Testimony of

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on

PROMOTING BANK LIQUIDITY AND LENDING THROUGH DEPOSIT INSURANCE, HOPE FOR HOMEOWNERS, AND OTHER ENHANCEMENTS

Before the

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

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Room 2128, Rayburn House Office Building

Good morning, Chairman Frank, Ranking Member Bachus, and Members of the Committee. Thank you for inviting me to speak today. I am Edward R. Morrison, Professor of Law at Columbia Law School. I have studied bankruptcy law and credit markets for ten years. I hold a law degree and a Ph.D. in economics from the University of Chicago. I completed judicial clerkships on the Seventh Circuit Court of Appeals and the Supreme Court of the United States. I am also a member of the National Bankruptcy Conference, but my testimony today does not necessarily reflect the views of other Conference members.

Today I would like to make four points regarding H.R. 703.

First, it would be a mistake to include both H.R. 703 and H.R. 200 ("Helping Families Save Their Homes in Bankruptcy Act of 2009") in the Consolidated Appropriations Act for Fiscal Year 2009. H.R. 200 would permit homeowners to cramdown their mortgages in a Chapter 13 bankruptcy case. This bill is costly and unnecessary. It is costly because cramdown will expose our financial institutions to large losses and generate a host of undesirable consequences for homeowners. Cramdown is also unnecessary because Section 6 ("Safe Harbor") of H.R. 703 can be augmented to accomplish the same objectives as cramdown but at lower cost, as I explain below.

Second, it is unnecessary to salvage the Hope for Homeowners Act, as Section 5 attempts. That Section would increase the permissible loan-to-value ratio on refinancings and take other steps to make the program more attractive to lenders and homeowners. These amendments are unnecessary. If Section 6 of H.R. 703 is augmented instead, as I explain below, it can avoid more foreclosures than Hope for Homeowners at a fraction of the cost.

Third, Section 6 of the Bill takes an important step in the right direction by creating a safe harbor for servicers. Under Section 6, servicers can modify mortgages, and avoid legal liability for doing so—even if the securitization contract forbids modification—provided they modify mortgages in a reasonable, good faith belief that modification will increase returns, on a net present value basis, to investors. This "safe harbor" is an integral element of a proposal that I have developed with Christopher Mayer and Tomasz Piskorski of Columbia Business School. But the safe harbor in Section 6 is insufficient to assure that modifications will be done when they make economic sense. To begin with, Section 6 does not do enough to protect servicers from costly litigation or to give them economic incentives to modify mortgages. H.R. 703 should include a cost-shifting provision that reimburses the actual legal costs of servicers who are sued but successfully invoke the safe harbor. In addition, the bill should include an incentive program that increases the gain to servicers from successful mortgage modifications. Currently, many servicers prefer foreclosure to modification because they receive greater compensation from foreclosure.

Fourth, and finally, H.R. 703 should also include incentives that encourage second lien lenders to surrender their claims (and not hold up modification efforts by servicers of primary mortgages) when these second liens are unlikely to be paid anything in a foreclosure. Currently, an appreciable percentage of primary mortgages—both those that are privately securitized and those held by Fannie Mae, Freddie Mac, and other government-sponsored entities—are held by homeowners with second liens. Without the cooperation of second lien lenders, it is often difficult to modify primary mortgages.

1. WHY BANKRUPTCY CRAMDOWN IS COSTLY AND UNNECESSARY

There can be little doubt that we face a crisis in our housing markets. House prices dropped about 18 percent in the last year according to Case and Shiller/S&P, likely the largest national decline in prices since the Great Depression. This has led to a crisis of foreclosures, with 2.25 million foreclosures started last year[1] and another 1.7 million expected during 2009.[2] Foreclosures contribute to declining house prices, deteriorating communities, and failing banks.

The crisis is likely to deepen without prompt action. Housing prices have not hit bottom. As of September 2008, there were more than 2.2 million vacant homes, 4 million vacant rental properties, and 4.5 million houses on the market, unsold. Unless we take steps to reduce this massive inventory of homes, house prices will continue falling.

Nor have foreclosures hit their peak. As of October 2008, sixty-day delinquency rates exceeded thirty-three percent among the 2.8 million outstanding securitized subprime loans and seventeen percent among the 2.2 million securitized Alt-A loans. Equally important, many securitized option ARMs will hit negative amortization limits between 2009 and 2011. An option ARM gives the borrower the option to make monthly payments that are less than the accruing interest on the loan. The unpaid interest is added to the principal balance. If that balance grows sufficiently large relative to the original loan, it will hit a "negative amortization limit." Once that limit is reached, the homeowner is obligated to make large minimum monthly payments that assure full repayment of the mortgage over the remaining term. Many homeowners will soon be at their "negative amortization limits," and we can expect foreclosures to spike as homeowners suddenly face significantly larger monthly mortgage payments.

The housing crisis is an important social problem, meriting government intervention, for several reasons. First, as house prices fall, so does the wealth of homeowners and the assets of financial institutions. More than two-thirds of all American households own their own homes. Most homeowners have relatively modest stock and pension holdings; the bulk of their wealth is tied up in their homes. As house prices keep falling, these households suffer increasing wealth declines, making them more likely to retrench and cut spending.

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[1] http://www.federalreserve.gov/newsevents/speech/bernanke20081204a.htm

[2] http://www.nhc.org/Credit Suisse Update 04 Dec 08.doc

Additionally, the crisis in our financial sector is tied inextricably to the crisis in our housing markets. Home mortgages—and financial instruments tied to home mortgages—are a major asset of banks and other financial institutions. As home values fall and foreclosures spike, financial institutions see their balance sheets (and their ability to supply credit) deteriorate. As these institutions have suffered significant losses recently, they have necessarily reduced lending. This has led to government assistance through the TARP.

Immediate action is essential. But we need government policies that yield quick results without bankrupting taxpayers and our financial system. Cramdown legislation goes in the wrong direction. Bankruptcy amendments, allowing cramdown of home mortgages, would be costly, generate serious risks and unintended consequences, and likely delay the resolution of our housing crisis.

The government and motivated lenders already control most mortgages and have strong incentives to avoid unnecessary foreclosures. An oft-overlooked but important point is that we do not need the bankruptcy courts to intervene in the foreclosure process for most mortgages. Recent data show that taxpayers already control the fate of 35 million of the 55 million outstanding mortgages—nearly two-thirds of all mortgages—through Fannie Mae, Freddie Mac, and the FHA.[3] The government is therefore positioned to control the bulk of workouts without bankruptcy reform. Cramdowns would just delay this process, and in fact entangle the government in costly cramdown litigation. Additionally, taxpayers would bear the bulk of all losses from cramdowns.

Who holds the remaining third of outstanding mortgagees? Securitized lenders control about 8 million mortgages.[4] The remaining 12 million mortgages are presumably in the hands of private lenders, including not only the large money center banks, but also community banks and credit unions. These private lenders are taking aggressive, new efforts to modify loans. It is really only the privately securitized

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[3] According to the Mortgage Bankers Association, there are about 55 million mortgages outstanding. Fannie Mae and Freddie Mac control 30.7 million as of Sept 30, 2008 (http://www.fhfa.gov/webfiles/406/FederalPropertyMgrReport11609.pdf). The Federal Housing Administration controls another 4.8 million (http://portal.hud.gov/portal/page?_pageid=73,1828027&_dad=portal&_schema=PORTAL).

[4] Authors calculations from data from Black Box Logic, LLC as of October, 2008.

mortgages where modification efforts have been failing. In Section 3 below I show how H.R. 703 can be augmented to address these mortgages directly.

The government, accordingly, already has the power to mitigate foreclosures among the vast majority of mortgages. Indeed, President Obama has promised to spend between $50 billion and $100 billion reducing foreclosures as part of the second $350 billion that was authorized under TARP. The government, therefore, is preparing to allocate significant resources to reducing foreclosures among mortgages over which it has control. Among the remaining mortgages, a narrowly-tailored legislative strategy can mitigate foreclosures, as I discuss below. Bankruptcy cramdown, by contrast, will (i) undermine government efforts to modify mortgages that are already under its control and (ii) generate high costs and undesirable effects with respect to other mortgages.

Cramdown applies a costly one-size-fits-all approach to mortgage modification. The proposed bankruptcy reforms in H.R. 200 apply a one-size-fits-all approach to all mortgages. But different modification strategies may be appropriate for homeowners with different incomes and credit scores. Lenders and servicers have discovered this, especially during the past several months, as they have experimented with new strategies for minimizing losses to investors and default by homeowners. Introducing cramdown would inhibit this kind of experimentation. Proposed legislation[5] would invoke a standard set of modifications—reducing principal to current market value, reducing interest to the rate on conventional mortgages plus a reasonable risk premium, and extending the duration of the loan.

Some claim that a one-size-fits-all approach is actually a virtue, because it would be cumbersome and costly for judges (or trustees) to tailor mortgage modifications to the particular needs and abilities of homeowners. This claim, however, points to an additional problem with cramdown: it imposes burdens that bankruptcy judges and trustees are unable to shoulder.

An overwhelmed judiciary may lead to delayed resolutions. Bankruptcy reform would likely delay the resolution of the crisis for years, especially if millions of borrowers file for Chapter 13 bankruptcy. Currently the federal judiciary has 368

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[5] See House Bill H.R. 200, the "Helping Families Save Their Homes in Bankruptcy Act of 2009."

bankruptcy judges.[6] During the 12-month period ending June 30, 2008, there were 967,831 bankruptcy filings.[7] Thus the average judge managed 2,630 bankruptcy filings in the past year, even without home mortgage cramdowns. Now these judges would be asked to oversee a new process on potentially millions of additional filings.

Some cramdown advocates believe that it would not impose excessive burdens on bankruptcy judges and trustees. They point to the fact that, in the current environment, judges already handle massive caseloads. Yet this massive caseload has prompted Congressional hearings on the excessive burden shouldered by bankruptcy judges.[8] As well, more than two-thirds of bankruptcy plans fail, suggesting that it is not easy to increase judicial caseloads without adding significant cost to the bankrupt process. And while some advocates of cramdown downplay its judicial burden, others seem to point to this burden as a reason why a one-size-fits-all approach is actually a virtue, because it reduces the complexity of mortgage modification in bankruptcy courts.[9] When advocates of cramdown have conflicting views on its virtues and costs, policymakers should take seriously alternative policies, such as the one I propose below.

Losses to taxpayers and lenders could be enormous and unnecessary. Proponents of bankruptcy reform believe it would impose no (or minimal) costs on taxpayers. That is untrue. Cramdown may be no more costly than *doing nothing* about the foreclosure crisis. But doing nothing is not the only alternative. There are many alternatives, such as

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6 The most recent data we could find are from Sept. 30, 2007, and appear in "Judicial Business of the United States Courts" by the Administrative Office of the U.S. Courts, available at http://www.uscourts.gov/judbus2007/contents.html. This publication reports that Congress has authorized the appointment of 352 bankruptcy judges. However, as of Sept. 30, 2007, there were 11 vacancies. In addition, 27 retired bankruptcy judges had been "recalled" to serve on a part-time or full-time basis. This means that there were (352-11)+27=368 judges handling bankruptcy cases as of Sept. 30, 2007.

7 This statistic is reported by the Administrative Office of the U.S. Courts at http://www.uscourts.gov/bnkrpctystats/statistics.htm#calendar

8 See, e.g., Statement of Judge Michael J. Melloy before the Subcommittee on Commercial and Administrative Law, Committee on the Judiciary, U.S. House of Representatives (May 22, 2003).

9 Statement of Rep. Brad Miller before the Committee on the Judiciary (Jan. 22, 2009) ("One witness today criticizes the legislation before this committee as 'one size fits all.' Mr. Chairman, with ten million families facing foreclosure, we can't afford a lot of elaborate, individualized tailoring.").

the one I discuss in Section 3 below. Relative to these alternatives, cramdown exposes taxpayers to enormous losses. This is true for two reasons.

First, taxpayers lose money when mortgage lenders and investors lose money. This is because the federal government has loaned to or guaranteed the debt of many major financial institutions that participate in mortgage markets:

- Outstanding debt and mortgage guarantees from Freddie Mac and Fannie Mae represent more than $5 trillion.
- The Federal Housing Authority originated hundreds of billions of loans that are now at risk.
- The FDIC has many billions more at risk as a result of loan guarantees issued during the takeovers of Indy Mac, Washington Mutual, and other failed lenders.
- The government has guaranteed loans to AIG, Citigroup, and now Bank of America. Future efforts to save the banking system would undoubtedly cause taxpayers to shoulder further mortgage-related losses due to cramdown.
- The Federal Reserve has risks from former Bear Stearns securities and many other securities it now holds as collateral.

We therefore need a policy that minimizes losses to investors, while at the same time avoiding as many foreclosures as possible.

Second, cramdown exposes lenders to greater losses than alternative policies. Although housing prices fluctuate, mortgage cramdown, by definition, results in a permanent reduction in principal. Many lenders have developed mortgage modification strategies that are as effective as cramdowns but less expensive to lenders. Many of these strategies, such as forbearance, do not involve principal write-downs. The FDIC/Indy Mac program, for example, provides for reductions in interest rates and forbearance on principal payments.[10] The recently announced effort by JP Morgan/Chase uses a similar strategy of loan forbearance. Many of the Bank of America

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[10] Forbearance reduces the amount of principal that a lender applies interest to when computing monthly mortgage payments.

and Citigroup modifications to subprime loans involve interest rate reductions rather than principal reductions. Fannie Mae and Freddie Mac have rolled out their own programs that do not rely on principal write-downs.

Different modification strategies, therefore, will be appropriate for different borrowers, in order to simultaneously avoid foreclosure and minimize losses to lenders. Bankruptcy cramdown, as noted above, does little (or nothing) to tailor modifications to the needs and abilities of borrowers. It instead applies a costly, one-size-fits-all approach.

Equally important, once cramdown is an option, it will prevent other kinds of modifications that are less costly but equally effective. Borrowers have little incentive to accept a lender's modification proposal when they can go to bankruptcy court and have a judge strip down their principal balances to conform to a *temporary* condition in the housing market. If the borrower has already defaulted, the costs of a bankruptcy filing will be small relative to the gains available from cramdown, which allows for a permanent reduction in the principal balance on the mortgage. When housing prices rise again, as they eventually will, the borrower will enjoy most of this appreciation if the home is sold more two years after the Chapter 13 filing (and all of the appreciation if it is sold more than four years after the filing). Cramdowns will have eliminated the possibility that a lender can ever recover its losses on borrowing. This is deeply problematic because (i) cramdowns are no more effective than less costly alternatives and (ii) the higher costs of cramdowns are borne by taxpayers.

Moral hazard could make the situation worse. Up to twelve million homeowners hold mortgage debt that exceeds the value of their homes.[11] These homeowners have negative equity. Yet most of these homeowners are still current on their mortgages, because (thus far) only about four million borrowers are 60 days or more delinquent.[12] Although they are current on their mortgages, homeowners with negative equity may find bankruptcy attractive once cramdown is possible. They may stop paying their mortgages—or at least stop paying before taking other, difficult steps to address their financial difficulties. If they do stop paying, bankruptcy filings will

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[11] This estimate is provided by Moody's Economy.com and reported in CNNMoney.com.
[12] In December 2008, the Mortgage Bankers Association reported a delinquency rate equal to 6.99 percent. With 55 million outstanding mortgages, this implies that 3.85 million mortgages were delinquent at that time. The number is likely significantly higher today.

surge dramatically. This is not a hypothetical. The 1990s saw bankruptcy filings surge as credit card debts mounted. Many individuals viewed bankruptcy as a low-cost avenue for discharging these debts. It would be troubling if we saw the same occur with respect to mortgage debts. The losses to investors (and taxpayers generally) would be large.

