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Worsening Foreclosure Crisis: Is It Time to Reconsider Bankruptcy Reform?: Hearing Before the Subcomm. on Administrative Oversight and the Courts of the S. Comm. on the Judiciary, 111th Cong., July 23, 2009 (Statement of Adam J. Levitin, Associate Prof. of Law, Geo. U. L. Center)

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Written Testimony of

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Before the
Senate Committee on the Judiciary
Subcommittee on Administrative Oversight and the Courts

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Witness Background Statement

Adam J. Levitin in an Associate Professor of Law at the Georgetown University Law Center, in Washington, D.C., where he teaches courses in bankruptcy and commercial law. He is also Director of the Georgetown-Hebrew University in Jerusalem Executive LLM Program in Business and Commercial Law and the Robert Zinman Resident Scholar at the American Bankruptcy Institute.

Before joining the Georgetown faculty, Professor Levitin practiced in the Business Finance & Restructuring Department of Weil, Gotshal & Manges, LLP in New York. Professor Levitin has also served as Special Counsel for Mortgage Affairs for the Congressional Oversight Panel and as law clerk to the Honorable Jane R. Roth on the United States Court of Appeals for the Third Circuit.

Professor Levitin’s research focuses on financial institutions and their role in consumer and business finance, including credit card and mortgage lending, securitization, identity theft, DIP financing, and bankruptcy claims trading. His articles have appeared in numerous law reviews and finance journals and have won the 2007 Editors’ Prize of the American Bankruptcy Law Journal and the 2009 Article Prize of the American College of Consumer Financial Services Lawyers. Professor Levitin is also a regular commentator on Credit Slips, a blog devoted to credit and bankruptcy issues.

Professor Levitin holds a J.D. from Harvard Law School, an M.Phil and an A.M. from Columbia University, and an A.B. from Harvard College, all with honors.

Professor Levitin has not received any Federal grants nor has he received any compensation in connection with his testimony and does not represent any party with regard to mortgage regulatory issues. The views expressed in Professor Levitin’s testimony are his own and do not represent the positions of the American Bankruptcy Institute.
Mr. Chairman, Members of the Committee:

Good morning. My name is Adam Levitin. I am an Associate Professor of Law at the Georgetown University Law Center in Washington, D.C., where I teach courses in bankruptcy, commercial law, contracts, and structured finance. My research and writing focus on consumer finance and corporate bankruptcies. In particular, I have written about the obstacles to mortgage modification in the current crisis. I have also recently served as Special Counsel for Mortgage Affairs for the Congressional Oversight Panel for the Troubled Asset Relief Program, and am currently the Robert Zinman Resident Scholar at the American Bankruptcy Institute. The views I express today are my own.

I. Where We Are Now

We are now well into the third year of the foreclosure crisis, and there is no end in sight. Since 2007 between five and six million homes entered foreclosure. As of March 31, 2009, the Mortgage Bankers Association reported that 3.85% of residential mortgage loans were currently already in foreclosure, a rate nearly quadruple historical averages. (See Chart 1.) Additionally, 5.65% of mortgages were more than 60 days delinquent and 9.12% were at least a month delinquent. By the end of 2010, another 7 million homes are expected to enter foreclosure.1 Unless the crisis is abated, by the time it runs its course, as many as one in five residential borrowers will have gone into foreclosure.

Chart 1: Percentage of 1-4 Family Residential Mortgages in Foreclosure2

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1 Not Much Relief, NEW YORK TIMES, July 5, 2009, at WK7.
2 Mortgage Bankers Association, National Delinquency Surveys
Private lenders, industry associations, and two successive administrations have made a variety of efforts to mitigate the crisis and encourage loan modifications and refinancings, including a series of much vaunted initiatives—the HOPE Now Alliance, FHASecure, Hope4Homeowners, and the Making Home Affordable Program—but these have only had what can charitably be described as limited success. There is still limited data on the Making Home Affordable Program, and it shows greater promise than past initiatives, but there is no indication that it will affect a substantial shift in the foreclosure balance. Instead, these programs all seem like exercises in rearranging the deck chairs on the Titanic.

