

Statement for the Record

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Subcommittee on Commercial and Administrative Law

Committee on the Judiciary

United States House of Representatives

January 29, 2008

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The American Bankers Association appreciates the opportunity to submit a statement for the record on possible legislative changes to the Bankruptcy Code, particularly as embodied in the Emergency Home Ownership and Mortgage Equity Protection Act of 2007, H.R. 3609. The American Bankers Association brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than \$125 million in assets – represent over 95 percent of the industry's \$12.7 trillion in assets and employ over 2 million men and women.

There is no question that our country is going through a very difficult time as many homeowners struggle to meet their monthly mortgage payments. Changes to the Bankruptcy Code, while well-intentioned, are not an effective means to deal with the current situation, nor are they likely to prevent problems from repeating themselves in the future. In fact, the proposed changes embodied in H.R. 3609 are likely to have severe long-term consequences, raising the costs of a mortgage loan for *every borrower*. Making such changes now would hurt the very market that Congress seeks to help. It makes no sense to further restrict credit at a time when every effort possible is being made to stimulate the economy and avoid a recession.

The fallout of the mortgage markets has been very troubling to the banking industry – an industry filled with institutions that have existed for decades and are committed to serving our

communities for many more decades to come. The vast majority of banks were making basic mortgage loans that were underwritten on the basis of borrowers' ability to repay and with adequate documentation. We agree with Congressman Barney Frank, Chairman of the House Financial Service Committee, when he said: "Reasonable regulation of mortgages by the bank and credit union regulators allowed the market to function in an efficient and constructive way, while mortgages made and sold in the unregulated sector led to the crisis."¹ It has been the actions of loosely-regulated non-bank lenders, with little stake in the subsequent performance of the loans that they have made, that have caused much of the damage for consumers and for the industry. In fact, many banks tried to warn local consumers against "toxic" types of loans, only to watch as those consumers went down the road and took on obligations they did not understand and apparently could not resist – largely from non-bank mortgage originators.

Fortunately, banks are coming forward as part of the solution to the current challenges. Banks are well capitalized and are in a position to step in to refinance loans to help borrowers avoid foreclosure. We believe that the government and private-sector efforts to work with borrowers to avoid foreclosure are starting to take hold. Statistics compiled by MBA show that nearly a quarter of a million loans were put into repayment plans or modified in the third quarter of 2007. On January 18, the HOPE NOW alliance of counselors, lenders, and servicers reported that 370,000 homeowners were helped in the second half of 2007 through repayment plans and workouts, and that the number of borrowers being helped "is accelerating rapidly." At the same time, bankers are increasing their originations of new mortgages for buyers who want to purchase houses today. Both efforts are crucial to help keep our economy growing.

If H.R. 3609 becomes law, it will lead to too much uncertainty and raise costs for *all* mortgage loans. Banks will not know the value of their collateral and, in order to manage their risks prudently,

¹ *Boston Globe*, September 14, 2007.

will be forced to pull back from making some mortgage loans. Simply put, this is no time to change the rules on the way collateral is handled. Banks are in a position to help, but cannot do so effectively if uncertainty is injected into the rules. To change this policy now, especially when the country is facing a highly volatile and uncertain housing market, is bad public policy and would have several negative consequences for current and future homeowners, the housing market, and the economy. Therefore, the ABA strongly opposes the changes in the Bankruptcy Code that are being contemplated in H.R. 3609.

In our statement, we emphasize three key points:

- **H.R. 3609 will make it harder and more costly for consumers to obtain mortgages, which is exactly the opposite of what the mortgage market needs now.**

- **H.R. 3609 will encourage more bankruptcies and discourage borrowers from addressing problems early and working with lenders to facilitate a resolution.**

- **H.R. 3609 will eliminate required credit counseling which has helped reduce bankruptcy filings, facilitated workouts, and improved borrowers financial practices that benefit them now and in the future.**

I. H.R. 3609 Will Make it Harder and More Costly for Consumers to Obtain Mortgages

At the heart of the bill are provisions that would allow bankruptcy judges to alter the terms of mortgage agreements. If enacted, H.R. 3609 would allow judges to unilaterally cramdown a portion of the outstanding mortgage balance on a primary residence, thereby converting it from secured to unsecured debt. The bill would also allow judges to modify other mortgage terms such as the applicable interest rate and repayment period. Historically, these actions were prohibited because they would undermine the long-standing public policy to encourage liquidity in the mortgage market and increase home ownership. Specifically, when Congress rewrote the bankruptcy laws in 1978, it deliberately retained the prohibition on cram downs and other changes to first mortgages by bankruptcy judges to keep housing affordable for as many Americans as possible.