Cramdown legislation could delay the foreclosure crisis and generate a massive number of bankruptcy filings. Bankruptcy is no panacea for consumers. Around two-thirds of all Chapter 13 cases terminate prematurely,[13] often leading to a Chapter 7 liquidation or a state-law foreclosure, and leaving creditors in a much worse position relative to having addressed the problem at the time of the original bankruptcy filing.

Equally devastating, third-party servicers might find it more attractive to deal with a homeowner in bankruptcy than to attempt a loan modification outside of bankruptcy. Proponents argue that bankruptcy reform would give borrowers a tool to fight back against servicers. Yet, the opposite could be the case. Servicers might prefer bankruptcy to loan modification for the same reason that servicers now prefer foreclosure to modification. Under most securitization agreements, servicers would likely be able to recover expenses incurred in connection with a homeowner's bankruptcy filing, just as they now recover expenses incurred in connection with a foreclosure. There is no reimbursement for costs incurred in performing a loan modification. This could result in millions of Chapter 13 bankruptcy filings that harm consumer credit and appreciably delay resolution of the crisis.

The cost of future credit could rise significantly, especially for individuals with imperfect credit records. Empirical evidence suggests that if mortgages are subject to strip-down in bankruptcy, the cost of future credit will rise as lenders incorporate this new risk into their lending decisions.[14] Future mortgage amounts will be smaller and borrowing costs will be higher. While many would argue that cheap and easy credit was what got us into this economic crisis, lenders are likely to raise the cost of

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[13] Wenli Li, *What Do We Know About Chapter 13 Personal Bankruptcy Filings*, Bus. Rev., 4th Quarter, p. 19 (2007)

[14] *See* Tables 2a and 4a of Adam J. Levitin and Joshua Goodman, "The Effect of Bankruptcy Strip-Down on Mortgage Markets," Georgetown University Law Center, Business, Economics and Regulatory Policy Working Paper Series Research Paper No. 1087816 (2008). *See also* Karen Pence, *Foreclosing on Opportunity: State Laws and Mortgage Credit*, 88 Rev. Econ. & Stat. 177 (2006).

borrowing already as a result of this crisis. Bankruptcy reform would increase borrowing costs further, resulting in even less borrowing and likely further reduce demand for housing.

To be sure, H.R. 200 applies only to mortgages originated before its effective date. But it seems likely that Congress will face strong pressure, in the future, to apply cramdown to mortgages originated after that date. This is especially likely if the housing crisis continues, and bankruptcy cramdown legislation could contribute to a delayed resolution of the crisis.

2. IT IS UNNECESSARY TO SALVAGE THE HOPE FOR HOMEOWNERS ACT

In its current form, and in the form proposed by H.R. 703, the Hope for Homeowners Act will likely generate large costs and small benefits. Costs are large because taxpayers will bear the risk of redefault after the FHA refinances the homeowner's mortgage, and CBO estimates point to a fairly high (forty percent) re-default rate. Benefits are small from the Act because it, like bankruptcy cramdown proposals, applies a one-size-fits-all approach to mortgage modification. Only one kind of modification is permitted: a reduction in principal to ninety percent (ninety-three percent under H.R. 703) of current appraised value and refinancing the mortgage as a fixed-rate thirty-year mortgage (longer durations are possible). Less aggressive modifications can be just as successful in averting foreclosure, but less costly to investors and taxpayers. I outline an approach that is more effective and less costly in Section 3 below.

3. SECTION 6 OF H.R. 703 SHOULD BE THE FOCUS OF POLICY REFORMS NOW.

H.R. 703 points in the right direction. Section 6 would create a "safe harbor" for servicers who modify mortgages in a reasonable, good faith belief that modification will increase recoveries from the mortgages, on a net present value basis, relative to foreclosure. The safe harbor would insulate these servicers from legal liability, even if modifications are prohibited by their agreements with securitization trusts or investors.

This is an essential first step towards a comprehensive policy for addressing the foreclosure crisis. But it is only a first step. In a new proposal—co-authored with Christopher Mayer and Tomasz Piskorski of Columbia Business School—I identify the next steps. The proposal has two parts. The first eliminates barriers to modification among *primary* mortgages that have been privately securitized. The second clears another important obstacle to modification of primary mortgages: resistance by *second* lien lenders. I briefly outline my proposal below. A detailed description, along with supplemental cost-benefit calculations and constitutional analysis, is attached to this testimony.

Part 1: Addressing Foreclosures Among Securitized Primary Mortgages

Privately securitized mortgages lie at the core of the housing crisis, accounting for more than 50 percent of foreclosure starts. Recent research shows that when these mortgages become delinquent, servicers opt for foreclosure over mortgage modification much more often than private lenders who service their own mortgages.[15]

The solution to this problem is to facilitate modification by:

1. ***Compensating servicers who modify mortgages***. Using TARP funds, the federal government should increase the fee that servicers receive from continuing a mortgage and avoiding foreclosure, thereby aligning servicers' incentives with the interests of borrowers and investors. The increased fee—an Incentive Fee—should equal ten percent of all mortgage payments made by borrowers, with a cap for each mortgage of $60 per month ($720 per year). Servicers should also receive a one-time payment equal to twelve times the previous month's Incentive Fee if the borrower prepays the mortgage, rewarding servicers that accept short sales. These payments would be in addition to the normal servicing fees as specified by the PSA. This Incentive Fee program should exist for only three years, after which improvements in the economy will likely reduce the need for it.

2. ***Removing legal constraints that inhibit modification***. The federal government should enact "safe harbor" legislation that eliminates explicit restraints on modification and creates a safe harbor from litigation for reasonable, good faith modifications that raise returns to investors. This safe harbor should be an affirmative defense, which servicers can assert in the event of litigation. If investors bring suit, but a servicer successfully

[15] See "Securitization and Distressed Loan Renegotiation: Evidence from the Subprime Mortgage Crisis" by Tomasz Piskorski, Amit Seru, and Vikrant Vig available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1321646

> invokes the safe harbor, the investors will pay the servicer's actual legal costs, including attorney and expert-witness fees. Investors, of course, will need adequate information to assess whether litigation is appropriate. Therefore, the safe-harbor legislation should require servicers to make public the details of any modification.

Together, the Incentive Fee and the Safe Harbor will prevent up to one million foreclosures over three years, at a cost of no more than $10.7 billion.

H.R. 703 tracks part, but not all, of our proposal. Section 6 offers a safe harbor that is similar to the one we propose, but is missing two key elements. First, it does not require plaintiff-investors to reimburse the legal costs of defendant-servicers who successfully invoke the safe harbor in a court of law. Second, it does not require servicers to publish detailed information about their modification efforts. Both elements are essential to a meaningful safe harbor.

More importantly, H.R. 703 offers no Incentive Fees to servicers. Without Incentive Fees, servicers will be reluctant to pursue modification, even if they enjoy the protection of a safe harbor. This is because most securitization agreements compensate servicers for costs incurred during the foreclosure process, but not for expenses associated with loan modification. Even if modification is successful, it typically does not generate sufficient fees to cover the costs of modification. Consequently, servicers often choose to foreclose, even when modification makes good economic sense for borrowers and investors.

Our Incentive Fee proposal would strongly encourage servicers to modify mortgages when it makes economic sense. Servicing fees would more than cover the direct costs of modifications, estimated to be as much as $750 to $1,000.[16] Equally important, the Incentive Fee proposal better aligns servicers' interests with those of investors by giving them a percentage of all cash flow. By paying an Incentive Fee only when borrowers make payments, we reward successful modifications. A servicer whose loan modifications are unsuccessful and result in a quick re-default would collect few

[16] See for example Barclays 2008 Global Securitization Annual.

Incentive Fees.[17] Our proposal, therefore, rewards servicers for keeping future payments as high as possible without putting the homeowner in a position where he or she is likely to re-default soon after modification. This is exactly the tension that a portfolio lender deals with in its own loans. Of course, there will still be circumstances when costly foreclosure will be unavoidable, but the Incentive Fee will encourage servicers to look for other options.

Part 2: Addressing Second Liens as Obstacles to Modification

There is one other appreciable barrier to modifications that appears to be a major concern—the existence of second liens on properties with a delinquent or potentially delinquent first mortgage. According to our calculations from deeds records, about one-third of mortgages originated after 2000 have either a second lien or a piggyback loan (a piggyback loan is a second lien that is taken on at the same time as the first mortgage).[18] Typically, these loans provided additional credit for homeowners to purchase the house or to finance additional expenditures after the purchase.

Second liens can be a barrier to successful modifications of first mortgages. There are some cases in which modification of the first mortgage might yield greater recovery than a foreclosure to first mortgage lenders, but the servicer of the first mortgage is unwilling to pursue modification unless the second lien lender agrees to relinquish its claims. If the second lien lender does not relinquish (or reduce) its claim, a modification of the first mortgage will just allow the homeowner to allocate more of her income to the second lien.

Even if the first mortgage exceeds the home's expected foreclosure value—implying zero recovery to the second lien lenders in foreclosure—the second lien servicer has little incentive to agree to a modification that extinguishes the second lien. As long as there is some uncertainty surrounding foreclosure value, no matter how small, the servicer of the second lien would prefer foreclosure to loan modification. The former offers a slight chance of recovery to second lien lenders; the latter offers no recovery. Moreover, the terms of securitization agreements might prevent the second

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[17] Evidence suggests that more than one half of loan modifications in the first quarter of 2008 re-defaulted within 6 months, so it is important only to reward servicers for pursuing successful loan modifications (OCC/OTS Report, 12/2008).

[18] About 81 percent of mortgages with a second lien have only a second lien, while another 15 percent have a second and third lien, and 4 percent have 3 or more additional liens.

lien servicer from agreeing to any modification that extinguishes the mortgage. Finally, by delaying and appearing obstinate, the second lien lender might convince the first mortgage servicer to "buy out" the second lien at a price above its true value. This is often called a "hold-up" problem.

Professors Mayer and Piskorski and I have developed a new, voluntary proposal that would give second lien lenders financial incentives to relinquish their claims whenever a first mortgage servicer pursues modification. Under our proposal, the government would pay compensation to a second lien holder who agrees to relinquish all of its claims against the home and the borrower. This compensation would equal five percent of the current balance of the second lien, capped at $1,500 per property. If multiple liens exist, this payment would be split between the liens. This compensation could be paid using TARP funds.

In order to limit taxpayer costs, and focus primarily on foreclosure prevention, we would limit compensation to second lien lenders who relinquish their claims in response to a decision by the first mortgage servicer to conduct a significant modification of the primary mortgage. By significant, we mean a modification that reduces the borrower's monthly payments by at least 10 percent. This program would only apply to primary residences. As well, compensation would be available only when the first and second liens are held by different lenders. Finally, our proposal would apply to all second liens, because the hold-up problem poses an appreciable barrier to modification beyond just privately securitized mortgages.

This proposal would deal with the one remaining impediment to loan modifications—second liens—that impacts all mortgages. Our proposal would facilitate up to 1.1 million mortgage modifications at a cost of approximately $1.65 billion.[19] This

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[19] We compute the cost of compensation as follows. Using deeds records, we estimate that about 13.3 million homes are subject to both first mortgages and second liens as of October 2008. Among these homes, 8.9 million homes have loan-to-value ratios exceeding 92 percent. (In our calculations, we assume a loan-to-value ratio equal to 92 percent; this allows for future house price declines of 8 percent or more.) When the loan-to-value ratio is only 92 percent, a second lien lender is unlikely to agree to relinquish its claim, for obvious reasons. We assume that around one-quarter of these mortgages are at risk of foreclosure. Among those, modification might make sense half of the time. Thus about 1.1 million second lien mortgages might require compensation for the relinquishment of their rights. If all second lien holders agree to relinquish their rights, the total cost of compensating them will be no more than $1.65 billon.

cost is quite moderate compared to the possible expenditure of $50 to $100 billion to reduce foreclosures. Our proposal is superior to bankruptcy cramdown for many of the same reasons that cramdown does not make sense for primary mortgages.

CONCLUSION

The Administration and Congress must take immediate action to address the foreclosure crisis. House prices continue to spiral downward in much of the country. Foreclosures are taking place at an alarming rate and will grow if we do not act quickly.

But quick action must be accompanied by sensible, narrowly-tailored policies that minimize the impact on taxpayers. Bankruptcy cramdown reforms will only delay resolution of the current crisis and impose large, avoidable costs on taxpayers.

Instead, the Administration and Congress should build on Section 6 of H.R. 703, which points to an effective, low-cost strategy. This strategy includes a safe harbor for servicers, much like the one set out in Section 6, but also (1) an incentive plan that encourages sensible loan modifications, (2) a cost-shifting provision that reimburses the actual legal costs of servicers who are sued even though they are acting consistent with the terms of the safe harbor, and (3) a separate incentive plan that encourages second lien lenders to cooperate when servicers attempt to modify primary mortgages. Elements (1) and (2) of this strategy can prevent up to one million foreclosures at a modest cost to taxpayers of $10.7 billion. Element (3) would facilitate as many as 1.1 million loan modifications at a cost of $1.65 billion. Together these programs put us on the road to recovery.

I am grateful for the opportunity to address you today and look forward to answering your questions.

Draft 11: January 6, 2009

A New Proposal for Loan Modifications

by Christopher Mayer, Edward Morrison, and Tomasz Piskorski[*]

Executive Summary

We are witnessing an unprecedented housing and foreclosure crisis, with 2.25 million foreclosures started last year and at least 1.7 million foreclosure starts expected this year. Privately securitized mortgages are at the core of the problem. These mortgages—which were originated without a guarantee from government-sponsored entities—account for more than one-half of foreclosure starts, despite accounting for about fifteen percent of all outstanding mortgages. Servicers of these securitized mortgages make the critical decision of what to do when a mortgage becomes delinquent; choosing to pursue a foreclosure or a modification of the mortgage. Existing research suggests that these servicers opt for foreclosure much more often than private lenders that service their own mortgages. While Fannie Mae, Freddie Mac, the FHA, and private lenders are actively and aggressively pursuing mortgage modifications, servicers of securitized loans are still lagging behind.

Two factors are driving servicers' reluctance to modify loans when modification makes economic sense. First, servicers are not properly compensated for loan modification. Second, legal constraints prohibit many servicers from pursuing modification. Even when legal constraints are absent, significant litigation risk attends any loan modification.

Securitization investors are undoubtedly aware of these problems, which reduce their returns. But the number of investors is so large—and their interests so divergent—that they are unable to reach consensus in favoring of rewriting securitization agreements and giving servicers greater freedom to modify loans. The typical securitization has as complicated a capital structure as many corporations. No one is surprised when a troubled corporation needs government assistance (via Chapter 11 reorganizations) to rewrite contracts with investors. It is simply too costly and complicated to reach a consensus among investors without government assistance.

We propose a comprehensive solution to this crisis:

1) **Compensate servicers who modify mortgages.** Using TARP funds, the federal government should increase the fee that servicers receive from continuing a mortgage and avoiding foreclosure, thereby aligning servicers' incentives with interests of borrowers and investors.