Unfortunately, there is still no consensus on why we are seeing so few loan modifications, even with tremendous government incentive payments to mortgage servicers. Some have argued that securitization structures create a variety of obstacles to loan modification, including outright contractual prohibitions and limitations, litigation risk, and adverse incentives for the servicers who make the modification decisions. Others have argued that factors like redefault risk and self-cure risk make loan modification a poor bet economically for mortgagees, and that the simple reason modifications are not happening is that they are not profitable, even compared to losses of sixty cents on the dollar in foreclosure. Others have pointed to factors like lack of servicer experience and capacity in loan modification. And of course these are hardly exclusive positions. Different factors may play different roles depending on the particular mortgagee.

Whatever the explanation for lack of modifications, we are presented with the inescapable fact that a distressingly large number of American families are losing their homes. These families are not just speculators who were looking to flip homes or cash out equity on refinancings or even greedy purchasers who bought McMansions they really couldn’t afford by putting little money down in hopes of quickly accumulating home equity in an appreciating market. These families now include people who played by the traditional mortgage market rules, put their 20% down, got traditional fixed-rate mortgages, and bought houses that in normal market conditions would be within their means.

We are also presented with the terrible knowledge that the foreclosures are not about to stop anytime soon. In fact, they are likely to get much worse.

II. The Shifting Causes of Default and Foreclosures

The foreclosure crisis has gone in waves of defaults. First there were the speculators, who borrowed close to 100% of property values and maybe more with construction mortgages. As soon as property values flattened, much less dropped, they bailed, as the costs of carrying the mortgages was more than the appreciation that they anticipated receiving on sale. Many of these loans were non-recourse and the speculators simply walked away.

Next came a wave of defaults caused by payment reset shock, primarily from expiration of teaser rates on hybrid ARMs. Hybrid ARMs have a fixed teaser rate for one to three years,

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and then an adjustable rate that is usually substantially higher. (These loans are often called 2/28s or 3/27s, with the numerator in reference to the length of the teaser and the denominator in reference to the remaining term of the mortgage.) The teaser rate made occupancy for the teaser period quite affordable. Many hybrid ARMs were subprime loans, meaning that they were at a substantially above-market rate. Sometimes this was because of the risk posed by the borrower, sometimes it was because the borrower wanted to get a low teaser rate by gambling on the ability to refinance later when the teaser expired, and sometimes it was simply because prime borrowers were duped or steered into taking out these mortgages.

Homeowners who took out hybrid ARMs anticipated being able to refinance the properties when the teaser rate expired. A refinancing, however, requires some equity in the property (and in the declining market, substantial equity in the property). Many of these mortgages were made by homeowners who had little equity in the property to begin with, but who anticipated accumulating it quickly in the appreciating market of the housing bubble. When the market fell, they lacked the equity to refinance. What’s more, many faced stiff prepayment penalties if they refinanced.

As a result, they were stuck with the hybrid ARMs when the teaser period expired. Most of these loans had been underwritten based on an ability to pay the teaser rate, rather than the reset rate, and even the teaser rate underwriting was often a stretch. When the rates reset, payment on these mortgages was frequently unaffordable, and even when it was, the homeowners were caught with negative equity and facing a declining market. The result was another wave of defaults.

Many of the hybrid ARMs were made in 2005 and 2006 with two-year teasers. Many of the teaser expirations have already occurred, so this wave has crested, and low interest rates have mitigated some of the rate reset effect. There are, however, also a significant number of so-called 5/1 ARMs with a rate reset occurring five years after the loan’s origination. The rate resets on the 5/1s underwritten during the bubble still lie ahead.

Now we are looking at another wave of defaults from interest rate resets, this time on so-called pick-a-pay or pay-option ARMs. Pay-option ARMs permit the borrower to choose the level of monthly payment. Typically there are four choices—as if the loan were amortizing over 15 years; as if the loan were amortizing over 30 years; interest only (non-amortizing); and negatively amortizing. The interest rate in a pay-option ARM is always adjustable based on an index rate. Pay-option ARMs generally have negative amortization limits. If there is too much negative amortization (often 10-15%), then the loan will be recast into an amortizing ARM. If the homeowner has been making too many payments at the negatively amortizing rate, the payment shock of the reset will be significant. Moreover, because these loans are negatively amortizing, they would be difficult to refinance even in a good market, but in a falling market they are impossible to refinance because they are underwater.