The provisions in H.R. 3609 will create new lending risks that will certainly raise the costs to lenders for making any mortgage loan and inevitably lead to higher mortgage interest rates and fewer loans made to all borrowers. The Mortgage Bankers Association (MBA) estimates that H.R. 3609 could increase interest rates on first mortgages by at least 1.5 percent. The impact is likely to be felt most strongly by higher-risk, but creditworthy, borrowers and may mean the difference between owning a home and continuing to pay rent to a landlord.

The interest rate that bank's set for a mortgage loan depends on several factors, including:

- The creditworthiness of the borrower (the ability and likelihood that the borrower will repay the debt);
- The collateral backing the loan (which the borrower pledges in the event of default);

- The costs of administering the loan (e.g., monitoring, servicing, legal actions, foreclosure, and the ability to take control and sell the collateral to recoup some of the losses on the loan); and
- The cost of funding the loan (e.g., deposit and secondary market funding).

Except for creditworthiness, all of these factors will be adversely affected by the proposal and will lead to higher interest rates and reduced credit availability. While we appreciate that the bill applies only to the primary residence, lenders already typically charge a higher interest rate and require a larger downpayment for second homes – which can be crammed down in a bankruptcy under current law. This is another indication of the potential consequences on first homes should the bill be enacted.

Value of Collateral is Diminished: The difference between interest rates on unsecured versus secured loans is substantial. The reason is simple: the expected loss once a default occurs is much greater for an unsecured loan than for a secured loan where the sale of the collateral can offset a portion of the loss to the lender. One need only look at the difference in interest rates on credit cards (which are unsecured) versus auto or mortgage loans. Thus, borrowers benefit significantly from pledging the collateral, and they also have more incentive to make the payments as they do not want to risk losing that collateral.

The changes proposed in H.R. 3609 make the underlying collateral less valuable and raise the expected loss on ***all*** mortgages for ***every*** lender. The unpredictability regarding how loan terms might change – whether it be a cramdown in value, or a change in the interest rate or other term of the loan – makes valuing the benefit of the collateral practically impossible. Slight changes in any of these terms can significantly affect the potential to recoup losses in the event the borrower declares bankruptcy. Lenders simply cannot predict at the time the loan is originated what changes in terms a judge may later impose. Therefore, because the value of the collateral is less certain, the interest rate reduction

borrowers enjoy from pledging the asset will be less and the interest rate paid on the mortgage will be higher.

Ability to Control the Collateral Will be Impaired: The ability to control the collateral pledged by the borrower and sell it to recover some of the losses is a critical component of secured lending. Without it, the collateral has little value and the loan will get priced more like an unsecured loan. The bill would make it more difficult for the lender (or the claim holder if the loan is sold in the secondary market) to exercise its contractual rights to modify the terms of the loan or to seize the collateral, further raising the potential for loss and extending the time for any recovery. Once again, the lender will raise interest rates to cover this uncertainty, require a larger down payment, and restrict lending to more creditworthy borrowers where the likelihood of default is much less. This means that deserving individuals who would not qualify for low-risk mortgages will find mortgage credit harder to come by and at a much higher cost – taking either a bigger bite out of their income or making the loan beyond their reach entirely.

Investors in the Secondary Mortgage Markets Will Demand Higher Returns: Another important cost that helps to determine the interest rate on any mortgage loan is the cost of funding. The low mortgage interest rates and broad availability of credit that characterize the U.S. mortgage markets are attributable to an active secondary market for mortgage-backed securities. Today, market conditions have made investors wary of mortgage-backed securities (particularly those that are not backed by prime loans). Investors have become concerned about changes in the payments being made on the underlying mortgages backing their investments. If H.R. 3609 were to be enacted, it would significantly add to the uncertainty about the performance of and expected income stream from mortgage loans. This will be particularly true of securities that are supported by pools of subprime loans where the likelihood of default, by definition, is much greater than for prime loans.