2) **Remove legal constraints that inhibit modification.** The federal government should enact legislation that modifies existing securitization contracts. The legislation should

[*] Mayer- Senior Vice Dean and Paul Milstein Professor of Real Estate, Columbia Business School; Morrison- Professor of Law, Columbia Law School; Piskorski- Assistant Professor, Columbia Business School. The authors wish to thank Adam Ashcraft, Richard Epstein, Andrew Haughwout, Glenn Hubbard, Thomas Merrill, Gillian Metzger, Henry Monaghan, Karen Pence, Amit Seru, Joseph Tracy, and Vikrant Vig for helpful thoughts and comments and Rembrandt Koning, Benjamin Lockwood, Bryan McArdle, Ira Yeung and Michael Tannenbaum for excellent research assistance. The authors alone take responsibility for this proposal and any errors or omissions therein.

eliminate explicit restraints on modification and create a safe harbor from litigation that protects reasonable, good faith modification that raises returns to investors.

We estimate that our plan will prevent nearly one million foreclosures over three years, at a cost of no more than $10.7 billion. It also raises no constitutional concerns, because it builds on well-established Supreme Court case law.

It is important to emphasize that our proposal benefits homeowners as much as it helps servicers and investors. A homeowner is a prime candidate for loan modification when her income is sufficient to make payments that, over time, exceed the foreclosure value of her home. This standard—payments exceeding the home's foreclosure value—is the same standard applied in proposals to change the Bankruptcy Code.

But proposals to change the Bankruptcy Code are deeply problematic. These proposals would allow homeowners to strip-down mortgages to the current home value and reduce interest rates. These proposals would raise future borrowing costs and could encourage solvent borrowers to miss payments (a form of moral hazard). The financial crisis would be much worse if fifty-two million borrowers, who are now current, attempt to invalidate their mortgages. Equally important, proposals to change the Code could dramatically increase bankruptcy-filing rates. Servicers will prefer mortgage modification in bankruptcy because their expenses are reimbursed in bankruptcy, not outside it. Thus, proposed reforms could push millions of borrowers into bankruptcy, delaying the resolution of the current crisis for years. Finally, bankruptcy reform is a blunt tool: it applies a one-size-fits-all approach to loan modification, and it would impact all mortgages, including the majority of outstanding loans now owned by Fannie Mae and Freddie Mac. The federal government can already encourage effective mortgage modifications through its conservatorship of these organizations, while taxpayers would likely be on the hook for losses to GSE mortgages through the bankruptcy process. Banks are now aggressively modifying their own mortgages.

Another alternative, the FDIC proposal, has many virtues but would have limited success and high costs. This proposal would pay servicers $1,000 for every modified loan, and would have the government share up to fifty percent of losses from unsuccessful modifications. This proposal does nothing to eliminate legal barriers, which would continue to deter modification. Further, the costs to taxpayers would be very large. The government, not investors, would bear the costs of failed modifications.

Introduction

The recent flood of foreclosures has reached crisis levels, with 2.25 million foreclosures started last year (Federal Reserve) and the forecast of 1.7 million foreclosures started in 2009 (Credit Suisse Foreclosure Update). Foreclosures contribute to falling house prices and deteriorating communities. Policy makers have struggled to stem this rising tide. Despite good intentions and appreciable effort, public policy to encourage write-downs or other loan modifications by servicers has had limited success.

Much research has pointed to falling house prices as a key contributor to the foreclosure crisis (Gerardi, Lehnert, Sherlund, and Willen). While government policy cannot restore house prices to their previous levels, policies that restore the normal functioning of the mortgage market can help stabilize house prices and reduce the likelihood of future defaults and foreclosures (Hubbard and Mayer). Nonetheless, even in the most optimistic scenario, we likely face millions of defaulting mortgages in the coming years.

We offer a new approach to foreclosure prevention that focuses on what has been the most intractable part of the foreclosure problem: the behavior of third-party servicers who manage portfolios of securitized portfolios. Why focus on servicers of securitized mortgages? Because securitized subprime, alt-A, and prime/jumbo loans accounted for more than one-half of foreclosure starts in 2008 despite representing about fifteen percent of all outstanding mortgages.[1] While the Fannie Mae, Freddie Mac, the FHA, and the largest private banks and portfolio lenders have announced their own aggressive programs to pursue mortgage modification, servicers of securitized mortgages lag behind.

We must address the foreclosure problem for securitized mortgages now, because the forecast for 2009 is even bleaker. As of October 2008, more than one-third of the 2.8 million outstanding securitized subprime loans and seventeen percent of the 2.2 million securitized alt-A loans were sixty days or more delinquent (Federal Reserve Bank of NY). Even worse, many of the alt-A option ARMs will hit their negative amortization limits between 2009 and 2011, resulting in rising payments and likely much higher default rates. Rumors suggest that some smaller servicers will soon face bankruptcy.

Our approach to combating foreclosures builds on recent research showing that portfolio lenders—lenders who service loans that they own—are significantly more successful in stemming foreclosures than third-party servicers, who service loans owned by other parties (Piskorski, Seru, and Vig). The researchers show that portfolio lenders achieve foreclosure rates that are nineteen to thirty-three percent lower than the rates experienced by third-party servicers. In fact, portfolio lenders are even more successful in reducing foreclosures for the highest quality loans, where current delinquency rates are rising the fastest (portfolio lenders achieve foreclosure rates thirty to fifty percent lower than third-party servicers). Finally, as we explain below, recent efforts to avoid foreclosures appear to be more successful. Portfolio lenders have rolled out programs applying forbearance and principal reduction to their own portfolios.

Third-party servicers, however, are often unable or unwilling to use the same tools as portfolio lenders are currently using.[2] Recent research also documents the failures of servicers to

[1] According to the Mortgage Bankers Association, about 1.64 million loans started the foreclosure process as of the third quarter of 2008. Our own calculations from data obtained from Braddock Financial shows that about 900,000 securitized loans began the foreclosure process as of October, 2008.
[2] Of course, many other foreclosures come from FHA programs and Fannie Mae and Freddie Mac, where the government already has appreciable influence in guiding programs to reduce foreclosures.

successfully modify loans. (See research by Alan White as well as a recent update.) White shows that loan modifications by servicers rarely reduce principal and many loan modifications raise payments, rather than lower them. His report provides great detail on the failings of servicers of securitized mortgages.

Our proposal eliminates barriers that prevent third-party servicers from effectively managing the foreclosure crisis. Commentary and evidence suggests servicers face two appreciable barriers: 1) Servicing contracts makes little economic sense in the current crisis. No one anticipated the extent of the current crisis and servicers are poorly compensated as a result. As well, servicers have too few incentives to pursue loan modification instead of foreclosure, even when modification makes good economic sense for investors. Most securitization agreements compensate servicers for costs incurred during the foreclosure process, but not for expenses associated with loan modification. Even if modification is successful, it typically does not generate sufficient fees to cover the costs of modification. Consequently, servicers often choose to foreclose, even when modification makes good economic sense for borrower and investors. 2) Servicers face explicit and implicit legal barriers to modifying mortgages successfully. Some pooling and servicing agreements (PSAs) place explicit limits on loan modifications. In other cases, vague provisions in the PSAs, and the consequent threat of lawsuits, serve to limit servicers' ability to modify loans successfully.

These barriers could be overcome if investors agreed to rewrite their PSAs. But a rewrite typically requires unanimous investor consent, especially if it would give servicers freedom to reduce principal or interest rates. This unanimity requirement serves as another barrier to successful loan modification. The typical mortgage pool has issued many securities in as many as twenty or more tranches, which have different priorities with respect to interest or principal, or both. The number of investors is so large—and their interests so divergent—that consensus is a near-impossibility. Put differently, mortgage securitization has dramatically increased the number of creditors to whom a homeowner is indebted. The typical securitization has as many creditors, and as complicated a capital structure, as many large corporations. No one is surprised when a distressed corporation—whether a small business or General Motors—is unable to convince creditors to rewrite their debt contracts. There are too many creditors with divergent interests. This is why we have Chapter 11 bankruptcy, which gives corporations power to rewrite contracts. Today, securitizations face precisely the same problem as General Motors: there is no way (at a reasonable cost) to reach a consensus among creditors. But homeowners bear the consequences of this standstill.

This is why government intervention is needed. We propose two steps to get around the barriers to successful loan modification: 1) an Incentive Fee structure that increases payments to servicers and better aligns their incentives with investors, and 2) a Legislative Proposal that removes explicit barriers to modification in PSAs and that reduces the litigation exposure of servicers who do modify loans.

Our proposal might prevent as many as one million foreclosures at a cost of no more than $10.7 billion that can be funded by TARP money. Other proposals do not address both barriers that servicers face. As well, our proposal would cost taxpayers considerably less money than other programs currently under consideration, with no requirement to provide costly loan guarantees. Losses for bad loans remain with private investors rather than taxpayers.

Our Proposal in Detail

Servicer Incentive Fees: We believe that servicers need greater resources and stronger incentives to modify loans. We propose that servicers of privately securitized mortgages be paid a monthly Incentive Fee equal to ten percent of all mortgage payments made by borrowers, with a cap for each mortgage of $60 per month ($720 per year). The servicer would also receive a one-time payment equal to twelve times the previous month's Incentive Fee if the borrower prepays the mortgage. These payments would be in addition to the normal servicing fees as specified by the PSA. The program would be limited to any securitized mortgage that is below the conforming loan limit at the origination date. The Incentive Fees, which would equal about $9 billion (see Appendix 2), can be paid from money authorized under the US Treasury's TARP program. The Incentive Fees should remain in place for a period of three years, after which improvements in the economy will likely reduce the need for the incentive program.

Our Incentive Fee program would substantially encourage servicers to modify mortgages. Servicing fees would now more than cover the direct costs of modifications, estimated to be as much as $750 to $1,000.[3] Equally important, the Incentive Fee program better aligns servicers' interests with those of investors by giving them a percentage of all cash flow. By paying an Incentive Fee only when borrowers make payments, we reward successful modifications. A servicer whose loan modifications are unsuccessful and result in a quick re-default would collect few Incentive Fees.[4] Our proposal, therefore, rewards servicers for keeping future payments as high as possible without putting the homeowner in a position where he or she is likely to re-default soon after modification. This is exactly the tension that a portfolio lender deals with in its own loans. Of course, there will still be circumstances when costly foreclosure will be unavoidable, but the Incentive Fee will encourage servicers to look for other options.

Our proposal increases servicer fees in much the same way that fees are elevated in some securitizations in which investors have been able to coordinate as a group. However, appreciable barriers—such as hold-up problems and conflicts of interest across various tranche holders—prevent coordination in the bulk of securitizations.

Our proposal also encourages short sales if they make economic sense. If a borrower prepays a mortgage for any reason, the servicer would receive a one-time Incentive Fee equal to twelve times the previous month's Incentive Fee. A prepayment could occur because for two reasons: the borrower may refinance the mortgage, or he or she may pursue a short sale. In some cases, short sales can make sense for both borrowers and lenders. The one-year Incentive Fee encourages a lender to accept a short sale when the alternative is a more expensive foreclosure. The lump sum Incentive Fee also ensures that loan modification costs are covered for borrowers who are likely to prepay.

Finally, our Incentive Fee program would apply only to securitized mortgages that fell below the conforming loan limit in the year in which the loan was originated. So-called jumbo mortgages do not face the same incentive problems as subprime and alt-A mortgages with lower loan balances. In particular, with an average mortgage balance exceeding $500,000, servicers receive much greater financial benefits when they modify a jumbo mortgage. Keeping a jumbo mortgage in the securitized pool instead of foreclosing can result in annual payments of $1,250

[3] See for example Barclays 2008 Global Securitization Annual.

[4] Evidence suggests that more than one half of loan modifications in the first quarter of 2008 re-defaulted within 6 months, so it is important only to reward servicers for pursuing successful loan modifications (OCC/OTS Report, 12/2008).

or more, enough to justify substantial effort by servicers to modify troubled mortgages. As well, the volume of jumbo mortgage defaults is lower, enabling servicers to give these loans more attention. Servicers of jumbo loans, however, would still see substantial legal relief from the second part of our proposal, described next.

Legislative Proposal: We propose specific, temporary legislation to eliminate legal barriers to loan modification in PSAs for all securitized loans. We believe that Congress has the authority, under the Commerce and Spending Clauses, to modify the terms of securitization contracts.

We propose two kinds of legislated changes to PSAs. First, Congress should enact legislation that eliminates explicit limits on modification, including both outright prohibitions and provisions that constrain the range of permissible modifications. The legislation should be temporary, lasting only three years. Second, Congress should create a "litigation safe harbor" that insulates servicers from costly litigation, provided they modify loans in a reasonable, good faith belief that they are acting in the best interests of investors as a group. The safe harbor is an affirmative defense, which servicers can assert in the event of litigation. Importantly, the defense is based on evidence that the servicer held a reasonable, good faith belief in the benefit of modification, not on evidence that the modification was in fact successful or not. If investors bring suit, but a servicer successfully invokes the safe harbor, the investors will pay the servicer's actual legal costs, including attorney and expert-witness fees.

Investors will, however, need information about modifications in order to assess their reasonability. Our proposal therefore requires servicers to make public the details of any modification. This reporting requirement will not only help investors understand and evaluate modifications, but will also provide useful information to other servicers and lenders, who can study previous modifications, assess what works and what does not, and thereby develop successful standards for the future.

We also recommend that servicers halt foreclosure proceedings during the first few months after our proposed legislation becomes effective. Servicers will need time to assess whether pending foreclosures should be halted in favor of modification that advances the best interests of investors.

Our Legislative Proposal raises no meaningful constitutional concerns and has been vetted by leading constitutional scholars. The Proposal is a temporary program to moderate an avalanche of foreclosures during an economic crisis. It is more tailored and potentially less burdensome on investors than temporary legislation enacted during the Great Depression and upheld by the Supreme Court. Indeed, our program should benefit investors, because it fosters loan modification only when it increases returns—relative to foreclosure—to investors as a group. Appendix 3 presents our legal analysis in detail and presents specific legislation.

These two elements of our Legislative Proposal address a number of flaws in existing PSAs, which were created when investors and underwriters did not envision a housing collapse of the magnitude we are now seeing. Although the proposed legislation will abrogate contractual rights of investors, it will also free servicers to undertake loan modifications that increase payments—relative to a foreclosure—to investors as a group. Thus, the bulk of investors will benefit from this legislation, despite the loss of contractual rights.

Most PSAs do not explicitly limit modifications, but instead contain vague language that can paralyze servicers. With respect to these securitizations, our proposal can best be viewed as clarifying the interpretation of the PSAs. For example, the typical PSA advises the servicer to act in the "best interests" of the securitization trust. Yet the contracts do not specify what counts as the "best interests" of the trust. Modification could reduce the cash flow rights of some investors, particularly junior-tranche investors, relative to foreclosure. These investors can often expect a share of coupon payments during the foreclosure process, which can last eighteen months. Modification might eliminate these cash flow rights. Indeed, some junior tranche holders have sued servicers that actively pursue modifications. Our legislative proposal (a) clarifies that servicers' primary duty is to act in the economic interest of investors as a group and (b) provides protection against lawsuits when the servicer can show that its actions were consistent with this duty.