Most pay-option ARMs were not subprime loans. Instead, they were made to prime borrowers, but were often underwritten with reduced documentation, making them so-called “Alt-A” loans. Credit Suisse has estimated that most of the pay-option ARM market will be experiencing rate resets over the next two years (see graphic below). Again, while low interest rates will mitigate the payment reset shock, the switch from negative amortization to positive amortization alone will result in a greatly increased monthly payment for many pay-option
borrowers, who will then be confronted with making significantly greater monthly payments for a property in which they have no equity.

Figure 1.7. Monthly Mortgage Rate Resets
(First reset in billions of U.S. dollars)

The fourth wave of defaults has already begun, and the worst is still ahead of us. This wave is fueled by a declining market, as underwater homeowners with no prospect of positive equity in the near future strategically default on their mortgages. (By strategic default, I mean default by a homeowner who can pay a mortgage, but does not because it is not economically sensible to do so.) A number of studies have identified negative equity as a, if not the, primary factor in current foreclosures.6

For homeowners who purchased in the past five years, over 30% are underwater, and perhaps a quarter of all residential mortgagors are underwater. Unfortunately, foreclosures create negative feedback loops that result in more foreclosures. Foreclosures push down housing prices. Depressed housing prices contribute to negative equity. And negative equity encourages strategic defaults and more foreclosures.

Rising unemployment will only exacerbate the problems of negative equity. When a home is both underwater and the monthly payments are unaffordable out of current earnings, a default is nearly inevitable. Not surprisingly, defaults are spreading into the conventional prime market, jumbo prime, second lien, and HELOC markets, with unemployment and negative equity, rather than payment reset shock as drivers. Prime defaults and foreclosures started to surge sharply at the close of 2008 and have continued to do so into 2009. (See Chart 2, below.)

**Chart 2: Prime Mortgage Delinquencies and Foreclosures**

III. Housing Futures Predict Further Market Declines and a Slow Recovery

These are not just my pessimistic predictions, or even those of bearish analysts. It is also what the market as a whole believes. U.S. housing market futures based on the Case-Shiller Home Price Index are traded on the Chicago Mercantile Exchange. The Index is pegged to January 2000 as 100. At its peak in June 2006, the Index was at 226.29. As of April 2009, the Case-Shiller Index stands at 150.34, a 33% drop from peak. The futures market anticipates it falling to a low of 133.6 in May 2010 (down 41% from peak) and still not climbing above 160 in November 2013 (down 29% from peak), which is where it stood in January 2009 and October 2009.

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7 Mortgage Bankers Association, National Delinquency Surveys.
In other words, the market anticipates that housing prices will only rise 6% over the next four years. (See Chart 3.)

**Chart 3: S&P/Case-Shiller Composite 10 Home Price Index and Chicago Mercantile Exchange Futures on Composite 10 Index**

While this would mean the housing market hitting a bottom and recovering somewhat, it also means that it will take four years for prices to get back to their already depressed values of this year. It also means that many of the families that took out mortgages between 2003 and 2008 will have negative equity in their homes.

This presents a problem not just for current foreclosures, but for years into the future. The nature of life is that people have different housing needs at different stages of life and have to move from time to time. The birth of children, illness, death, divorce, and new jobs all necessitate moves. If a homeowner who has to move has negative equity, the choice is between foregoing the move, somehow finding the cash to make up the negative equity, and losing the house in foreclosure. Many will choose the foreclosure route, and this means years of elevated foreclosure rates, even if there will not be an acute crisis.