Adding yet more uncertainty for investors already made nervous by the market turmoil will delay the return of these markets. Investors do not like uncertainty. This is especially true of those with fiduciary responsibility to pension and insurance funds and others with low risk tolerances. These fiduciaries are increasingly concerned about the impact of the subprime housing problems and the uncertainty that surely will result from H.R. 3609 will make them far less likely willing to accept any mortgage-backed security in the future.

Because the proposed change gives judges wide discretion to choose which mortgage terms to adjust and to what degree, and because this discretion is likely to be applied in different ways across the country (and even differently within the same federal court), investors will not be able to rely on consistent treatment and will have difficulty assessing the true risk. As a result, they will either not buy the asset or will require a much higher return on their investment. This will make it far more difficult to reestablish the stability and liquidity in the mortgage-backed securities sector that are essential to restore the flow of funding for healthy housing and home building markets. The higher returns demanded by investors will translate into higher interest rates for borrowers. Larger down payments are likely to be required, which affects first-time homebuyers particularly. The result for all borrowers is higher costs of homeownership. For the economy, it adds further delay to the recovery of the housing sector and would stifle the stimulus efforts that Congress is undertaking to help avoid recession. For the long-term, H.R. 3609 will take the edge off the growth potential of one of the most important components of national economic growth.

Simply put, all of these changes will add significantly to the risk and costs that a lender faces when making any loan. To cover this risk, the interest rate charged will certainly increase and the willingness to lend to higher-risk, but creditworthy borrowers will decrease. Moreover, since any lender will not know what loans will end up in the bankruptcy process, the rate of interest on *all* mortgage

loans – both prime and subprime – will rise. *This would impose a cost on all homeowners including the vast majority who meet their obligations and never file for bankruptcy.*

It is also worth noting an asymmetry in the process. In a cramdown the creditor takes an irrevocable loss. Once home values start to appreciate again – as they surely will based on historic trends and the demographic realities of new household formation that will drive housing demand over the next decade – the borrower reaps a windfall, but the creditor who suffered the loss does not share in this gain.

The vast majority of economists, mortgage experts, and even the Congressional Budget Office (CBO) believe H.R. 3609 would have an adverse impact on interest rates and credit availability. For example, CBO noted in its analysis of economic stimulus options that one of the costs of the bill “would be higher mortgage interest rates.”² Professor Joseph Mason of Drexel University testified before the Senate Judiciary Committee that “it is straightforward to conclude” that cram downs will increase the cost of mortgage credit. Professor Mason responded to written questions from the Committee in more detail: “Allowing bankruptcy judges to unilaterally change the terms of a mortgage to those less favorable to the lender will impose unexpected and un-forecastable costs upon lenders and therefore raise the cost of providing funds to borrowers that can qualify for such treatment.”

Academic studies also show the costs are real and have an impact on lending. For example, Columbia University professor Charles Calamiris and Drexel University Professor Joseph Mason concluded the following:

There is concrete evidence of the adverse effects of imposing cram-down on borrowing contracts. In response to increasing agricultural distress in 1978, Congress instituted a temporary provision for mortgage cram-downs for family farmers under Chapter 12 of the Bankruptcy Act. Bankers confirm that Chapter 12

² See, CBO Paper – Options for Responding to Short-Term Economic Weakness (January 2008) at 25. <http://www.cbo.gov/ftpdocs/89xx/doc8916/Frontmatter.2.1.shtml>

cram-down has indeed made lending to small farmers a substantially riskier proposition, and they consequently have largely withdrawn funds from this business line.

The withdrawal of agricultural lenders took place when family farmers sorely needed capital from all sources. Cram-down radically affects credit allocation and does not support orderly and efficient allocation of resources in bankruptcy. Cram-downs significantly hurt mortgage lending in agriculture in the 1980's. Cram-downs for home mortgage debt would result in the same type of credit contraction witnessed in the agricultural sector.³

Moreover, in studying the impact of cramdowns for farm real estate in Chapter 12 bankruptcy, the United States Department of Agriculture (USDA) estimated that cramdowns raise the interest rates on farm real estate loans by 25 basis points to 100 basis points.⁴ This means as much as a 10 percent increase in the monthly mortgage payments just because of the uncertainty surrounding the collateral value.