Our Legislative Proposal is slightly more complicated for the minority of PSAs that contain explicit provisions barring modifications. These provisions can include outright prohibitions on modification, caps on the number of mortgages that can be modified (e.g., five percent of the pool), limits on the frequency of modifications (e.g., no more than once during a twelve month period), limits on the range of permissible modifications (e.g., the modified interest rate cannot fall below a set floor), and requirements that a servicer purchase any modified loans—at par value—from the securitization trust. Our proposal will abrogate provisions like these. It is important to note, however, that our legislation enables modification only when it increases overall investor value. To be sure, some junior tranche holders might be harmed. But this effect of our proposal likely raises no constitutional concerns. Moreover, we believe that our proposal makes sense given the economic crisis we are facing in the housing market. The benefits from modification far outweigh the burdens on a small class of investors. Nonetheless, we believe that policymakers should provide compensation to these investors, who have suffered economic losses.[5] Note, however, that compensation to junior-tranche investors will be necessary only when legislation abrogates contractual provisions that would have guaranteed, absent abrogation, cash flow rights to these investors. Our computations indicate that the total cost of this compensation would be no more than $1.7 billion (see Appendix 4).

<u>Cost-Benefit Analysis</u>

Our plan can reduce foreclosures by between 675,000 and one million at a cost of about $9 billion, or $10.7 billion if we include compensation to junior investors. We propose that these expenditures come from TARP funds, but an alternative funding mechanism could be a tax on the industry. No matter how such a program is funded, the reduction in foreclosures will be relatively cheap compared to the costs and risks of other plans, as we discuss below. We present simple estimates of our program's cost-benefit tradeoffs in Appendix 2. These computations are based on the assumption that, by breaking down barriers that currently prevent servicers from

[5] Our Legislative Proposal, described in Appendix 3, would give the Federal Housing Authority (FHA) responsibility for compensating aggrieved investors. After loan modification, investors could bring claims for compensation, but they would bear the burden of proving their losses from modification, relative to foreclosure. The FHA's budget for this compensation program would come from TARP funds. By vesting the FHA with authority to deliver compensation to aggrieved investors, our proposal does not place a costly burden on servicers to estimate, prior to modification, the particular harm suffered by particular investors. Servicers can take quick action to pursue modifications that increase returns to investors overall; the harm suffered by particular constituencies can be ignored. At the same time, aggrieved investors can look to the federal government for compensation.

modifying loans, our program will allow servicers to achieve the same success in reducing foreclosures as portfolio lenders. We build on computations in Piskorski, et. al. (2008).

In pursuing this two-pronged approach we are opening markets. Currently, there is a perverse divide between mortgages that are serviced by portfolio lenders and those that are serviced by third-party servicers. The former can and do modify when modification makes sense from borrowers' and lenders' perspectives. The latter are constrained by contracts that, we now realize, are highly inefficient. Our proposal therefore permits loan modifications where they make economic sense.

As well, this proposal changes the economics of mortgage servicing from being a loss leader to a profitable business. This has two large benefits. First, we substantially reduce the likelihood of highly disruptive bankruptcies among smaller, so-called monoline servicers, who now manage about one-third of all securitized mortgages. We also relax the liquidity constraints faced by smaller servicers, who now are barely able to cover the costs of a substantial mortgage modification program. As well, by making mortgage servicing profitable, we encourage larger servicers to purchase smaller servicers. Such consolidation could provide important economic benefits. There are substantial economies of scale in mortgage servicing, particularly with large fixed costs and benefits from learning in pursuing mortgage modification.

Our proposal imposes no burdensome obligations on servicers that might generate large additional losses on lenders and investors. It does not create incentives to default by homeowners who are currently making their mortgage payments. It does not systematically limit credit availability to potential borrowers, as alternative proposals do. Instead, our proposal encourages lenders and servicers to continue finding ways to limit future foreclosures.

It is also important to emphasize that our proposal benefits homeowners as much as it helps servicers and investors. A homeowner is a prime candidate for loan modification when her income is sufficient to make payments that, over time, exceed the foreclosure value of her home. This standard—payments exceeding the home's foreclosure value—is the same standard applied in alternative proposals, such as amendments to the Bankruptcy Code (described next). Our proposal, therefore, goes a long way toward protecting homeowners, while at the same time avoiding the pitfalls of alternative proposals.

<u>Alternative Proposals</u>

Alternative proposals generally fall into three categories: 1) allowing judges to modify mortgages and "cram down" principal amounts in bankruptcy; 2) making explicit payments to servicers that modify loans; and 3) allowing homeowners to take on second liens from the government, with personal liability for the loan balances. We briefly address the reasons that we think these alternatives are less attractive than our proposal and provide more detail in Appendix 1.

Bankruptcy Reform. Bankruptcy Code amendments would generate important risks and unintended consequences. While three million borrowers are sixty days or more delinquent, fifty-two million borrowers are current on their mortgages. During the 1990s, when it was relatively easy to discharge credit card debt in bankruptcy, bankruptcy filings skyrocketed as credit card balances grew. Proposed reforms would make it easier to discharge mortgage debt in bankruptcy. It would be problematic if, in response to these reforms, many borrowers saw bankruptcy as a vehicle for eliminating mortgage debt. If many additional homeowners stop paying their mortgage, the losses in the financial system would skyrocket, as would the cost to taxpayers through the implicit guarantee of Fannie Mae and Freddie Mac debt (more than $5.25 trillion of mortgage guarantees), losses to Ginnie Mae, the FDCI, and many financial institutions that may be bailed-out as they are "too-big-to-fail." And bankruptcy is no panacea for consumers. Around two-thirds of all Chapter 13 cases terminate prematurely (see Wenli Li), leaving the homeowner liable for her mortgage debt and creditors in a much worse position relative to having addressed the problem at the time of the bankruptcy filing.

Additionally, third-party servicers might find it more attractive to deal with a homeowner in bankruptcy than to attempt an out-of-court loan modification. Proponents argue that bankruptcy reform would not increase bankruptcy filings; it would instead give borrowers leverage in out-of-court negotiations. But the opposite might be the case. Servicers might prefer bankruptcy to loan modification for the same reason that servicers now prefer foreclosure to modification. Under most PSAs, servicers would likely recover expenses incurred in connection with a homeowner's bankruptcy filing, just as they now recover expenses incurred in connection with a foreclosure. There is no reimbursement for costs incurred in performing a loan modification. This could result in millions of Chapter 13 bankruptcy filings that harm consumer credit and appreciably delay a resolution of the crisis.

Equally troubling, bankruptcy reforms apply a one-size-fits-all approach to delinquent mortgages. Proposed legislation[6] would invoke a standard set of modifications—reducing principal to current market value, reducing interest to the rate on conventional mortgages plus a reasonable risk premium, and extending the duration of the loan—when a homeowner files for Chapter 13. But different modification strategies may be appropriate for homeowners with different incomes and credit scores. Lenders and servicers have discovered this, especially during the past several months, as they have experimented with new strategies for minimizing both losses to investors and defaults by homeowners. Bankruptcy reform would inhibit this kind of experimentation.

Because they contemplate a one-size-fits-all approach, recent proposals would be quite harmful to lenders, who have developed alternative modification strategies that may be more successful in avoiding unnecessary foreclosures and less expensive to lenders. Forbearance is one such an alternative: it reduces the principal to which the lender applies interest when computing monthly mortgage payments. A borrower, for example, might be asked to pay interest on only eighty percent of the loan balance. The FDIC/Indy Mac program, for example, provides for reductions in interest rates as well as forbearance on principal payments.[7] J.P. Morgan/Chase recently announced a similar strategy of loan forbearance. Some recent modification programs involve neither forbearance nor strip-down. They instead involve only interest-rate reductions. Bank of America and Citigroup, for example, have pursued many sub-prime modifications involving interest rate reductions. Similarly, Fannie Mae and Freddie Mac have rolled out programs that do not rely on principal write-downs (bankruptcy reform would harm not only private lenders, but also government sponsored entities).

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[6] *See, e.g.*, Senate Bill S. 2636, Foreclosure Prevention Act of 2008 (Feb. 13, 2008); Helping Families Save Their Homes in Bankruptcy Act of 2008 (July 29, 2008).

[7] There are problems with the FDIC/Indy Mac program, because it encourages borrowers to miss payments in order to qualify for a loan modification. Nonetheless, this program can be rolled-out in a large enough scale to make a significant dent in foreclosures over a short period of time and thus has significant benefits.

Borrowers have little incentive to accept proposed modifications like these when they can simply go to court and have a judge strip-down their principal balances. Strip down causes a permanent reduction in the outstanding mortgage debt. When house prices rise, as they eventually will, the homeowner enjoys all of the appreciation. Strip-down therefore eliminates the possibility that a lender will ever recover its losses on borrowing. Because of this, borrowers have strong incentives to reject modification proposals, hold out for a better deal, file for bankruptcy if necessary, and thereby delay the resolution of housing problems for years. Instead of fostering innovative and tailored modifications by servicers, as our proposal would, proposed bankruptcy reforms would encourage bankruptcy filings and produce loan modifications that impose excessive losses on investors and do too much or too little to minimize the risk of homeowner default.

There are further problems with proposed bankruptcy reforms. In some legislative proposals, modification would be available only to Chapter 13 debtors "who, after allowance for expenses permitted by the [Bankruptcy Code's] means test …, cannot afford to" cure past defaults and continue paying the original mortgage debt.[8] Additionally, the debtor's mortgage must be subprime or "nontraditional."[9] These limits are troubling. Modification may be sensible even if a homeowner fails the Code's means test, which computes important "expenses" based on IRS standards, not the homeowner's actual history of expenses.[10] Likewise, modification may be sensible even if a loan does not qualify as "nontraditional." As Appendix 2 explains, a significant number of prime jumbo mortgages are likely to enter foreclosure during the next three years.

Finally, empirical evidence suggests that if mortgages are subject to strip-down in bankruptcy, the cost of future credit will rise as lenders incorporate this new risk into their lending decisions. Future mortgage amounts will be smaller, and borrowing costs will be higher, for homeowners with low credit scores. Although many would argue that cheap and easy credit is what got us into this economic crisis, lenders have already tightened the supply of credit. Bankruptcy reform would increase borrowing costs further, resulting in even less borrowing and a further reduction in demand for housing.

Payments to Servicers. A recent FDIC proposal would pay servicers $1,000 to modify a loan and have the government share up to fifty percent of any losses from post-modification default as long as the borrower made at least six payments under the new plan. This program provides a specific formula for the type of modification and for eligibility (full documentation, owner-occupied properties, mortgage payment-to-income ratios as low as thirty-one percent). This proposal is a big step forward and our proposal has many features in common with the FDIC plan. But the FDIC program has several important risks. Modification payments are made based on a formula that encourages servicers to "modify" as many loans as possible (a modification only qualifies if it cuts payments by at least ten percent). Thus, servicers' incentives are no longer aligned with those of investors. Servicers might prefer to modify all loans, whether or not a modification is necessary in order to receive the incentive payment and the government loan guarantee, reducing ultimate payments to investors. As well, servicers would not be free to use their own modification programs with features such as loan forgiveness, which have been employed successfully by many portfolio lenders. Servicers would be encouraged to reduce

[8] Sen. Rep. 110-514, p. 11 (Sept. 26, 2008).
[9] *See* Senate Bill S. 2136, Helping Families Save Their Homes in Bankruptcy Act of 2008, § 101.
[10] 11 U.S.C. § 707(b)(2)(A)(ii)(I).

borrowers' payments to a very low level, which greatly increases the likelihood of a borrower making six payments, but also reduces the payoff to investors. Larger than necessary losses for investors might place additional financial institutions at risk and further delay the recovery of the credit markets. Finally, the cost to taxpayers could be quite high. Servicers would surely endeavor to "modify" as many loans as possible in order to be eligible for the mortgage guarantee, appreciably raising the cost of such a program. Taxpayers would face large liabilities for years to come based on the possibility that modified loans might again fail. Our proposal does not impose any such taxpayer liability, which is very difficult to estimate but could be enormously expensive.

The FDIC program also does not fully address the question of servicer liability. Without changing PSAs, incentive payments might make servicers more susceptible to litigation alleging that they violated their duties to the trusts in order to earn increase fees from loan modifications.[11] And, of course, some PSAs prohibit or limit loan modification. Nonetheless, one could combine parts of the FDIC proposal with the legislation envisioned in our proposal to further encourage servicers to modify loans.

Government loans. A third group of proposals suggests that borrowers take on full-recourse second mortgages to help work out of the crisis.[12] Of course, most homeowners would not want to take on a personal liability to stay in a house that is now substantially underwater. In order to induce homeowners to take on the second mortgages, the government would provide a substantial benefit in the form of a very low interest rate and/or some loan future forgiveness. Even with these inducements, it is uncertain why borrowers would choose to take on personal liability as opposed to defaulting or attempting to obtain a modified mortgage with the lender if that were possible. These programs have many unappealing features for the government as well. First, they set a dangerous precedent: the government would lend at its own borrowing rate, rather than a rate that is privately profitable. This precedent could be applied to all sorts of credit market problems in the future. Additionally, these proposals envision a form of personal liability that would not be dischargeable in bankruptcy. But it is hard to imagine the government collecting from a sick or unemployed borrower. Thus, the risks of default and the costs of loan forgiveness are substantial under these programs, yet taxpayers would receive no compensation.

At the same time, some programs would result in lenders being "bailed out" without sharing in the government losses on the second liens. The Homeownership Vesting Plan pushed by Mark Zandi, for example, would cost over $100 billion and would impact 1.7 million homeowners—a cost of $57,000 per homeowner. None of these costs would be covered by the industry or investors. Hubbard and Mayer provide a more attractive program to absorb negative equity. Under the Hubbard-Mayer plan, lenders and taxpayers would share in the losses from negative equity, but taxpayers would also receive a benefit based on future appreciation of house values. The net cost to taxpayers would be much lower under such a plan and it would cover millions more additional homeowners. Such a program of shared losses seems much more attractive than pursuing personal liability. In this sense, the Hubbard-Mayer proposal is complementary to this proposal. Their plan deals predominantly with borrowers who can make

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[11] See, for example, the recent lawsuit filed by Grais and Ellsworth LLP on behalf of two private investors when Countrywide agreed to modify 400,000 loans as part of a settlement with fifteen state Attorneys General over predatory lending practices.

[12] See, for example, proposals on Homeownership Vesting Plan by Mark Zandi of Moodys/Economy.com or Helping People Whose Homes are Underwater by Martin Feldstein.

payments and have good credit. If the Hubbard-Mayer proposal were enacted, it would reduce, but not eliminate the need to deal with loan modifications as described above.

Below we discuss our proposal in more detail. Appendix 1 provides detailed support for the claims underlying our proposal, as well as critiques of selective alternative proposals. Appendix 2 describes our servicer Incentive Fee proposal and provides cost-benefit calculations. Appendix 3 presents our legislative proposal as well as the arguments as to its constitutionality. We also present draft legislation. Appendix 4 presents the cost-benefit analysis for the compensation of potentially aggrieved investors.

