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As the Mortgage Industry Changes, Mortgage Laws Should Also Change

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Thank you, Congressman Delahunt, for the invitation to testify today. These are truly times of crisis, here in Massachusetts and across the country. This field hearing provides an important opportunity to understand that crisis and to begin to piece together new laws that will help us work through it and prevent it from happening again.

Changes in the lending industry have led to problems that are crushing millions of individual families, strangling communities and choking the worldwide economy. I am here today to discuss how these changes destroyed a system of housing finance that, since the Great Depression, had helped families expand homeownership and gradually build wealth, replacing it with a system that has triggered a housing boom and bust that will cost millions of families their homes.

Just as the mortgage market has changed, Congress should change the laws dealing with mortgages. Because we are in a state of crisis, with millions of homeowners unable to pay their mortgages, today I focus on a legal remedy that would keep families in their homes while it helped stabilize worldwide financial markets. I urge Congress to amend the bankruptcy laws to give families in financial trouble the same powers to readjust their mortgages that are currently available to the owners of vacation homes, to landlords with rental property, and to corporations with business property—in short, powers available to every owner of real estate *except* homeowners trying to save the houses they live in.

Mortgage Lending Before Asset Securitization

For more than sixty years, a family that wanted to buy a home met with a mortgage lender to review the family's finances and to determine how much the family could borrow. In most cases, the lender kept the mortgage—that is, the lender received payments over time from the family until the mortgage was paid off. If the family could not pay, the lender would bear the loss. If the family paid in full, the lender kept the profits. People who wanted to invest in mortgages invested capital directly in the lending institutions.

That simple story had three principle advantages:

- The lender had a huge stake in making careful lending decisions. If the lender was imprudent, it would incur too many losses; if the lender was too stingy, it would make too few loans and too little profit.

- If the family was unable to make its payment, there was a single lender who could negotiate an optimal solution—including refinancing, delaying payments, selling the house, etc. Foreclosures were rare, in part because the lenders were careful initially and in part because they knew that foreclosures destroyed value for both lender and the homeowner. The value of each mortgage was fairly easy to determine. The interest rate, payment history, and value of the underlying property were readily ascertainable, so that it was a

fairly easy matter to determine the projected value of the stream of payments over time.

These three benefits kept the mortgage system strong. Foreclosure rates remained at less than 1%, and losses were rare.

The impact on families was clear. Few people ended up in houses they could not afford. In the mid-1970s, first-time home buyers put down, on average, 18 percent of the purchase price in order to get a mortgage.[1] They purchased a thirty-year, fixed rate mortgage, which became more affordable over time as their incomes rose and their house payments remained level. The number one retirement plan in America was to pay off the family home and live on social security. For most families, purchasing a home was a place to live and a long-term strategy to build wealth, not a speculative venture.

Asset Securitization Changed Mortgage Lending

In the mid-1990s, as mortgage interest rates fell, families refinanced their homes. While many continued to go to traditional lenders who engaged in the same financial examinations and required the same equity in the home as lenders had required for decades, new companies sprang up offering new kinds of mortgage products. The central idea behind these mortgages was to offer low, introductory payments with very high back-end payments—and pre-payment penalties if a family paid off the mortgage before the high payments had been made.

By the early 2000s, in effect, two kinds of mortgages were available: traditional mortgages, with modest profit margins for the lenders and the newer mortgages that promised higher payments. These new mortgages were typically called subprime or Alt-A to reflect the fact that the borrowers had not gone through the traditional credit scrutiny and were not making substantial down payments. To give a sense of just how expensive these subprime mortgages were, consider this: In 2001, when standard mortgage loans were in the 6.5 percent range, Citibank had a home mortgage lending division with an *average* mortgage rate (which included both subprime and traditional mortgages) of 15.6 percent.[2] To put that in perspective, a family buying a $175,000 home with a subprime loan at 15.6 percent would pay *an extra $420,000* during the 30-year life of the mortgage—that is, over and above the payments due on a prime mortgage. Had the family gotten a traditional mortgage instead, they would have been able to put two children through college and purchase half a dozen new cars. Citibank is a random example. It was not alone. Mortgage brokers, some affiliated with traditional lenders and some independents, began selling mortgages to families and passing those mortgages

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[1] U.S. Bureau of the Census, Data User Services Division, *Statistical Abstract of the United States 1993,* 113th ed. *The National Data Book,* compiled by Glenn W. King under the direction of Marie Argana (1993), p. 734, Table 1247, Recent Home Buyers—General Characteristics, 1976 to 1992.

[2] Lew Sichelman, "Community Group Claims CitiFinancial Still Predatory," *Origination News,* January 2002 (reporting on new claims of CitiFinancial's predatory practices after settlements with state and federal regulators).

along to intermediaries. Those intermediaries paid the brokers a higher premium for high-risk, high-profit mortgages. In fact, brokers received quotes on a daily basis promising to pay more to the broker as the terms of the loans deteriorated for the family.

