Typically the rate increase at the first adjustment is capped somewhere between 1.5 and 3 percentage points. On this loan, the rate reached the fully indexed rate at the second adjustment two-and-a-half years into the loan.

[9] A Freddie Mac researcher reports one out of five subprime borrowers could qualify for prime loans, (*see* Mike Hudson and E. Scott Reckard, *More Homeowners with Good Credit Getting Stuck in Higher-Rate Loans*, L.A. Times, p. A-1 (October 24, 2005)), and a lending industry association recently acknowledged that many borrowers placed into 2/28 mortgages could have qualified for thiry-year, fixed rate loans for a rate typically just 50 to 80 basis points (i.e., .5 or.8 of a percent) higher than the teaser rate on the loan they received. (s*ee* February 5, 2007 letter from CRL to Senators Dodd, Allard, Schumer, Reed and Bunning, attached as an exhibit to the Testimony of Martin Eakes before the U.S. Senate Committee on Banking, Housing and Urban Affairs, at p. 7 (responding to claims made by the Coalition for Fair and Responsible Lending (CFAL)), available at http://www.responsiblelending.org/pdfs/martin-testimony.pdf).

[10] *See Structured Finance*.

[11] *See Structured Finance.*

[12] Jonathan R. Laing, *Coming Home to Roost*, p. 26 Barron's, February 13, 2006.

[13] *See Structured Finance*.