APPENDIX 1: IMPORTANT SUPPORTING EVIDENCE FOR OUR PROPOSAL

- **Portfolio lenders do many more modifications than servicers of securitized pools**
- **Servicers face many disincentives to modify mortgages under the typical PSA. Our proposal substantially improves incentives for servicers to pursue successful loan modifications.**
- **Not all foreclosures can or should be stopped. Many loan modifications fail for good reasons. As many as 2/3 of Chapter 13 plans fail**.
- **What are the problems with proposals to allow first liens to be stripped down in Chapter 13 bankruptcy?**
- **What is the FDIC proposal in more detail?**
- **How does our proposal compare to the Hope for Homeowners Act?**

1) **Portfolio lenders do many more modifications than servicers of securitized pools.**

   a) Piskorski, Seru, and Vig (2008) show that seriously delinquent mortgages controlled by servicers of securitizations enter foreclosure much more quickly than portfolio loans. The results suggest that delinquent loans are modified much more aggressively when they are held in a lender's portfolio than when they have been securitized and managed by a third-party servicer. Conditional on a loan becoming delinquent, loans held by the lending institution have a 19 to 33 percent lower foreclosure rate when compared to similar loans that are securitized. When the results are split out by credit quality, the differences are larger for loans to the highest quality borrowers. For mortgages with the best credit quality, portfolio lenders achieve default rates that are 30 to 50% lower than rates experienced by third-party servicers. This evidence is consistent with the view that, relative to servicers of securitized loans, servicers of portfolio loans undertook actions that resulted in substantially lower foreclosure rates. These findings suggest that securitization imposes significant renegotiation costs and a failure to modify securitized loans may have substantially contributed to the recent surge in foreclosure rates. A recent OCC/OTS report finds similar results, although it does not control for the risk factors that differ across the various types of mortgages. [13]

   b) Portfolio lenders appear to be making appreciable progress in reducing foreclosures. While historically mortgage modifications were relatively rare there are compelling arguments that in time of big adverse shocks (like substantial decline of house prices) debt renegotiation could create value for both lenders and borrowers. The increased mortgage modification activity by lenders supports this point of view.

   c) Recent programs use modification tools that have had much greater success, suggesting that portfolio lenders are likely to be even more successful than in the past. In November 2008, the largest portfolio lenders announced mortgage modification programs that are much more aggressive than earlier programs and thus may have even greater success in

[13] *See OCC and OTS Mortgage Metrics Report 3Q 2008*.

reducing foreclosures. These programs rely on forbearance and in some cases permanent reductions in outstanding balances.

Thus, portfolio lenders' success in reducing foreclosures could be underestimated in Piskorski et. al. (2008). This conclusion is consistent with evidence on the performance of recent mortgage modifications. For example, a recent study by Credit Suisse (Subprime Loan Modifications Update, October 1, 2008) finds that the re-default rate of loan modifications depends crucially on the type of modification. Rate freezes (where the rate is frozen around the ARM reset date) and principal reduction modifications (where principal is permanently forgiven) have re-default rates less than half of those for more traditional modifications. Eight months after modification during the fourth quarter of 2007, only 15% of rate modifications and 23% of principal modifications were 60+ days delinquent. The delinquency rate was much higher (44%) among traditional modifications, which involved higher payments after modification. The 23% re-default rate among principal modifications is particularly encouraging in light of the fact that more than 80% of loans were delinquent prior to modification. Therefore, the historical re-default rate associated with traditional modifications may not be applicable to recent modification efforts. The industry is identifying more efficient ways to modify loans in the current environment.

2) **Servicers face many disincentives to modify mortgages under the typical PSA. Our proposal substantially improves incentives for servicers to pursue successful loan modifications.**

   a) Loan modifications typically cost more than servicers are paid to pursue a modification. Third-party servicers have strong economic incentives to push borrowers into foreclosure rather than pursue substantial mortgage modifications. A loan modification may cost the servicer as much as $750 to $1,000 (see Mason). If the modification is successful, the servicer receives the normal fee (0.25 percent per year) for keeping the loan in the portfolio. With much uncertainty about the likelihood of success, loan modification does not pay for many servicers. Earlier research shows that servicers respond to economic incentives in servicing commercial mortgages.[14]

   To make the above argument concrete, consider a seriously delinquent subprime loan with outstanding balance of $180,000. The servicer is facing a choice: start foreclosure, or offer a loan modification that reduces the loan balance by 20 percent to $144,000. Suppose that, with a modification, there is a 50 percent chance the modification will be successful and the borrower will resume paying. However, there is also a 50 percent chance that modification will fail and the servicer will need to pursue foreclosure 6 months later. The foreclosure process takes 18 months; recoveries in foreclosure are equal to 50 percent of the loan balance, here $90,000. Assume that the servicer receives its fee (.25%) on all outstanding loan balances until the foreclosure is complete, whether or not the borrower makes payments. Thus, if the balance is $180,000, the servicer's annual fee is .25% * $180,000 = $450. Assume, as well, that there is no discount rate (reasonable given that short-term interest rates are quite low) and that interest payments on the modified mortgage amount ($144,000) will at least cover the risk-adjusted rate of return for new investments.

[14] *See* Yingjin Gan and Christopher Mayer, "Agency Conflicts, Asset Substitution and Securitization," working paper (2007).

Investors would strongly prefer that the servicer try the modification. The expected value of recoveries is $124,000 with modification and $90,000 with foreclosure.[15]

Now consider a servicer who is choosing whether to implement a modification plan that costs $1,000 per modification. Without modification, the servicer will receive $675: the foreclosure process takes 18 months; during that time, the servicer will receive fees at the rate of $450 per year. Over 18 months, fees will total $675.

Modification will reduce the servicer's annual fee to $360 (0.25% * 144,000). If modification is unsuccessful, the servicer will lose $280: from the date of the modification through the end of the foreclosure process (24 months), it will receive fees equal to $720 ($360*24), but it will also spend $1,000 on modification. Thus, unsuccessful modification yields a net loss. On the other hand, if mortgage modification is successful, the servicer's payoff depends on the duration of the loan. The servicer will net $800 if the modified loan continues for 5 years (5 years of fees, or $1,800, offset against the $1,000 cost of modification). It will net $1,880 if it continues for 8 years.

Now compare modification to foreclosure. Foreclosure yields a certain payoff of $675. Modification yields a 50 percent chance of a $280 loss and a 50 percent chance of a gain that depends on how long the loan continues. Suppose the successfully modified loan will continue for five years. Then the servicer will not modify: the expected gain from modification is only $260: 50%*(-$280)+50%*(800). The servicer will only choose modification if the successfully modified loan will continue for nearly eight years or longer. Thus, the borrower must make payments according to the modification, without refinancing or defaulting, for almost 8 years for the servicer to break even, not at all a sure outcome. In addition, the servicer must cover the cost of modification up-front, while receiving the revenue well into the future, not a sure thing given the extent to which many servicers face appreciable funding and liquidity constraints. As a result many servicers decide to foreclose.

b) <u>If a mortgage goes to foreclosure, fees associated with foreclosure are reimbursed, providing financial benefits to servicers.</u> Servicers might contract out services that they would otherwise perform in order to obtain additional financial payments from a foreclosure. And these additional fees are senior to everything else, so they are sure to be paid. As well, servicers are paid their servicing fee based on the outstanding balance during the entire foreclosure process, which can last as long as a year or two. This is true even if the recovery from a foreclosure is expected to be much lower than the mortgage balance. Thus in most cases, the cost-benefit analysis clearly favors foreclosure over modification, even if successful modifications save investors tens of thousands of dollars.

c) <u>Under our proposal, incentives for servicers and investors are more closely aligned.</u> Servicers are paid an Incentive Fee only if the borrower makes his/her payments every month. Since servicers are paid a percentage of the monthly principle and interest payments, the servicer has an incentive to make those payments high enough to generate a good return to investors, but low enough to be affordable to borrowers. Incentive fees are not paid if the borrower stops paying or if the servicer begins the foreclosure process.

3) **Not all foreclosures can or should be stopped. Many loan modifications fail for good reasons. As many as 2/3 of Chapter 13 plans fail.**

[15] The investors receive 0.5*$144,000 + 0.5*$90,000= $124,000.

a) Many mortgages cannot be saved. Comments by lenders suggest that many defaulted mortgages are on properties that are owned by investors or households who have no reasonable way to make their payments. Unemployed households will not be able to make payments even with the most generous modification program. Under-reporting of second liens and investor-owned properties is rampant and makes many loans simply unsalvageable. These factors help explain the often high rate of failure for loan modifications, even those pursued by portfolio lenders.

b) About 2/3 of all Chapter 13 plans fail within 5 years.[16] While some argue that this is because mortgages cannot be restructured in Chapter 13, we know that loan modifications also fail frequently. We cannot realistically expect to help everyone under any plan.

4) **What are the problems with proposals to allow first liens to be stripped down in Chapter 13 bankruptcy?**

a) Moral Hazard: Bankruptcy reform might well appreciably reduce the incentive of many solvent borrowers to keep making their payments on mortgages. It is important to understand that while 3 million borrowers are 60 days or more delinquent, 52 million borrowers are current on their mortgages. We know that easier bankruptcy laws for credit cards have led to millions of bankruptcy filings. We will have a catastrophe if most borrowers get the idea that they do not have to pay their mortgages.

b) Bankruptcy reform may have the unintended effect of encouraging servicers to *push* borrowers to file for bankruptcy in order to renegotiate their mortgages. Under most Pooling and Servicing Agreements, servicers are not reimbursed for expenses incurred in renegotiating mortgages. But our read of PSAs suggests that servicers can be reimbursed for some fees in bankruptcy, just as they now are reimbursed for those fees in the foreclosure process. If this is true, servicers might prefer bankruptcy to straight loan modifications. In a bankruptcy case, servicers can contract out some services that they now perform in-house, reducing costs and collecting higher fees. As well, the bankruptcy process might provide a litigation safe harbor for investor suits that servicers are modifying too many loans or that servicers need to repurchase certain modified loans. This is opposite the claims by many bankruptcy proponents who argue that the threat of bankruptcy will force servicers to finally renegotiate outside of bankruptcy. It could be that servicers will only renegotiate in bankruptcy, forcing millions of borrower to have their credit ruined and pursue an expensive process in order to get a mortgage reduction.

c) Bankruptcy Code amendments will almost surely raise borrowing costs and lower available credit for housing to risky borrowers. Current proposals would amend Chapter 13 to permit mortgage strip down. Homeowners could use the Chapter 13 process to reduce their mortgage debt to the current value of their homes, as estimated by a bankruptcy judge. The judge would also be given authority to adjust the rate and term of the mortgage. Two recent papers show that this kind of reform—which imposes losses on lenders—reduces the credit available to homeowners, especially those with low credit scores. Karen Pence[17] studied state laws that increase foreclosure costs by forcing

[16] Wenli Li, *What Do We Know About Chapter 13 Personal Bankruptcy Filings?*, Federal Reserve Bank of Philadelphia (Fourth Quarter 2007).

[17] See Karen Pence, *Foreclosing on Opportunity: State Laws and Mortgage Credit*," 88 Rev. Econ. & Stat. 177 (2006).

creditors to use costly judicial procedures. These procedures can generate costs equal to 10 percent of the loan balance. Pence compares mortgage markets in states with and without these costly foreclosure processes. She finds loan sizes are 3 to 7 percent smaller in states with the costly processes. This study offers strong evidence that credit is less accessible to potential homeowners when laws restrict lender recoveries. Similar evidence is provided by Adam Levitin and Joshua Goodman, who study mortgage markets during the late 1980s and early 1990s, when a number of bankruptcy courts permitted homeowners to strip-down mortgages in Chapter 13 bankruptcy.[18] Levitin and Goodman find that, within six months after courts permitted strip downs, loan-to-value ratios fell by nearly 2.8 percent among homeowners in the 80th percentile of the interest-rate distribution (see Table 4a). Among homeowners with interest rates at or below the median, mortgage rates rose between 0.15 and 0.27 percentage points within 6 months after courts permitted strip down (see Table 2a). The Levitin and Goodman evidence might well underestimate the effect of allowing strip down on credit availability. There was significant uncertainty, across judicial districts regarding the validity of court rulings permitting strip down. Lenders must have recognized a significant risk that courts or Congress might eventually clarify the law to allow prohibit strip down in all states (as the Supreme Court did in 1994). The Pence results, by contrast, are based on relatively stable differences in state laws and find larger impacts of reduced creditor rights on mortgage credit availability.

d) <u>While some proposals would place a limit on bankruptcy reform provisions, nothing prevents a future Congress from applying bankruptcy to additional cohorts of mortgages.</u> Once the precedent has been set, it is easier to apply the Bankruptcy Code to first lien mortgages in the future. By contrast, our legal proposal relies on a specific legal precedent that applies *only* in a major economic crisis (the precedent was set during the Great Depression). As a result, absent an economic crisis, the government would be unable to extend our proposal to modify contracts into the future. In that sense, our proposal is credibly tied to the economic crisis and not beyond.

e) <u>Bankruptcy reform applies a one-size-fits-all approach to all mortgages and home owners.</u> Some versions of the proposed legislation would limit modification to subprime and other "nontraditional" mortgages.[19] But different modification strategies may be appropriate for homeowners with different incomes and credit scores. Lenders and servicers have discovered this, especially during the past several months, as they have experimented with new strategies for minimizing losses to investors and default by homeowners. Bankruptcy reform would inhibit this kind of experimentation. Proposed legislation[20] would invoke a standard set of modifications—reducing principal to current market value, reducing interest to the rate on conventional mortgages plus a reasonable risk premium, and extending the duration of the loan.

Bankruptcy modifications would only be available to Chapter 13 debtors "who, after allowance for expenses permitted by the [Bankruptcy Code's] means test …, cannot

[18] Adam J. Levitin and Joshua Goodman, "<u>The Effect of Bankruptcy Strip-Down on Mortgage Markets</u>," Georgetown University Law Center, Business, Economics and Regulatory Policy Working Paper Series Research Paper No. 1087816 (2008).
[19] *See* Senate Bill S. 2136, Helping Families Save Their Homes in Bankruptcy Act of 2008, § 101.
[20] *See*, *e.g.*, Senate Bill S. 2636, Foreclosure Prevention Act of 2008 (Feb. 13, 2008); Helping Families Save Their Homes in Bankruptcy Act of 2008 (July 29, 2008).

afford to" cure past defaults and continue paying the original mortgage debt.[21] Moreover, modification may be sensible even if a homeowner fails the Code's means test, which computes important "expenses" based on IRS standards, not the homeowner's actual history of expenses.[22] Likewise, modification may be sensible even if a loan does not qualify as "nontraditional." As Appendix 2 explains, a significant number of prime jumbo mortgages are likely to enter foreclosure during the next three years. Instead of fostering innovative and tailored modifications by servicers, as our proposal would, proposed bankruptcy reforms would encourage bankruptcy filings and produce loan modifications that impose excessive losses on investors and do too much or too little to minimize the risk of homeowner default.

f) <u>The one-size-fits-all approach could be quite harmful to lenders, who have come up with other alternatives that may be equally or even more successful in reducing unnecessary foreclosures, but are less expensive to lenders.</u> Forbearance is one such an alternative. The FDIC/Indy Mac program provides for reductions in both interest rates and forbearance on principal payments.[23] While there are some problems with the incentives in the FDIC/Indy Mac program that encourage borrowers to miss payments in order to qualify for a loan modification, this program can be rolled-out in a large enough scale to make a significant dent in foreclosures over a short period of time and thus has significant benefits. The recently announced effort by JP Morgan/Chase uses a similar strategy of loan forbearance. Many of the Bank of America and Citigroup modifications to subprime loans involve interest rate reductions rather than principal reductions. Fannie Mae and Freddie Mac have rolled out their own programs that do not rely on principal write-downs (bankruptcy reform would not only harm private lenders, but also government sponsored entities). Borrowers have little incentive to accept a lender's offer of forbearance (or interest-rate reduction) when they can go to court and have a judge strip-down their principal balance, leading to a permanent reduction in the amount of money they owe on their mortgage. When house prices rise, as they eventually will, strip-downs eliminate the possibility that a lender will ever recover its losses on borrowing. Thus borrowers have incentives to hold out for a better deal than they are likely to be currently offered, potentially delaying the resolution of housing problems for years.