The intermediaries who bought mortgages from the brokers bundled them together with other mortgages, often selling to other intermediaries to created even bigger pools of mortgages. Once a critical mass was reached, the intermediaries created a new form of securities in the pool of mortgages. Instead of selling equal shares in the pool, the payment rights to the mortgages were divided into different layers, or tranches, with different legal rights. The holder of securities in a particular tranche would have a complex configuration of rights that differed significantly from the rights of someone who held securities in a different tranche of the same pool of mortgages. This meant that the stream of payments generated over time as people made payments on their mortgages would be divided according to staggeringly complex formulas. Because these pools of securities were devised by different bundlers and other intermediaries with no regulatory oversight, there were no standard rules governing the rights of the various parties. Instead, the rights of the various investors were described in lengthy, complex documents.

To further complicate this pattern, some tranches of ownership were recombined into new pools, which were then divided into new tranches. The paperwork became even more complex. Rating agencies purported to evaluate the riskiness of these tranches, but with no history of payments on high risk mortgages and little way to evaluate the complex pooling agreements, the agency models were badly flawed. Even tranches with high risks carried AAA ratings.

In contrast with traditional mortgage lending, asset securitization involved a long chain that began with someone who sold the mortgage to the homeowner, then passed it along a chain of intermediaries until the investors purchased shares in a mix of mortgages and rights. To facilitate the collection of payments from the debtors, yet another business emerged: mortgage servicers charged the investors fees to collect mortgage payments and distribute the proceeds according to some pre-set formula.

The consequence of this chain was to destroy precisely the values that had been protected in tradition mortgage lending. With asset securitization,

- Brokers had incentive to sell mortgages, not to screen borrowers. The brokers were paid regardless of the performance of the mortgage, which meant they had every incentive to pass along risks. Indeed, because high risk mortgages offered higher profit margins, brokers were paid more to sell high risk mortgages.

- When these loans began to go bad, there was no single owner to work out efficient solutions. Instead, with fractured ownership, different workout option benefitted owners of some tranches at the expense of others, confronting the manager of the pool with insoluble conflicts of interest. The payment structure between the pool manager and the pool investors created

- When homeowners began to default at historically high levels, and the stream of income changed, the complex instruments made it impossible for anyone to value the pool of mortgages or a specific tranche with any accuracy. As a result, no one has any confidence in the valuation of mortgage based securities that are carried on the books or held as collateral in other business loans.

The trouble created by mortgage servicers that represent pools of asset-backed mortgages has deepened the housing crisis. Mortgage servicers have no incentive to take the time and effort to workout the agreement with the homeowner that will best maximize value for both the borrower and the lender. The mortgage servicers get paid according to the terms of the asset securitization documents, which typically provide little extra money to cover the time needed for evaluation and workout and which give little guidance to resolve the inherent conflicts of interest among the tranches. In fact, mortgage servicers often have little incentive to do more than collect payments as they are made and push for foreclosure when they are not.

With incentives poorly aligned between the mortgage servicers and the homeowners and holders of mortgage backed securities, it is little wonder that those working with troubled homeowners have little success renegotiating mortgages. Homeowners report that they often cannot even reach mortgage servicers by phone or mail. For the same reasons, voluntary mortgage write-down programs are having little effect.

Perhaps the best explanation phenomenon was given last month by Massachusetts' Attorney General Martha Coakley when she testified before Congress.[3] Based on extensive research in Massachusetts, her office found:

- Only a very small number of distressed mortgages were the subject of meaningful loan modification.
- None of the loan modifications reduced the principal balance of the mortgage.
- None of the loan modifications reduced the monthly payments burdening homeowners.
- In many cases, the monthly payment increased after the loan modification.

Representatives from Attorney General Coakley's office met with the senior vice-presidents of state government relations for major lenders. They were given glossy reports, press releases and self-congratulatory statistics, but when they were asked to commit to a basic loan modification protocol, the answer was no. As Attorney General Coakley noted in her testimony, "We got the brush-off."

[3] Testimony of Massachusetts Attorney General Martha Coakley, *Lenders and Servicers' Promises of Mortgage Modifications in Massachusetts Are Not Matched by Meaningful Actions That Promote Sustainable Mortgages,* U.S. House Financial Services Committee, September 17, 2008.

How Asset Securitization Affected Families

Asset securitization has been defended as producing new sources of financing for homeowners. But it was designed to boost profits for lenders—at the expense of homeowners. Subprime lenders launched their business by preying on families that already owned their own homes, rather than expanding access to new homeowners. Fully 80 percent of subprime mortgages involve refinancing loans for families that already own their homes.[4] For these families, subprime lending did nothing more than increase the family's housing costs, taking resources away from other investments and increasing the chances that the family would lose its home if anything went wrong.