II. H.R. 3609 Will Encourage More Bankruptcies and Discourage Borrowers From Working With Lenders To Facilitate a Resolution

Foreclosure is a losing proposition for all parties. Consumers lose their home while lenders lose money and their customers. For this reason, responsible lenders want to avoid the foreclosure process whenever possible. The industry is already taking positive steps to reach out to troubled borrowers and help them avoid foreclosure. As mentioned at the outset, the HOPE NOW alliance reported that 370,000 homeowners were helped in the second half of last year and that work continues in earnest this year. Individual mortgage lenders and servicers are contacting customers who are behind on their mortgage payments or who may be facing adjustable rate mortgage resets. Through telephone calls,

³ Calomiris, Charles W. and Mason, Joseph R., "High Loan-to-Value Mortgage Lending: Problem or Cure?" AEI Studies on Financial Market Deregulation, 1999.

⁴ "Do farmers Need a Separate Chapter in the Bankruptcy Code?" *Issues in Agricultural and Rural Finance*, United States Department of Agriculture, Economic Research Service, October 1997.

direct mail, e-mail, and interactive web sites, these companies are letting customers know of the various options at their disposal for anticipating and managing the challenges that accompany a mortgage rate reset. These options include affordable refinancing terms and payment plans that will allow borrowers to remain in their homes.

H.R. 3609 would undermine these efforts. Rather than helping to facilitate refinancing or restructuring of mortgage loans to avoid foreclosure, the proposed changes embodied in H.R. 3609 will have the opposite effect by encouraging even more people to take the issue to the courts. In fact, the bill moves the entire bankruptcy system backwards and encourages debtors to use bankruptcy not as a last resort, but as a financial management tool. There is little doubt that if this bill is enacted many debtor attorneys will aggressively advertise that troubled borrowers should ignore market-based refinancing opportunities or mutually agreeable restructuring facilitated by organizations like HOPE NOW.

H.R. 3609 would jam the bankruptcy courts and fosters abuse of the system. CBO's analysis of economic stimulus options states that H.R. 3609 would "add to the caseload of the bankruptcy court system causing delays in resolving cases." Consider, for example, the problem of deciding what the home's fair market value is – a critical decision given the financial magnitude of the potential cramdown. Inevitably, the courts will be asked to referee – and would certainly become mired in – the battles over competing appraisals to determine the market value. Unlike the other avenues to providing relief to troubled borrowers, bankruptcy (like all litigation) is an adversarial process in which debtor counsel will present as evidence the lowest possible appraisal. To the extent that bankruptcy judges accept such "lowball" appraisals in the hundreds of thousands of cases that bill's proponents predict will be filed, they will further destabilize the overall housing market by dragging market valuations lower than they would otherwise be.

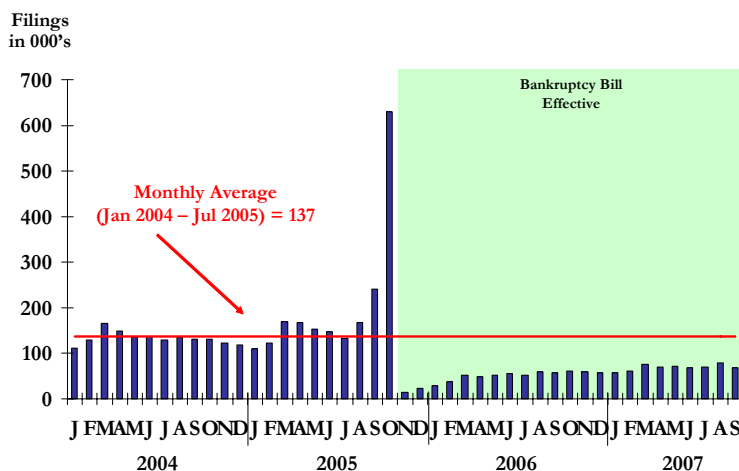
H.R. 3609 also creates incentives for increased fraud and abuse in the bankruptcy system.