5) **What is the FDIC proposal in more detail?**

a) The FDIC proposes paying servicers $1,000 for each loan re-worked under a systematic and sustainable loan modification program. The proposal describes a sustainable loan as a loan with a debt-to-income ratio of as low as 31% and documented income. The IndyMac model combines interest rate reductions, term length extensions, and principal forbearance to achieve lower monthly payments. Under this proposal, if a modified loan re-defaults, the government will share up to 50% of the losses from the re-default. The loss sharing guarantee takes effect only after the borrower has made six payments following modification, and ends eight years after the modification. Loan modifications are limited to owner-occupied properties. Modifications are structured so that the net present value of modification is greater than the net present value of foreclosure. Servicers must modify all loans that pass the NPV test, i.e. they cannot cherry-pick loans

[21] Sen. Rep. 110-514, p. 11 (Sept. 26, 2008).
[22] 11 U.S.C. § 707(b)(2)(A)(ii)(I).
[23] Forbearance reduces the amount of principal that a lender applies interest to when computing monthly mortgage payments.

to modify. For loans that currently have LTVs above 100%, government participation in loss sharing decreases as the LTV increases, such that first liens with over 150% LTV are not eligible for government loss sharing. Modifications that do not lower monthly payments by at least ten percent are also excluded from the loss sharing guarantee. Here is a link to the FDIC proposal: http://www.fdic.gov/consumers/loans/loanmod/.

6) **How does our proposal compare to the Hope for Homeowners Act?**

The Hope for Homeowners Act allows borrowers to refinance into 30-year fixed rate, federally insured mortgages. In exchange for the federal insurance guarantee, the lender must voluntarily reduce the outstanding loan balance on the existing mortgage to 96.5 percent of the home's current value. Subordinate lienholders are offered an immediate up-front payment for releasing their liens. Lenders are allowed to extend the term lengths of loans. All prepayment penalties and late fees must be waived. Eligible borrowers are restricted to borrowers with no secondary residences and whose monthly payments exceed 31 percent of their gross income. The borrower agrees to pay an upfront insurance fee and a monthly insurance fee. In addition, the borrower must share both the equity created at the beginning of the new mortgage and the equity created from future house price appreciation with the FHA. http://www.hud.gov/hopeforhomeowners/index.cfm

a) Our proposal is more flexible, and less costly to taxpayers. Our proposal imposes no mandatory write-down in loan balances. Servicers are given incentives to choose the optimal form of modification—write-down, adjustment in interest rate, forbearance—that avoids foreclosure at the lowest cost to investors. In addition, Congress authorized the Federal Housing Administration (FHA) to insure up to $300 billion of new loans. Very few loans have been guaranteed to date, suggesting the Hope for Homeowners Act is having little impact.[24] But even if the cost of this program is only 5% of the authorized amount, it will be more costly than our proposal, which may avert nearly 1 million foreclosures at a cost of $9 billion.

[24] "HUD Chief Calls Aid on Mortgages A Failure," *Wash. Post*. A01 (Dec. 17, 2008).

APPENDIX 2: Our Servicing Incentive Fee Proposal and Cost-Benefit Analysis

We believe that servicers need greater resources and stronger incentives to modify loans. Current incentive fees for servicers of securitized loans are simply insufficient (see Appendix 1) to encourage mortgage modifications even if the legal barriers to do so are removed (See Appendix 3).

The Servicing Incentive Fee Proposal

Under our proposal, servicers of securitized loans will be paid a servicing Incentive Fee equal to 10% of monthly mortgage payments, capped at $60 per loan. This additional incentive should remain in place for a period of three years to allow markets to recover. After that time, the bulk of all loans will be performing, and thus require little incentive to re-work, or they will have been modified or gone through foreclosure. The Incentive Fees would apply only to securitized mortgages that were below the conforming loan limit in the year in which those mortgages were originated.

Our estimates, based on industry studies, suggest that this additional Incentive Fee (capped at a maximum of $720 per year per loan) combined with standard servicing fees already in place (0.20 to 0.375 percent of the outstanding balance annually) would provide proper incentives for mortgage modifications. By increasing servicers' fees, we reward successful modifications. Unlike normal servicing fees, which are based on a percentage of outstanding mortgage balances, the Incentive Fees are paid only when servicers obtain payments from borrowers. This program discourages unsuccessful modifications, which result in a quick re-default, because servicers receive no payments when the borrower stops paying. On the other hand, simply paying servicers to pursue modification may create a perverse incentive to reduce future borrower payments to a very low level, harming investors. Our proposal, therefore, rewards servicers for keeping future payments as high as possible without putting the homeowner in a position where he or she is likely to re-default soon after modification.

We exclude jumbo mortgages from Incentive Fees because these loans have very high average loan balances, typically exceeding $500,000. The average annual fees generated by these mortgages, typically exceeding $1,250, are more than enough to justify substantial effort by servicers to modify troubled loans. Servicers of jumbo loans would, however, still see substantial legal relief from the next part of our proposal, described in Appendix 3.

Cost-Benefit Analysis

According to Loan Performance, about 2.8 million securitized subprime mortgages were outstanding as of October 2008. We assume 25% of these will default over the course of 2009, then 15% in 2010, and then 10% in 2011, absent substantial changes in mortgage modifications. About 2.2 million securitized Alt-A mortgages were outstanding in October 2008.[25] We assume that about 16 percent of these will go into foreclosure in each of the next three years, if substantial mortgage modifications are not undertaken. Finally, about 1.5 million prime jumbo mortgages are outstanding as of October 2008 according to Braddock Financial data. We assume that about 4% of these will go into foreclosure in each of the next three years. These estimates are consistent with other recent studies of foreclosure likelihoods for these mortgage populations.

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[25] *See* Federal Reserve Bank of New York, Credit Conditions in the United States.

For our simulations, we assume that mortgage modifications by servicers under our plan will have the same success rate as mortgage modifications by portfolio lenders. Following Piskorski, Seru, and Vig (2008), this implies a reduced foreclosure rate of between 20-30% for subprime loans, 30-40% for Alt-A loans, and 40-50% for prime, jumbo mortgages.

We begin by examining subprime and Alt-A securitized mortgages, the bulk of which would be eligible for Incentive Fees under our modification program. If we assume an improved modification success rate of 30% for subprime mortgages, the servicing Incentive Fees would total $4.8 billion over three years and would prevent more than 420,000 foreclosures in that same three year period. With an Alt-A success rate of 40%, Incentive Fees would total $4 billion over three years and save 440,000 alt-A foreclosures. So, for the riskiest pools of mortgages, Incentive Fees would total $9 billion and save nearly 900,000 foreclosures, a cost of about $10,000 per foreclosure saved. Assuming a lower modification success rate of 20% and 30% for subprime and Alt-A loans, respectively, 600,000 foreclosures could be prevented at a total cost of around $8.6 billion, a cost of $14,500 per foreclosure saved.

Our plan will also affect the incentives of prime jumbo servicers, even though they will not receive incentive payments. Our plan removes legal barriers that prevent these servicers from pursing modifications. Up to 12 percent of prime jumbo loans could face foreclosure during the next three years. Our plan could avert 72,000 to 90,000 of these foreclosures (a 40-50 percent reduction in foreclosures) by allowing servicers to use the same types of modification programs for securitized loans as are currently being used by portfolio lenders.

Thus, our program could save up to a million foreclosures by addressing incentive problems for securitized loans, a 35 percent reduction.

These calculations are only approximations. We have assumed that the servicing Incentive Fee for every non-delinquent, non-foreclosed loan will equal the maximum possible fee, $720 per loan per year. The actual fee paid will likely be lower. Some modifications will reduce monthly mortgage payments to a level that entitles the servicer to less than the maximum fee. On the other hand, we assume no refinancings or prepayments that would generate a one-time payment equal to 12 times the previous month's Incentive Fee. We expect some refinancings and short sales in the pool. Also some of the loans we consider have balances above the conforming limit; they would not qualify for the program. Nonetheless, the total cost of our Incentive Fee program can be no more than $11 billion, which is the maximum servicing Incentive Fee for 3 years for all currently outstanding non-agency loans in question. Thus, the cost to taxpayers through TARP would be modest.

Our calculations rely on the Piskorski et. al. (2008) study, which uses data ending in March 2008. Without post-2008 data we do not know whether foreclosures that have been prevented thus far might yet occur in the future. This raises the possibility that we have *overestimated* the potential reduction in foreclosures. On the other hand, that study examines a period during which portfolio lenders used a relatively limited set of tools for modifying loans. They rarely relied on forbearance, forgiveness, and other tools that are increasingly used today. This raises the possibility that we have *underestimated* the potential reduction in foreclosures.

APPENDIX 3: Our Legislative Proposal and Constitutional Analysis[26]

Legislators and commentators have assumed that Bankruptcy Code amendments are the only constitutional tools available to Congress as it tries to mitigate the foreclosure crisis. We do not agree. We believe that Congress has authority, under the Commerce and Spending Clauses, to modify the terms of securitization contracts and give mortgage servicers greater discretion to pursue modification in lieu of foreclosure. Using this authority, Congress has the opportunity to craft a far more targeted solution to the current crisis than is possible through Bankruptcy Code amendments.

In 1933, at the height of the Great Depression, Minnesota imposed a moratorium on foreclosures. As long as a homeowner made monthly payments equal to the rental value of the home, a lender was forbidden from forcing a sale of the home. This legislation was temporary, designed to mitigate an economic crisis, and upheld by the United States Supreme Court.[27] Today, in the context of another economic crisis, we propose another temporary program to moderate an avalanche of foreclosures. We propose federal legislation that gives third-party mortgage servicers (a) discretion to choose between loan modification and foreclosure when a mortgage nears or enters default (our legislative proposal) and (b) strong incentives to select modification when it will yield greater recovery to investors, as a group, than foreclosure (our incentive proposal). Our proposals do not impose a significant burden on the U.S. Treasury. Nor do they burden credit markets, as Bankruptcy Code amendments would. Nor do they raise constitutional concerns, as we discuss below.

Appendix 2 discusses our incentive proposal. The constitutionality of this proposal is straightforward. First, the Commerce Clause[28] authorizes Congress to regulate markets that cross state lines or have a significant impact on interstate commerce.[29] The mortgage securitization market, without doubt, satisfies these criteria. Second, the Spending Clause[30] authorizes Congress to allocate federal funds for public purposes and to condition those funds on particular conduct.[31] Our incentive proposal allocates federal TARP funds to servicers if they avoid foreclosure.

Our legislative proposal is somewhat more complex. This Appendix describes the proposal in detail and justifies its constitutionality.

The Legislative Proposal

[26] This proposal was vetted by constitutional law scholars at Columbia Law School, the University of Chicago Law School, and Yale Law School. We are grateful for their assistance.
[27] *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398 (1934).
[28] U.S. Const. Art. I, § 8, cl. 3.
[29] *Perez v. United States*, 402 U.S. 146 (1971) ("The Commerce Clause reaches, in the main, three categories of problems. First, the use of channels of interstate or foreign commerce which Congress deems are being misused … . Second, protection of the instrumentalities of interstate commerce … . Third, those activities affecting commerce. It is with this last category that we are here concerned.").
[30] Art. I, § 8, cl. 1.
[31] *Buckley v. Valeo*, 424 U.S. 1, 90-92 (1976); *South Dakota v. Dole*, 483 U.S. 203, 206-07 (1987) ("The Constitution empowers Congress to 'lay and collect Taxes, Duties, Imposts, and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States.' Art. I, § 8, cl. 1. Incident to this power, Congress may attach conditions on the receipt of federal funds, and has repeatedly employed the power 'to further broad policy objectives by conditioning receipt of federal moneys upon compliance by the recipient with federal statutory and administrative directives.'");

Our legislative proposal will modify existing pooling and servicing agreements (PSAs). The proposal has three elements. Specific legislation appears at the end of this Appendix.

First, we propose legislation that *temporarily* suspends PSA clauses that limit loan modification. These clauses include outright prohibitions on modification, caps on the number of mortgages that can be modified (e.g., five percent of the pool), limits on the frequency of modifications (e.g., no more than once during a twelve month period), and limits on the range of permissible modifications (e.g., the modified interest rate cannot fall below a set floor). During the next three years—through calendar year 2011—mortgage servicers will be free to participate in our incentive program and modify mortgages, subject to the litigation safe harbor described below. By the end of 2011, we hope, the U.S. economy will have recovered, making our proposal unnecessary.

This legislation abrogates the terms of PSAs in order to facilitate loan modification and thereby increase payments to investors as a group. Most investors, therefore, will be benefited—not harmed—relative to their expected payoff from foreclosure. Some junior-tranche investors could be harmed, because they can expect coupon payments during a lengthy foreclosure process. Modification may eliminate these expected cash flow rights.

Although this effect raises no constitutional problems, and although policymakers could ignore the effect, our proposed legislation would provide compensation for aggrieved investors. This would be accomplished by empowering a federal agency—such as the Federal Housing Authority (FHA)—to administer a compensation program for aggrieved investors. After modification occurs, investors could file compensation claims with the agency. The investors would bear the burden of proof. The agency could accept, contest, or deny the claim, subject to judicial review. The agency's budget would be drawn from TARP funds.

It is important to emphasize, however, that an investor would be entitled to compensation only under three conditions: (i) legislation abrogated PSA provisions that explicitly limited loan modification, (ii) had these provisions not been abrogated, the loan would have gone to foreclosure, and (iii) the investor would have received greater cash flow from foreclosure than modification. Most PSAs do not include explicit limits on modification. Even when they do, the limits do not prevent all modifications. A servicer might implement the same modification whether or not legislation abrogates limits in the PSA. Thus, the FHA (or another agency) will likely make compensatory payments in a small minority of modifications.

Vesting a federal agency with authority to compensate aggrieved investors is attractive for two reasons. First, it ensures that our proposal does not systematically disadvantage any particular class of investors. Second, it places no burdens on servicers to estimate the losses to particular investors from modification. It would be complicated to assess these losses, and this complexity could greatly slow the process of resolving foreclosures. We believe that quick action to stop foreclosures would benefit the public interest.

Second, we propose a "litigation safe harbor" for servicers who participate in our program and modify mortgages. Currently, significant litigation risk attends any modification because the terms of PSAs are imprecise and subject to conflicting interpretations. It is unclear, for example, when a modification serves the "best interests" of the trust and whether the servicer must repurchase every mortgage that is modified.[32] Our proposal eliminates this uncertainty: A

[32] This latter issue is the subject of the Countrywide litigation. *See* Paul Jackson, "A Tale of Two Loan Modifications, As Investors Sue Countrywide," *Housing Wire* (Dec. 2, 2008).

servicer will avoid liability to investors if, at the time it performed the loan modification, it reasonably and in good faith believed that modification would increase the returns to investors as a group.

Investors will need information to assess whether a servicer's decisions are consistent with a reasonable, good-faith belief in the merits of modification. We therefore propose that servicers publish detailed, loan-level data on modifications and post-modification payments.

Third, we believe that costs of litigation should, in appropriate cases, be shifted to aggrieved investors. If an investor brings suit after a modification, but the participating servicer successfully invokes the modification safe harbor, the investor will bear all of the servicer's legal costs (including reasonable attorney fees and fees for expert witnesses). In this way, servicers can be confident that good-faith modifications will not increase the risk of costly litigation. This safe harbor will also be temporary and apply only to participating mortgage servicers who conduct modifications during the next three years (through the end of 2011).