Not only does this mean more families losing their homes in foreclosure, more losses for lenders and MBS investors, and more blighted properties for communities, but it also means that true stabilization for the U.S. housing market will be delayed and investors will have difficulty pricing investments because of uncertainty about default rates. As the Congressional Oversight Panel noted in its March 2009 report on the foreclosure crisis:
Homeowners with negative equity cannot sell their homes unless they can make the balloon payment that lurks in the background. Many homeowners will eventually need to move for jobs, for assisted living, for larger or smaller living spaces, or to be near family. If they can find rental housing at an equivalent monthly payment price, they will abandon homes burdened by negative equity. Significant negative equity raises the serious risk that foreclosures have merely been postponed, not prevented.

Negative equity will create significant distortions in the labor, elderly care, and housing markets. Moreover, negative equity will keep foreclosures above their historically low levels. These delayed foreclosures will continue to plague the U.S. housing market and financial institutions’ books for decades.\(^8\)

Unfortunately, none of the current loan modification or refinancing efforts attempt to deal with the negative equity problem in a way that offers a long-term solution. The Home Affordable Refinance Program permits borrowers with loans owned or guaranteed by Fannie Mae and Freddie Mac to refinance at up to 125% of the property’s current appraised value. This allows underwater homeowners to lower their monthly payments, which addresses affordability issues. But it also means that these homeowners will still be paying mortgages on loans worth far more than their houses (and assuming a 7% broker’s fee on sale, anyone with a 93% LTV ratio or higher is effectively underwater). Some individuals might be willing to pay a 25% premium to retain their home. But for others that will prove too much, if not immediately, than in the near future when life events present an impetus to relocate.

To recapitulate:

- We know we are in the midst of an economic catastrophe for the American family and for many communities and that more trouble is to come.
- We know that these problems are likely to last not just for another six months, but for several years, and that they will place a drag on the entire economy, ensuring that recovery, whenever it comes, will be slow.
- We know that there are two factors driving defaults on mortgages—unaffordable payments (often due to rate resets and unemployment) and negative equity (due to high initial loan-to-value ratios and falling housing prices).
- We know that foreclosures place downward pressure on home prices and beget more foreclosures, creating a negative feedback loop or death spiral in the housing market.
- We know that there still aren’t nearly enough loan modifications being done to offset the tide of foreclosures.
- We know that almost no loan modifications address negative equity by reducing principal balances. Of the 185156 loan modifications in the first quarter of 2009, only 3,389 or

1.8% involved principal balance reductions, and all but four of these were for loans held in portfolio, rather than securitized. 9

- We also know many loan modifications do not address affordability by reducing monthly payments. 45.8% of the loan modifications done in the first quarter of 2009 resulted in monthly payments remaining unchanged or even increasing (in 18.5% of cases). 10

- We also know that we still don’t have consensus about why the numerous refinancing and modification programs attempted by industry, the Bush administration, and the Obama administration haven’t made significant headway against the volume of defaults and foreclosures, but we can say that it is likely multicausal and not subject to a silver bullet cure.

IV. Bankruptcy Modification of Mortgages

This situation leaves only one option on the table for the federal government: permit homeowners to modify their mortgages in bankruptcy. Whatever the factors may be that are inhibiting voluntary and government-subsidized loan modifications, they are immaterial if a mortgage loan can be modified in bankruptcy. Permitting the modification of single-family principle residence mortgages in bankruptcy would create a mechanism that would address the negative equity problem as well as the affordability problem while also denying relief to speculators who would abuse the system, and homeowners who cannot realistically afford even a modified mortgage. 11 This mechanism could be immediately available and would have no additional cost to the taxpayers, and it would not result in higher mortgage costs or less mortgage credit availability as long as lenders’ foreclosure losses remain greater than bankruptcy modification losses.