Professor Mason said in his Senate Judiciary Committee testimony that allowing judges to change the terms of mortgages in bankruptcy “sets the stage for a potential abuse of the bankruptcy system to further speculative purposes.” He also believes it would encourage people to cash out their home equity, thus dramatically reducing a major component of retirement savings for most Americans.

Bankruptcy provides a fresh start for those that truly need it. This was true before Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) and it remains true today. Recognizing that the bankruptcy system had been providing billions of dollars of debt relief without ever questioning whether filers truly needed relief or to what degree, Congress enacted BAPCPA to help restore personal responsibility and integrity to the bankruptcy system. This legislation implemented an objective income/expense test designed to ensure that debtors (who earn more than the median income in their state) who can repay a portion of their debt should be required to do so. BAPCPA also requires debtors to receive credit counseling before they are determined to be eligible for bankruptcy. The purpose behind this provision is to ensure that debtors understand the alternatives to bankruptcy and the consequences of filing for bankruptcy. Debtors that do eventually file for bankruptcy are required to participate in a financial management course prior to receiving their discharge, thus helping them avoid future financial difficulties.

In the two years since BAPCPA became effective, average bankruptcy filings have fallen to roughly half of what they were prior. This is evidence that borrowers are, in fact, employing

Pre- and Post-Bankruptcy Filing Rates



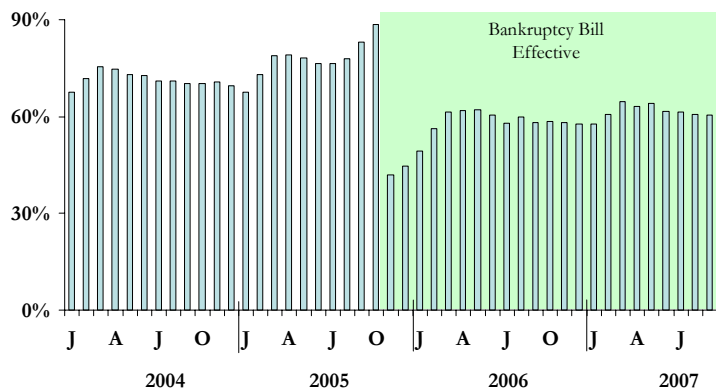
Source: Administrative Office of the U.S. Courts

alternatives to bankruptcy. It also indicates that debtors are reaching out to lenders to try and negotiate workable repayment plans. Moreover, it suggests that debtors are no longer looking at the bankruptcy system as a financial planning tool and abusing the protections it affords.

The lower number of bankruptcy filings since the law became effective also verifies the notion that many debtors who seek bankruptcy protection actually have the ability to repay at least a portion of their debt. Since enactment of BAPCPA, the share of Chapter 7 bankruptcy filings relative to all filings (in Chapter 13 and Chapter 7) has also declined considerably (see chart on the next page). In the years leading up to enactment of BAPCPA, the share of Chapter 7 filings was nearly 73 percent. Since enactment of the new law, that share has fallen to just over 60 percent.

Effect of Bankruptcy Bill on Chapter 7 Filings

Chapter 7's as a Percentage of Chapter 7's & 13's



Source: Administrative Office of the U.S. Courts

If the current bankruptcy law is altered so that judges are allowed to modify the terms of home mortgages for primary residences in Chapter 13 bankruptcies, the potential for cram-downs, lowered interest rates and over-extended repayment periods will once again allow debtors to use the bankruptcy system as a financial planning

tool rather than a tool of last resort. In fact, lawyers for debtors will aggressively advertise that they can significantly reduce mortgage terms for bankruptcy filers. Given that mortgages are the biggest asset for the vast majority of debtors, the promise by lawyers to reduce borrowers' housing payment obligations significantly while still being able to remain in their homes will attract not just those who are truly in need of a fresh start, but others also – including those that are current on their mortgage and “investors” that were attempting to flip houses and now want to be bailed out of a bad investment.