Constitutional Analysis

Our legislative proposal uses federal legislation to regulate mortgage securitization contracts. Because the securitization market crosses state lines and, without doubt, has a major impact on interstate commerce, Congress has authority under the Commerce Clause to enact the proposed legislation. But because the legislation alters the terms of existing contracts (the PSAs), it raises other constitutional concerns. The most important is that our proposal violates the Takings[33] and Due Process[34] clauses of the Fifth Amendment, because it abrogates vested contractual rights.

The Takings Clause prohibits the federal government from taking private property for public use without just compensation. The Clause "is designed not to limit the governmental interference with property rights *per se*, but rather to secure *compensation* in the event of otherwise proper interference amounting to a taking."[35] Even assuming our legislative proposal amounts to a takings, it is not an unconstitutional takings because investors are compensated, in kind, for the legislative interference. Servicers will be given discretion to modify loans and incentive to do so only when it *improves* payments to investors as a group. Relative to foreclosure, modification will only increase expected returns to investors. Supreme Court cases make clear that no takings occurs when a government policy causes no monetary loss.[36] That will be the case for most investors here. Put differently, our Legislative Proposal makes securitized mortgages more valuable to investors. Although it impairs property rights, it impairs rights that are—in the current environment—*destroying* value.

To be sure, some investors may suffer a reduction in expected payoffs. This is most likely to be true for junior-tranche investors, who are often be entitled to a share of coupon payments during the foreclosure process, which can last eighteen months. Because it avoids the lengthy foreclosure process, loan modification will eliminate the investors' rights to coupon payments.

[33] U.S. Const. Am. V ("… nor shall private property be taken for public use, without just compensation… .").
[34] U.S. Const. Am. V ("No person shall be … deprived of … property, without due process of law … .").
[35] *Lingle v. Chevron U.S.A., Inc*., 544 U.S. 528, 536-537 (2005), quoting *First English Evangelical Lutheran Church of Glendale v. County of Los Angeles*, 482 U.S. 304, 315 (1987)
[36] *Brown v. Legal Found. of Washington*, 538 US 216 (2003).

This deprivation, however, is not an unconstitutional takings. Investors are losing contractual rights—a share of coupon payments, set by contract—not real property rights. Different rules ("regulatory takings") apply to the former rights. Most importantly, with respect to our proposal, the Supreme Court has emphasized repeatedly that the subject matter of almost every contract is susceptible to government regulation. Therefore, any party to a contract is or should be aware that future government regulation could reduce the value of contractual rights.[37] Here, the securitization contracts give investors interests in mortgages. The market for mortgage loans, as noted above, is one that Congress can regulate. If the government uses regulation to take contractual rights for its own benefit, a taking issue could arise.[38] But that is not the case here: our proposal nullifies some contractual rights in order to avert premature foreclosures. The direct beneficiaries are homeowners, investors, and servicers, not the federal government.[39] Nonetheless, we propose compensation to aggrieved investors—with compensation delivered by an administrative agency—to eliminate lingering constitutional doubts, smooth the modification process, and ensure a quick resolution of the crisis.

For similar reasons, there is no violation of the Due Process Clause. The standard test for assessing the constitutionality of economic and social legislation—that it must bear a "rational relationship" to a legitimate governmental objective[40]—is notoriously lenient[41] and easily met here.[42] First, our proposal serves a legitimate state interest—minimizing the foreclosure crisis. Second, it is rational response to the crisis. Our proposal offers a temporary, incentive-based

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[37] *See, e.g., Lucas v. South Carolina Coastal Council*, 505 U.S. 1003, 1027-1028 (1992) ("And in the case of personal property, by reason of the State's traditionally high degree of control over commercial dealings, [the property owner] ought to be aware of the possibility that new regulation might even render his property economically worthless (at least if the property's only economically productive use is sale or manufacture for sale)."); *Connolly v. Pension Ben. Guar. Corp.*, 475 U.S. 211, 223-24 (1986), quoting *Norman v. Baltimore & Ohio R. Co.*, 294 U.S. 240, 307-308 (1935) ("Contracts, however express, cannot fetter the constitutional authority of Congress. Contracts may create rights of property, but when contracts deal with a subject matter which lies within the control of Congress, they have a congenital infirmity. Parties cannot remove their transactions from the reach of dominant constitutional power by making contracts about them.")

[38] *Connolly*, 475 U.S. at 224.

[39] Additionally, our legislative proposal would abrogate a relatively minor provision (the right to coupon payments during the foreclosure process) in contracts between securitization trusts and junior-tranche investors. Because our proposal does not destroy all of the investors' contractual rights, it is unlikely to be viewed as a taking. *See, e.g., Andrus v. Allard* 444 U.S. 51, 65-66 (1979) ("[T]he denial of one traditional property right does not always amount to a taking. At least where an owner possesses a full 'bundle' of property rights, the destruction of one 'strand' of the bundle is not a taking, because the aggregate must be viewed in its entirety."); *Penn Central Transportation Co. v. New York City*, 438 U.S. 104, 131 (1978) ("'Taking' jurisprudence does not divide a single parcel into discrete segments and attempt to determine whether rights in a particular segment have been entirely abrogated. In deciding whether a particular governmental action has effected a taking, this Court focuses rather both on the character of the action and on the nature and extent of the interference with rights in the parcel as a whole… .").

[40] *Village of Belle Terre v. Boraas*, 416 U.S. 1, 8 (1974). *See also General Motors Corp. v. Romein*, 503 U.S. 181, 191 (1992); *Exxon Corp. v. Governor of Maryland*, 437 U.S. 117, 124-125 (1978).

[41] *Williamson v. Lee Optical*, 348 US 483, 487-88 (1955) ("It is enough that there is an evil at hand for correction, and that it might be thought that the particular legislative measure was a rational way to correct it.").

[42] *See also Lingle v. Chevron U.S.A., Inc.*, 544 U.S. at 542 ("[A] regulation that fails to serve any legitimate governmental objective may be so arbitrary or irrational that it runs afoul of the Due Process Clause," even if it survives scrutiny under the Takings Clause.).

program that encourages modifications that serve the best interests of investors. Although contract rights are curtailed, most investors will benefit. If they are harmed, our program offers compensation.

Finally, the Supreme Court has upheld various state statutes that have impaired existing contractual rights. Although these cases apply the Contracts Clause[43], which is inapplicable to federal legislation[44], they provide useful guidance. The Contracts Clause imposes more restrictive[45] constraints on state law than the Due Process Clause imposes on federal action. If our proposal would survive scrutiny under the Contract Clause, then, it raises no due process concerns.

In Contracts Clause cases, the Supreme Court has asked whether state legislation (i) surprises contractual parties, who reasonably expected to avoid state interference with their contractual rights, (ii) "rests on, and is prompted by, significant and legitimate state interests", and (iii) uses rational means to address the state interest.[46] Our proposal satisfies these inquiries. To be sure, when they agreed to the PSAs, investors probably did not anticipate the kind of legal intervention that we propose here. At the same time, however, they did not expect to avoid *any* legal intervention. The investors purchased securities, regulated by federal securities laws, which change frequently.

Even if legislation defeats the reasonable investment-backed expectations of investors, the Supreme Court has made clear that the legislation does not violate the Contracts Clause if it is motivated by "an important general social problem."[47] The interest here—avoiding a foreclosure crisis that threatens the nation's housing market—is undoubtedly a compelling social problem. And our proposal is a narrowly tailored program for mitigating that crisis. Limits on modification will be lifted, to permit modification; a litigation safe harbor will be available for good faith, reasonable modifications.

Indeed, our proposal is no more burdensome than the Minnesota foreclosure moratorium, which was challenged before the Supreme Court and withstood scrutiny under the Contracts Clause.[48] Like that moratorium, our proposal is a temporary measure to address a major economic crisis. That program applied to all homeowners and cut back the foreclosure rights of lenders for two years. Although lenders could reassert their rights after that period ended, the moratorium itself caused permanent injury to lenders. This effect was acknowledged by dissenting justices when the moratorium was reviewed by the Supreme Court: "[I]t cannot be foreseen what will happen to the property during that long period of time. The buildings may deteriorate in quality; the value of the property may fall to a sum far below the purchase price."[49]

[43] U.S. Const. Art. I, s 10, cl. 1 ("No State shall ... pass any ... Law impairing the Obligation of Contracts ....")
[44] *National R.R. Passenger Corp. v. Atchison, Topeka & Santa Fe R.R.*, 470 U.S. 451, 472 (1985).
[45] *Pension Benefit Guar. Corp. v. R.A. Gray & Co*., 467 U.S. 717, 733 (1984) ("We have never held, however, that the principles embodied in the Fifth Amendment's Due Process Clause are coextensive with prohibitions existing against state impairments of pre-existing contracts. … Indeed, to the extent that recent decisions of the Court have addressed the issue, we have contrasted the limitations imposed on States by the Contract Clause with the less searching standards imposed on economic legislation by the Due Process Clauses.").
[46] *Energy Reserves Group v. Kansas Power & Light Co*., 459 U.S. 400 (1983).
[47] *Id*., at 412 n. 13.
[48] *Blaisdell*, 290 U.S. 398.
[49] *Id*., at 481-82 (Sutherland, J., dissenting) ("Moreover, it cannot be foreseen what will happen to the

This permanent injury did not undermine the constitutional status of the moratorium because, according to a majority of the Supreme Court, the Minnesota statute was motivated by an economic emergency, designed to "protect the vital interests of the community"[50], and reasonably tailored (in duration and scope) to "the exigency which called it forth"[51], particularly because investors received some compensation (payments equal to the rental value of the home) during the moratorium.

Our proposal shares features in common with the Minnesota statute. Ours is motivated by an economic emergency—the same emergency motivating other historic legislation, such as the Emergency Economic Stabilization Act of 2008,[52] which created the TARP. Our proposal is designed to protect the "vital interests of the community." The current foreclosure crisis is destructive to communities, homeowners, and investors. And our proposal is tailored to "the exigency which called it forth." It is temporary: it creates a limited period (through 2011) during which mortgage servicers are given discretion to modify troubled mortgages and protected by a litigation safe harbor. Like the Minnesota statute, our proposal effectively compensates lenders for the abrogation of their contractual rights. While the Minnesota statute compensated lenders explicitly, our proposal offers in-kind compensation: Servicers will modify loans only when modification *improves* payoffs to investors as a group. They will not enjoy the protection of our safe harbor if they pursue modification without a reasonable, good-faith belief that modification will benefit investors. Although our proposal will permanently impair the rights of investors—because it allows servicers to modify loans even when PSAs would prohibit or limit it—this does not necessarily distinguish it from the Minnesota moratorium, which permanently impaired the rights of lenders.

Proposed Legislation

The elements of our legislative proposal could be implemented by an Act along the following lines. This draft legislation does not include provisions that establish a compensation fund for aggrieved investors. We anticipate that these provisions would be modeled on existing federal laws.[53]

1. **Definitions.**

(a) "Securitized Mortgages" means residential mortgages that have been pooled by a Securitization Vehicle.

(b) "Securitization Vehicle" means a trust, corporation, partnership, limited liability entity, special purpose entity, or other structure that—

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property during that long period of time. The buildings may deteriorate in quality; the value of the property may fall to a sum far below the purchase price; the financial needs of appellant may become so pressing as to render it urgently necessary that the property shall be sold for whatever it may bring.

"However these or other supposable contingencies may be, the statute denies appellant for a period of two years the ownership and possession of the property—an asset which, in any event, is of substantial character, and which possibly may turn out to be of great value. The statute, therefore, is not merely a modification of the remedy; it effects a material and injurious change in the obligation.").

[50] *Id.*, at 444.

[51] *Id.*, at 447.

[52] Pub. L. No. 110-343 (2008).

[53] *See*, *e.g.*, The Cerro Grande Fire Assistance Act, Pub. L. No. 106-246 § 101, 114 Stat. 511, 583-590 (2000).

(i) is the issuer, or is created by the issuer, of mortgage pass-through certificates, participation certificates, mortgage-backed securities, or other similar securities backed by a pool of assets that includes residential mortgage loans;

(ii) holds such loans; and

(iii) has not issued securities that are guaranteed by the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation Fannie Mae, or the Government National Mortgage Association.[54]

(c) "Servicer" means a servicer of Securitized Mortgages.

(d) "Eligible Servicer" means a servicer of pooled and securitized residential mortgages, all of which are eligible mortgages.

(e) "Eligible Mortgage" means a residential mortgage, the principal amount of which did not exceed the conforming loan size that was in existence at the time of origination for a comparable dwelling as established by the federal national mortgage association.

(f) ''Secretary'' means the Secretary of the Treasury.

(g) ''TARP Funds'' means funds authorized for payment pursuant to the Troubled Asset Relief Program of the Emergency Economic Stabilization Act of 2008.

(h) "Effective Term of the Act" means the period beginning on the effective date of this Act and ending on December 21, 2008.

(i) "Incentive Fee" means the monthly payment to Eligible Servicers as determined in Section 3(a).

(j) "Prepayment Fee" means the payment to Eligible Servicers as determined in Section 3(b).

2. **Authority**. The Secretary is authorized to use TARP Funds to make payments to Eligible Servicers on the terms and conditions set out in Section 3.

3. **Fees Paid to Eligible Servicers**. During the Effective Term of the Act, Eligible Servicers are entitled to monthly fee payments consistent with the following terms and conditions:

(a) For every mortgage that was not prepaid during a month, Eligible Servicers are entitled to an Incentive Fee equal to ten percent of mortgage payments received during that month, provided that the Incentive Fee does not exceed $60 per loan.

(b) For every mortgage that was prepaid during a month, Eligible Servicers will receive a one-time Prepayment Fee equal to 12 times the previous month's Incentive Fee.

4. **Safe Harbor.** Notwithstanding any other provision of law, and notwithstanding any investment contract between a Servicer and a Securitization Vehicle, a Servicer –

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[54] With the exception of Section 1(b)(iii), our definition of "securitization vehicle" is borrowed from Senate Bill S. 2801, The Mortgage Enhancement and Modification Act of 2008 (April 2, 2008), and House Bill H.R. 5857, the Homeownership Protection and Housing Market Stabilization Act of 2008 (April 22, 2008).

(a) owes any duty to maximize the net present value of the pooled mortgages in the Securitization Vehicle to all investors and parties having a direct or indirect interest in such Vehicle, not to any individual party or group of parties; and

(b) shall be deemed to act in the best interests of all such investors and parties if the servicer agrees to or implements a modification, workout, or other loss mitigation plan for a residential mortgage or a class of residential mortgages that constitute a part or all of the pooled mortgages in such Securitization Vehicle, provided that any mortgage so modified meets the following criteria:

(i) Default on the payment of such mortgage has occurred or is reasonably foreseeable.

(ii) The property securing such mortgage is occupied by the mortgagor of such mortgage.

(iii) The servicer reasonably and in good faith believes that the anticipated recovery on the principal outstanding obligation of the mortgage under the modification or workout plan exceeds, on a net present value basis, the anticipated recovery on the principal outstanding obligation of the mortgage through foreclosure.[55]

(c) shall not be obligated to repurchase loans from or otherwise make payments to the Securitization Vehicle on account of a modification, workout, or other loss mitigation plan that satisfies the conditions of Subsection 4(b).