Chapter 13 of the Bankruptcy Code permits qualified debtors to propose a 3- or 5-year repayment plan, during which time all collection actions against the debtor are stayed. 12 Secured debts and priority must be paid in full, 13 and the debtor’s entire statutorily defined disposable income must go to paying unsecured creditors. 14 Upon successful completion of the plan, the consumer’s remaining pre-bankruptcy debts are discharged. 15

Within these parameters, however, the debtor has significant leeway to restructure or modify almost any type of debt. Interest rates can be reduced, amortization schedules changed,

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10 Id. at 25.
11 It is important to emphasize, however, that even with cramdown, Chapter 13 cannot help a homeowner, unless the homeowner has regular income. Regular income is a threshold eligibility requirement for Chapter 13. In a two-earner family, there need be only one regular income, but if a family’s difficulty in paying its mortgage is caused by unemployment of the sole earner, Chapter 13 would not be an option. The reason I emphasize the importance of regular income for Chapter 13 eligibility is that unemployment will be a major factor in the coming wave of foreclosures.
13 11 U.S.C. §§ 1325(a)(5) (secured creditors must receive present value of their collateral or the collateral itself under a plan); 1322(a)(2) (priority creditors must receive deferred cash payments for their full claim).
15 11 U.S.C. § 1328(a) (2005). There are certain exceptions to discharge. Id.
loan tenors increased, and negative equity erased. A consumer debtor can modify car loans, credit card debt, student loans, yacht loans, jet-ski loans, snowmobile loans, airplane loans, computer loans, jewelry loans, and appliance loans, as well as investment property mortgages and vacation home mortgages. A consumer debtor can also modify a principal residence mortgage if it is a multifamily property. This means that a consumer who rents out the basement or the attic can modify the mortgage on her house in bankruptcy. The only type of debt that a consumer cannot modify in bankruptcy is debt on a single-family principal residence. Currently, single-family principal residence mortgages must be repaid according to their original terms or the bankruptcy stay will be lifted and the mortgagee permitted to foreclose.

The policy behind the special protection for single-family principal residences is that Congress believed in 1978 that if mortgage lenders were shielded from losses in bankruptcy, competition would ensure that lenders would pass on these gains to consumers in the form of lower mortgage costs, thereby encouraging homeownership.

Unfortunately, the economic assumption behind the special protection for single-family principal residence mortgages in bankruptcy is incorrect. It is unlikely that bankruptcy modification of mortgages will result in higher costs of credit or less credit availability, despite the banking industry’s protestations to the contrary. The banking industry has not presented a scintilla of evidence that permitting cramdown would affect credit prices. Instead, they have made declarations based on a simplistic economic view that greater access to bankruptcy necessarily results in higher costs of credit and lower credit availability. The economics of bankruptcy, however, are more complicated.

I have conducted the only empirical work on the topic, and the clear finding from my research is that mortgage prices are largely insensitive to bankruptcy modification risk. No premium compensating for bankruptcy modification appears in primary mortgage pricing, secondary mortgage market pricing, or, most crucially, in private mortgage insurance pricing, and there is no discernible effect on homeownership rates from the protection. Permitting bankruptcy modification is unlikely to result in higher mortgage costs or lower mortgage credit availability.

This should not be a surprising finding. Lenders will only raise prices in reaction to permitting bankruptcy modification of all mortgages if it would result in greater losses to them than the alternative—foreclosure. The choice a mortgagee faces is not bankruptcy loss versus no loss, but bankruptcy loss versus foreclosure loss. So long as bankruptcy losses are smaller than foreclosure losses, permitting bankruptcy modification will not result in higher prices.

Thus, it all comes down to the question of whether lenders lose more in bankruptcy than in foreclosure. The best evidence on the question says they do not, and this is not surprising; bankruptcy law guarantees that lenders will recover at least as much as in a foreclosure.

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17 Nobelman v. American Savings Bank, 508 U.S. 324 (1993). The legislative history on the anti-modification provision 11 U.S.C. § 1322(b)(2) is scant and not particularly illuminating of Congressional intent (it is more illuminating of Congressional skepticism in response to mortgage industry claims). Moreover, the history of the anti-modification provision suggests that it was intended only to prevent adjustments to mortgage rates and amortizations, not interfere with 11 U.S.C. § 506, a generally applicable provision of the Bankruptcy Code that limits the amount of a secured claim to the value of the collateral, with any excess claim being treated as unsecured.
Any attempt to mitigate foreclosures faces the challenges of quickly deciding which homeowners to help, addressing the twin problems of negative equity and affordability, avoiding moral hazard, and determining who will bear the cost of loan modifications. Bankruptcy modification helps solve these very issues and can do so more effectively and cheaply than any other proposed solution. Bankruptcy modification is also the only way to bypass the contractual, legal, practical, and economic problems created by securitization.

