



Testimony of
The Honorable Marilyn Morgan
United States Bankruptcy Court
Northern District of California

HEARING ON
STRAIGHTENING OUT THE MORTGAGE MESS:
HOW CAN WE PROTECT HOME OWNERSHIP AND PROVIDE RELIEF TO CONSUMERS IN
FINANCIAL DISTRESS?

Before the
Subcommittee on Administrative and Commercial Law
Judiciary Committee
U.S. House of Representatives
September 25, 2007

Chairwoman Sánchez, Ranking Member Cannon, and Members of the Subcommittee, I am honored to have the opportunity to address you on this most important subject.

My name is Marilyn Morgan. I have served as a bankruptcy judge seated in San Jose, California for the past 19 years. My jurisdiction covers Silicon Valley, with its economic engine and high housing costs, and Salinas, the salad bowl for the nation, with its large population of migrant farm workers.

In the nearly thirty years that I have worked with the Bankruptcy Code, I have seen many different industries go through economic downturns that have resulted in the filing of bankruptcies by large numbers of consumers. This is the first time in my memory, however, where the framework of the Bankruptcy Code provides no remedy for those in the most critical economic distress – those facing the imminent foreclosure of their homes.

Nationwide, the home foreclosure rate doubled in the last year. And, according to statistics reported by RealtyTrac (an Irvine, CA real estate company), California's foreclosure rate is now second only to Nevada's. California's foreclosure filing rate in August 2007 reached one in every 224 households – twice the national average. This is a 363 percent increase from the same month a year before. In the semi-rural counties where I sit (San Benito, Monterey, and Santa Cruz), there are currently more than 1,350 homes in the process of foreclosure, and close to 800 that were recently sold in foreclosure. In Santa Clara County, where San Jose is situated, nearly 4,000 homes are currently in foreclosure, and nearly 1,000 recently were sold in foreclosure. This is only the tip of the iceberg. As others have documented, the foreclosure problem is likely to get worse very soon.

A look at the bankruptcy filings for the same community shows a significant increase. In August 2007, there were 413 bankruptcy filings in the San Jose Division – the highest number of bankruptcy filings since the Bankruptcy Abuse Protection and Consumer Protection Act went into effect in October 2005. But clearly, the thousands of homeowners facing foreclosure are not filing for bankruptcy protection because the Bankruptcy Code provides no remedy.

In preparation for my testimony before you, I met with a dozen lawyers from Salinas who are on the front lines grappling with the issues you are considering today. I asked them about the willingness of home lenders to modify loan terms to enable distressed homeowners to save their homes from foreclosure. They told me that, in contrast to the "talk" about voluntary forbearance, the reality is that lenders have been unwilling to offer workouts to debtors who are losing their homes. Home lenders either don't return phone calls at all, or they keep debtors and their attorneys hanging without an answer as the foreclosure sale date fast approaches. Among the attorneys I spoke with, not one could report a single meaningful workout with a home lender.

I heard many heartbreaking stories when I talked with the attorneys. Hard-working Americans with a real emotional investment in their homes and the "American way of life" have lost hope. Because of the strong family culture in many ethnic communities, whole families are being financially tapped out in an effort to save a home from foreclosure. I heard of grown men crying in their attorneys' offices.

And, while some home foreclosures are due to purchases with 100 percent+ financing, many others are losing homes they have owned for years. Some of these debtors refinanced their homes in order to pay off credit cards or make home repairs. The fine-print and confusing mortgage loan provisions are beyond the comprehension of many borrowers. The attorneys I met with described many instances in which loan brokers had "explained away" homeowners' questions about how the payments on a new loan would work with reassuring but misleading statements that any payment or interest rate increases noted on the paperwork would be avoided in the future.

Every week, I hold a court calendar where lenders seek authority to proceed with foreclosures. This calendar historically has been actively contested, with lawyers and their clients going through the emotional experience of fighting to save the family home and come up with a plan to cure a default. Now, however, ninety percent of the motions to foreclose go unopposed by the debtors, because there is no remedy available in my court and no hope for the homeowners. Too many homeowners find that even if they could cure the default, they can't afford the terms of the loan going forward because of the steep increase in the interest rate or other changes in the terms of the loan.

One such case involved an elderly couple who were persuaded to refinance the residence they had owned for many years in order to replace all their windows – a not uncommon situation affecting older homeowners who have been subjected to aggressive marketing pitches. The thousands of dollars for windows and high origination fees significantly increased their mortgage. To the homeowners, it looked like a very good deal because their monthly payments even went down a little bit. What they didn't understand was that the decreased payments were based on negative amortization, resulting in the mortgage actually increasing rather than being paid down over time. In order to just keep even with the interest, the monthly payment was almost twice the negatively amortized payment – and well beyond their financial capability. With falling home values, they cannot refinance their home. Because of the current bar in Chapter 13 to the restructuring of home mortgages, this couple has no remedy to prevent the loss of their home.

Congress is in the position to alter this reality. You can do so with a narrowly targeted change to the Bankruptcy Code that will help families avoid foreclosure.

As others have previously pointed out to this Subcommittee, under the Bankruptcy Code a mortgage on the debtor's residence is the only debt that the bankruptcy courts cannot modify, and the home is the only asset that cannot be protected in this way. The Bankruptcy Code does provide relief for those whose loans on investment properties or second homes have gotten them into financial trouble, but this relief does not extend to the working and middle-class families who are seeking to protect their residences.

The mortgage market today is very different than it was in 1978, when this provision was inserted in the Bankruptcy Code. Throughout the 1970s and early 1980s, fixed interest rate loans with relatively low loan-to-value ratios were the rule. Sub-prime lending has increased significantly in recent years, and today's mortgage market is dominated by so-called "exploding" ARMs, where monthly payment increases can double within a year or two, even as interest rates in the overall economy remain constant. These loans have left many borrowers with payments they cannot afford and mortgages that exceed the value of their homes.

Without being able to restructure these debts, borrowers cannot save their homes and get back on their feet financially. If Congress addresses this serious problem by enacting legislation to permit Chapter 13 debtors to modify mortgages on their primary residence, many thousands of homeowners throughout the nation may be able to avoid the loss of their homes. It is my experience that a home is the largest and most important asset a family has, and the mortgage loan is the family's largest single debt. The exclusion of the principal residence from modification prevents bankruptcy protection from reaching where it is needed most.

One question I have to ask myself is what the impact of the proposed changes will be on the courts. Clearly, there are a lot of abusive loans in my community and if Congress enacts this legislation, there will be a lot of work to be done. On the other hand, bankruptcy judges are trained to value property and to determine appropriate interest rates. This is what we do. Implementing the proposed legislation will be consistent with the scope of our current duties. And, if clear standards are provided in the legislation, our job will be easier, the process more efficient, and the results more predictable for both lenders and borrowers.

Speaking for myself, it bothers me to see a wrong without a remedy and to work within a legal system that is not responding to the needs of the community. As judges, all we have is time. It's just a question of understanding our priorities, and we look to you to establish those.

In closing, let me say that I appreciate the opportunity to testify before you today. I am happy to answer any questions you may have.