III. Credit Counseling is an Important Component of the Bankruptcy Process

Filing for bankruptcy remains an important avenue for debtors that truly need a fresh start. However, many individuals still do not fully realize that options other than bankruptcy are available to them – including working with lenders to find an appropriate payment plan on the debt. Many bankers have told us that prior to the change in the bankruptcy law, the first time they knew that a borrower was having difficulty was when they received the bankruptcy notice. These banks did not have ample opportunity to address this situation and help the borrower avoid bankruptcy.

The pre-filing counseling requirement has helped reduce the filings and facilitate workouts. While it is too soon to fully know the impact of this requirement, the early indications are the individuals, once they are aware of options, choose a path other than bankruptcy. In fact, the United States Trustee office found that between October 2006 and June 2007, 14 percent of individuals that completed the credit counseling requirement did not end up declaring bankruptcy.

Credit counseling provides an important independent source of information for debtors about the process and can confirm or deny the information provided to them by bankruptcy lawyers (who have a financial incentive to push the individual to file rather than having the debtor work out another solution). Credit counselors are well versed in housing assistance that can help a borrower save his or her home without filing bankruptcy. Many counselors are associated with a HUD-Approved Housing Counseling Agency. Moreover, to the extent that borrowers did not fully understand the terms of the mortgage that they signed, credit counseling can be the first step in helping to educate them about alternative mortgage options, ways to avoid taking on obligations beyond their means, and even to discuss whether owning or renting is more appropriate for their situation.

Thus, eliminating the credit counseling requirement would be against the interest of debtors and lenders. In this regard, the “compromise” version of H.R. 3609 is a giant step backwards from the bill

that was originally introduced. The initial version of H.R. 3609 would only have granted a waiver of the normal pre-filing credit counseling requirement where the debtor had submitted to the court “a certification that the holder of a claim secured by a debtor’s principal residence has initiated a judicial or non-judicial foreclosure on the debtor’s principal residence.” But the reported version has watered down that requirement to “a certification that the holder of a claim secured by the debtor’s principal residence *may* commence a foreclosure on the debtor’s principal residence (Emphasis added).” In other words, the bill would now provide a blanket exemption from the counseling requirement even where no foreclosure proceeding has even commenced. We have no idea what the courts would rule sufficient to trigger this exemption – but we have no doubt that debtor attorneys will argue that any notice from the claim holder regarding a past due amount, or even the original mortgage document setting forth the lender’s right to foreclose, is sufficient to trigger this exemption. The fact that the bill now requires the counseling to be completed within 30-45 days after the debtor has initiated a bankruptcy proceeding is irrelevant, because at that point the die has been cast and the adversarial process has commenced. We can understand why the debtor bar supports a blanket counseling exemption that will result in many debtors learning, too late, that they had viable non-bankruptcy options for addressing their housing finance problems – but we cannot understand why Congress would provide such a blanket exemption where foreclosure proceedings have not even been initiated.

In any event, there is no need for any such exemption as the Bankruptcy Code (Section 109) already allows judges to waive the counseling requirement for “exigent circumstances” where the debtor has sought counseling from an approved non-profit counseling agency but was unable to receive such assistance within five days. Moreover, there is ample time between the initiation and conclusion of a foreclosure action to receive the required counseling and make a fully informed decision about whether bankruptcy is the only viable option for a particular borrower.

Conclusion

Lenders are currently working to help individuals that are experiencing difficulties meeting their mortgage payments, or will have difficulties when their adjustable mortgages reset to higher interest rates. However, should this bill be enacted, it will be much more difficult to work with borrowers to do this and it will make it harder for people to obtain new loans or to refinance their existing mortgages. Interest rates will be higher and underwriting will be tightened, making it difficult to qualify for new loans, particularly for those borrowers with lower incomes, weaker credit and smaller downpayments – just the opposite of what is needed in today’s market. Simply put, H.R. 3609 would undermine the effectiveness of Congressional and private-sector housing-related initiatives and restrict credit at a time when an economic stimulus is needed to avoid recession.

Rather than introduce tremendous new uncertainty into the mortgage markets by eroding the value of collateral in the bankruptcy process, Congress should instead work to bring non-bank mortgage lenders up to the standards already in place for the banking industry. The ABA – and all our member banks – wants to be part of the solution and we stand ready to work with this Committee to effect positive change.