Permitting mortgage modification in Chapter 13 would provide an immediate solution to much of the current home foreclosure crisis. Bankruptcy courts are capable of immediately handling a large volume of filings, and the bankruptcy automatic stay would function like a foreclosure moratorium until cases could be sorted through.

Bankruptcy modification would not yield a windfall to housing speculators or second home purchasers and would only help homeowners who could ultimately afford a reasonable mortgage. A mortgage loan modification in bankruptcy can occur only as part of a repayment plan. The automatic stay would likely be lifted on an investment property (or second home) before a plan could be confirmed. Accordingly, speculators and homeowners intent on keeping their second homes are unlikely to file for bankruptcy to seek mortgage modification in the first place.

To qualify for Chapter 13 bankruptcy, in which a loan can be modified, a homeowner must have a regular income, and Chapter 13 plans must be feasible given the debtor’s means. This does not mean that any modification is permissible; federal common law of bankruptcy requires that modified loans reflect a reasonable risk premium for the debtor, and the Bankruptcy Code requires that a mortgagee receive at least the present value of the property. Only a debtor who can afford a loan modified within these limits will be able to keep her home. Permitting bankruptcy modification of primary home mortgages thus steers a true course between extending the right sort of relief and not extending it too broadly.

Nor would bankruptcy provide a windfall to homeowners in the event that property values appreciate in future years. While the homeowner would benefit from future appreciation, lenders have no reasonable expectation of this appreciation. Bankruptcy is supposed to, at the very least, give lenders what they would get in foreclosure, and when a home is sold in foreclosure, the lender gets cash for the value of the house, and does not receive any benefit from the property’s future appreciation.

Bankruptcy modification would also provide a solution for both of the distinct mortgage crises—negative equity and payment shock. Bankruptcy modification would help negative equity homeowners by eliminating their negative equity position (“cramdown”), which would reduce their incentive to abandon the property. Likewise, homeowners who are unable to

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24 Chapter 13 “cramdown,” also known as “strip down” or “lien stripping” or “claim bifurcation,” is not to be confused with the unrelated but eponymous Chapter 11 “cramdown,” the confirmation of a plan of reorganization under 11 U.S.C. § 1129(b) (2005), over the objections of a dissenting class of creditors or interests.
afford their mortgage because of a rate reset could modify their loans to make monthly payments fixed and affordable level.

Permitting bankruptcy modification would not create moral hazard for lenders or debtors. Lenders will lose loan value. While they will generally do better than in foreclosure, and the loss is not because of bankruptcy per se, there is still a high price for lenders that will discourage reckless lending. As for homeowners, Chapter 13 bankruptcy is not a “drive-by” process. In order to receive a discharge in Chapter 13, a debtor must live on a court-supervised, means-tested budget for 3 or 5 years, and fully repay certain debts, including allowed secured claims, domestic support obligations, and tax liabilities. There are also limitations on how often a debtor may receive a bankruptcy discharge. Nor would bankruptcy modification give homeowners a windfall. At best, a homeowner with negative equity would end up with zero equity, not positive equity. Given the large transaction costs to a sale, debtors are unlikely to sell their properties for anything beyond a de minimis profit over the next few years.

Finally, one of the greatest advantages of bankruptcy modification is that it has no cost for taxpayers. In an age of a trillion dollars in government bailouts, bankruptcy modification is a rare bargain. Bankruptcy courts are well staffed relative to historic filing levels, and court fees cover the administrative costs of the process. Bankruptcy modification has no cost to taxpayers, and stabilizing housing markets would greatly help economically beleaguered local governments.

The foreclosure crisis is not about to stop any time soon. Judicially-supervised restructuring of mortgages is the only tool we have left in the box. It’s a tool we know can work. It’s a tool that can save hundreds of thousands of families their homes and help stabilize communities, housing markets, and the economy. It’s time to use it.