(d) if it acts in a manner consistent with the duty set forth in subsections (a) and (b), shall not be liable for entering into a modification or workout plan to

(i) any person, based on that person's ownership of a residential mortgage loan or any interest in a pool of residential mortgage loans or in securities that distribute payments out of the principal, interest and other payments in loans on the pool;

(ii) any person who is obligated to make payments determined in reference to any loan or any interest referred to in paragraph (i); or

(iii) any person that insures any loan or any interest referred to in paragraph (i) under any law or regulation of the United States or any law or regulation of any State or political subdivision of any State.[56]

5. **Legal costs**. If an unsuccessful suit is brought by a person listed in Subsection 4(d), that person will bear the servicer’s actual legal costs, including reasonable attorney fees and expert witness fees, incurred in good faith.

6. **Reporting requirements**.[57] Every Servicer shall report regularly, but not less frequently than monthly, to the Secretary on the extent and scope of the loss

[55] Sections 4(a) and 4(b) parallel the standard approved by Congress in the Hope for Homeowners Act of 2008, 15 U.S.C. § 1639.

[56] Section 4(d) draws on the safe harbor proposed by House Bill H.R. 5857, The Homeownership Protection and Housing Market Stabilization Act of 2008 (April 22, 2008).

[57] This section draws on reporting requirements proposed by Senate Bill S. 3686, The Foreclosure Diversion and Residential Mortgage Loan Modification Act (Sep. 17, 2008).

mitigation activities of the mortgage owner.

(a) The reports shall include—

(i) the number of residential mortgage loans receiving loss mitigation that have become performing loans;

(ii) the number of residential mortgage loans receiving loss mitigation that have proceeded to foreclosure;

(iii) the total number of foreclosures initiated during the reporting period;

(iv) data on loss mitigation activities disaggregated to reflect whether the loss mitigation was—

(I) waiver of any late payment charge, penalty interest, or any other fees or charges, or any combination thereof;

(II) establishment of a repayment plan under which the homeowner resumes regularly scheduled payments and pays additional amounts at scheduled intervals to cure the delinquency;

(III) forbearance under the loan that provides for a temporary reduction in or cessation of monthly payments followed by a reamortization of the amounts due under the loan, including arrearage, and a new schedule of repayment amounts;

(IV) waiver, modification, or variation of any material term of the loan, including short-term, long-term, or life-of-loan modification that changes the interest rate, forgives the payment of principal or interest, or extends the final maturity date of the loan;

(V) short refinancing of the loan consisting of acceptance of payment from or on behalf of the homeowner of an amount less than the amount alleged to be due and owing under the loan, including principal, interest, and fees, in full satisfaction of the obligation under such loan and as part of a refinance transaction in which the property is intended to remain the principal residence of the homeowner;

(VI) acquisition of the property by the owner or servicer by deed in lieu of foreclosure;

(VII) short sale of the principal residence that is subject to the lien securing the loan;

(VIII) assumption of the homeowner's obligation under the loan by a third party;

(IX) cancellation or postponement of a foreclosure sale to allow the homeowner additional time to sell the property; or

(X) any other loss mitigation activity not covered; and

(v) such other information as the Secretary determines to be relevant.

(b) After removing information that would compromise the privacy interests of mortgagors, the Secretary make public the reports required by this Section.

7. **Sunset**. This Act shall sunset December 31, 2011.

APPENDIX 4: Cost of Potential Compensation to Junior Investors

Our proposal includes compensation for investors who (a) are parties to PSAs that explicitly limit modification and (b) suffer losses, relative to foreclosure, as a result of modifications that are permitted by our Legislative Proposal but barred by the original terms of the PSAs. The compensation, we believe, should be paid using TARP funds. The aggregate cost of compensation can be estimated as follows.

As of October 2008, there were about $1.52 trillion worth of outstanding privately securitized mortgages of which about $900 billion were subprime and alt-A and $620 billion were prime/jumbo mortgages. Among these securitized mortgages, about one third of the PSAs include explicit limits on modification.[58] The average interest rate on these mortgages, we assume, is about 7 percent for subprime and alt-A and 6 percent for prime. We assume that modification will affect junior investors who are, on average, entitled to 5 percent of interest payments from the subprime and alt-A mortgage pools and up to 1 percent from prime pools. We believe these numbers are reasonable in light of initial subordination levels and the recent wave of foreclosures, which has eliminated many junior positions. The smaller impact of mortgage modifications on junior positions in prime pools is motivated by the much lower subordination levels for these mortgages and smaller number of potential modifications. Loan modification will prevent these investors from receiving their respective percent share of up to 18 months of interest payments, which they would have received if the loan had gone through foreclosure.

Based on these assumptions, the total cost of compensating junior investors is $1.7 billion (equal to 0.011% of $1.5 trillion). These calculations may well overstate the actual cost because it assumes that junior investors lose 18 months of cash flow, but the number of months will be much smaller in many jurisdictions. Additionally, some securities might be pass through, eliminating the need to compensate junior holders, and the limits in some PSAs may not prevent optimal modification, in which case modification will not harm junior investors (relative to what they expected under the terms of the contract).

Our compensation amounts are low because the alternative that investors face is foreclosure. Some investors are claiming much higher levels of compensation than a few billion dollars. How do they get those much higher damage amounts? One argument made by investors is that there are clauses in the PSAs that require loans to be bought out of the trusts at par if they are modified. However, without this legislation, the value of those loans is not par, but it is the value of the loans in a foreclosure because servicers would not choose to modify mortgages under the existing PSAs. Thus our view is that compensation should be based on the entirety of our proposal, versus what would happen without our proposal (status quo).

For the 1/3 of PSAs that place appreciable limits on modifications, our proposal would eliminate those limits. However, at most, compensation would only be due to investors whose economic interests were harmed. The proposal gives a safe harbor for modifications that increase returns to investors as a group. The only investors who would be harmed is a small group of mezzanine investors who might lose some cash flow they would otherwise have received during the foreclosure process before their tranches were wiped out altogether. We propose to compensate those investors whose economic interests have been harmed with TARP money.

[58] *See, e.g.*, Credit Suisse, "The Day After Tomorrow: Payment Shock and Loan Modifications" (2007).

However, that compensation amounts to less than $2 billion, a relatively small sum given the large number of foreclosures prevented.

For the roughly 2/3 of PSAs that suggest that servicers operate "in the best interests of the trust," our proposal really just clarifies that the interpretation of that clause should refer to investors as a group. For those trusts, we do not see compensation as being necessary. The modifications allowed would increase returns to the trust as a whole. However, even if we did provide compensation for these trusts as well, the amount involved would be small—probably 2 times our estimate above, or $4 billion.

Adding the $1.7 billion cost of this adjustment, our proposal will cost around $10.7 billion and prevent nearly one million foreclosures.

A New Proposal to Compensate Second Lien Holders
by Christopher Mayer, Edward Morrison, and Tomasz Piskorski*

Second liens can be a barrier to successful modifications of first mortgages. Modification of the first mortgage might yield greater recovery to first mortgage lenders than a foreclosure. But there is little incentive to modify the first mortgage unless second lien lenders agree to relinquish their claims. Otherwise, a modification of the first mortgage will just allow the borrower to allocate more of her income to the second lien.

Even if the first mortgage exceeds the home's expected foreclosure value—implying zero recovery to the second lien lenders in foreclosure—the second lien servicer has little incentive to agree to a modification that extinguishes the second lien. As long as there is some uncertainty surrounding foreclosure value, no matter how small, the servicer will prefer foreclosure to loan modification. The former offers a slight chance of recovery to second lien lenders; the latter offers no recovery. Additionally, terms of pooling and servicing agreements might prevent the second lien servicer from agreeing to any modification that extinguishes the lien. As well, by delaying and appearing obstinate, the second lien lender might convince the first mortgage servicer to "buy out" the second lien at a price above its true value. This is often called a "hold-up" problem.

We propose that Congress create incentives for second lien servicers to cooperate with first mortgage servicers. Our proposal has two elements—(1) an Incentive Fee and (2) a Legislative Proposal.

Incentive Fee. We propose compensating second lien lenders who voluntarily surrender their mortgages in order to permit modification by first mortgage servicers. If a first mortgage servicer proposes a loan modification and, in response, the second lien servicer relinquishes its claims against the home and the borrower, the second lien lender will receive payment equal to five percent of the outstanding second lien balance, with payment not to exceed $1,500 per property. If multiple second liens exist, this payment will be split between the liens. This compensation can be paid using TARP funds.

In order to limit taxpayer costs, and focus primarily on foreclosure prevention, the Incentive Fee will be available only to a second lien lender that relinquishes its claims in response to a decision by a first mortgage servicer to conduct a significant modification of the primary mortgage. By significant, we mean a modification that reduces the borrower's monthly payments by at least 10 percent. This program will only apply to primary residences. As well, compensation will be available only when the first and

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second liens are held by different lenders. Finally, our proposal will apply to all second liens, because the hold-up problem applies beyond just privately securitized mortgages.

The cost of the Incentive Fee will be approximately $1.65 billion. As with our other proposal, the cost of this plan is quite moderate compared to the possible expenditure of $50 to $100 billion to reduce foreclosures. We compute the cost of compensation as follows. Using deeds records, we estimate that about 13.3 million homes are subject to both first mortgages and second liens as of October 2008. Among these homes, 8.9 million homes have loan-to-value ratios exceeding 92 percent. (In our calculations, we assume a loan-to-value ratio equal to 92 percent; this allows for future house price declines of 8 percent or more.) When the loan-to-value ratio is only 92 percent, a second lien lender is unlikely to agree to relinquish its claim, for obvious reasons. We assume that around one-quarter of these mortgages are at risk of foreclosure. Among those, modification might make sense half of the time. Thus about 1.1 million second lien mortgages might require compensation for the relinquishment of their rights. If all second lien holders agree to relinquish their rights, the total cost of compensating them will be no more than $1.65 billon.

Legislative Proposal. Our proposal gives second lien servicers sole authority to decide whether to surrender the lien in exchange for the Incentive Fee. Because this authority may be inconsistent with the terms of pooling and servicing agreements (PSAs), we propose that Congress enact a "litigation safe harbor" that insulates servicers from litigation, provided they surrender second liens only when they have a reasonable, good faith belief that the Incentive Fee will increase the recovery to investors, as a group, relative to foreclosure. This safe harbor will be an affirmative defense, which servicers can assert in the event of litigation, regardless of the actual terms of the PSAs. Judges will evaluate whether the servicer held a reasonable, good faith belief that the Incentive Fee would increase recoveries to investors, not on evidence that investors were in fact made better off. If investors bring suit, but a servicer successfully invokes the safe harbor, the plaintiff investors will pay the servicer's actual legal costs, including attorney and expert-witness fees.

This Legislative Proposal is constitutional for the same reasons that our Loan Modification Proposal is constitutional (see Appendix 3 of that proposal). Central to our constitutional analysis is the observation that, although our proposal abrogates terms of existing contracts, it does so in order to *improve* investor recoveries.

Additionally, the Incentive Fee and Legislative Proposal should be temporary measures to address the current foreclosure crisis. We propose that Congress terminate these measures at the end of calendar year 2011, by which time the current crisis should have moderated.

Together, the Incentive Fee and Legislative Proposal will help align the interests of first and second lien lenders. The Incentive Fee gives second lien lenders a financial incentive to cooperate with first mortgage servicers when they pursue loan modification. Because second lien lenders are widely dispersed and face barriers to cooperation, the Legislative Proposal empowers second lien servicers to act on their behalf. These servicers will respond to financial incentive created by the Incentive Fee only when it is in the best interests of second lien investors.

The Legislative Proposal could be implemented by legislation along the following lines:

1. **Definitions.**

(a) "First Mortgage" means a first-priority, senior mortgage on owner-occupied housing.

(b) "Subordinate Lien" means a subordinate lien on owner-occupied housing.

(c) "Modification" means a permanent change to the terms of a First Mortgage—including reduction in interest rates and fees, term or amortization extensions, forbearance or forgiveness of principal, or other similar changes—that reduces the borrower's monthly payments by at least ten percent.

(d) "Securitized First Mortgages" means First Mortgages that have been pooled by a Securitization Vehicle.

(e) "Securitized Subordinate Liens" means Subordinate Liens that have been pooled by a Securitization Vehicle.

(f) "Securitization Vehicle" means a trust, corporation, partnership, limited liability entity, special purpose entity, or other structure that—

(i) is the issuer, or is created by the issuer, of mortgage pass-through certificates, participation certificates, mortgage-backed securities, or other similar securities backed by a pool of assets that includes residential mortgage loans;

(ii) holds such loans; and

(iii) has not issued securities that are guaranteed by the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation Fannie Mae, or the Government National Mortgage Association.

(g) "First Lien Servicer" means a servicer of First Mortgages, including Securitized First Mortgages.

(h) "Subordinate Lien Servicer" means a servicer of Subordinate Liens, including Securitized Subordinate Liens.

(i) "Incentive Fee" means payment equal to five percent of the outstanding balance of a Subordinate Lien that is surrendered to the mortgagor pursuant to the Incentive Fee Program, defined in Section 3.

(j) ''Secretary'' means the Secretary of the Treasury.

(k) ''TARP Funds'' means funds authorized for payment pursuant to the Troubled Asset Relief Program of the Emergency Economic Stabilization Act of 2008.

(l) "Effective Term of the Act" means the period beginning on the effective date of this Act and ending on December 31, 2011.

2. **Authority**. The Secretary is authorized to use TARP Funds to make payments to Eligible Servicers on the terms and conditions set out in Section 3.

3. **Incentive Fee Program**. During the Effective Term of the Act, a

Subordinate Lien Servicer is entitled to the Incentive Fee, not to exceed $1,500, for every Subordinate Lien that is surrendered to the mortgagor, provided that

(a) the borrower's personal liability under the Subordinate Lien is extinguished,

(b) the Subordinate Lien Servicer submits proof that the First Mortgage underwent Modification immediately before or after the Subordinate Lien was surrendered, and

(c) the Second Lien Servicer is a different entity from the First Mortgage Servicer.

4. **Multiple Subordinate Liens**. If more than one Subordinate Lien encumbers the same property, each Subordinate Lien Servicer may participate in the Incentive Fee Program, but total payments to the Subordinate Lien Servicers may not exceed $1,500.

5. **Safe Harbor.** Notwithstanding any other provision of law, and notwithstanding any investment contract between a Subordinate Lien Servicer and a Securitization Vehicle, a Subordinate Lien Servicer –

(a) owes any duty to maximize the net present value of the pooled mortgages in the Securitization Vehicle to all investors and parties having a direct or indirect interest in such Vehicle, not to any individual party or group of parties; and

(b) shall be deemed to act in the best interests of all such investors and parties if the Subordinate Lien Servicer participates in the Incentive Fee Program, provided the Subordinate Lien Servicer reasonably and in good faith believes that the anticipated recovery under the Incentive Fee Program exceeds, on a net present value basis, the anticipated recovery on the principal outstanding obligation of the mortgage through foreclosure.

(c) if it acts in a manner consistent with the duty set forth in subsections (a) and (b), shall not be liable for entering into a modification or workout plan to

(i) any person, based on that person's ownership of a residential mortgage loan or any interest in a pool of residential mortgage loans or in securities that distribute payments out of the principal, interest and other payments in loans on the pool;

(ii) any person who is obligated to make payments determined in reference to any loan or any interest referred to in paragraph (i); or

(iii) any person that insures any loan or any interest referred to in paragraph (i) under any law or regulation of the United States or any law or regulation of any State or political subdivision of any State.

6. **Legal costs**. If an unsuccessful suit is brought by a person listed in Subsection 4(c), that person will bear the servicer’s actual legal costs, including reasonable attorney fees and expert witness fees, incurred in good faith.

7. **Sunset**. This Act shall sunset December 31, 2011.