Subprime lending has had an even more pernicious effect. It ensnares people who, in a regulated market, would have had access to lower-cost mortgages. Lenders' own data show that many of the families that end up in the subprime market are middle-class families that would typically qualify for a traditional mortgage. At Citibank, for example, researchers have concluded that at least 40 percent of those who were sold ruinous subprime mortgages would have qualified for prime-rate loans.[5] Nor is Citibank an isolated case: A study by the Department of Housing and Urban Development revealed that one in nine middle-income families (and one in fourteen upper-income families) who refinanced a home mortgage ended up with a high-fee, high-interest subprime mortgage.[6] For many of these families there was no trade-off between access to credit and the cost of credit. They had their pockets picked, plain and simple.

Why would middle-class families take on high-interest mortgages if they could qualify for better deals? The answer, quite simply, is they didn't know they could do any better. Many unsuspecting families are steered to an overpriced mortgage by a broker or some other middleman who represents himself as acting in the borrower's best interests, but who is actually taking big fees and commissions from subprime lenders.[7] In some neighborhoods these brokers go door-to-door, acting as "bird dogs" for lenders, looking for unsuspecting homeowners who might be tempted by the promise of extra cash. Other families get broadsided by extra fees and hidden costs that don't show up until it is too late to go to another lender. One industry expert describes the phenomenon: "Mrs. Jones negotiates an 8 percent loan and the paperwork comes in at 10 percent. And the loan officer or the broker says, 'Don't worry, I'll take care of that, just sign here.'"[8]

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[4] HUD, *Unequal Burden: Income and Racial Disparities in Subprime Lending in America*. Subprime Lending Report (April 2000). Available at http://www.hud.• gov/library/bookshelf18/pressrel/subprime.html

[5] See Sichelman, "Community Group Claims CitiFinancial Still Predatory."

[6] HUD, *Unequal Burden.* To be sure, subprime lenders have focused more of their efforts among poorer homeowners; 26 percent of low-income homeowners end up with predatory refinancing, more than twice the rate of moderate-income families.

[7] See, e.g., Howell E. Jackson and Laurie Burlingame, "Kickback or Compensation: The Case of Yield Spread Premiums," 12 STAN. J.L. BUS. & FIN. 289 (2007).

[8] Dennis Hevesi, "A Wider Loan Pool Draws More Sharks," *New York Times,* August 31, 2001.

Every now and then a case comes to the forefront that is particularly egregious. Citibank was recently caught in one of those cases. In 2002, Citibank's subprime lending subsidiary was prosecuted for deceptive marketing practices, and the company paid $240 million to settle the case (at the time, the largest settlement of its kind).[9] A former loan officer testified about how she marketed the mortgages: "If someone appeared uneducated, inarticulate, was a minority, or was particularly old or young, I would try to include all the [additional costs] CitiFinancial offered."[10] In other words, lending agents routinely steered families to higher-cost loans whenever they thought there was a chance they could get away with it.

Such steering hits minority homeowners with particular force. Several researchers have shown that minority families are far more likely than white families to get stuck with subprime mortgages, even when the data are controlled for income and credit rating.[11] According to one study, African-American borrowers are 450 percent more likely than whites to end up with a subprime than a prime mortgage.[12] In fact, residents in high-income, predominantly black neighborhoods are actually more likely to get a subprime mortgage than residents in low-income white neighborhoods—more than twice as likely.[13]

Millions of families have been deceived by sellers of high-profit mortgages. Those mortgages fueled a housing boom. Now families are left to pick up the pieces, and the financial markets continue to reel in the aftermath of faulty valuations of these mortgages. We have reached the limit of what can be done without federal intervention. To bring the holders of distressed mortgages to the negotiating table to work out value-creating deals, federal help is essential.

How Bankruptcy Law Can Help

The Constitution, Article I, Section 8, provides that Congress shall establish a uniform law of bankruptcies. A central feature of bankruptcy law has been the distinction between secured and unsecured loans. That is, a loan made with no collateral is subject to *pro rata* payment depending on the debtor's available assets. When a debtor

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[9] The charges alleged that Citibank's consumer finance unit employed deceptive practices to sell home loan insurance. To settle the case, Citibank agreed to pay $240 million, the largest settlement to date of a Federal Trade Commission consumer protection case. "Citigroup $240 Mln Lending Unit Settlement Approved," *Bloomberg News,* November 15, 2002.

[10] Paul Beckett, "Citigroup's 'Subprime' Reforms Questioned," *Wall Street Journal,* July 18, 2002.

[11] For a thorough discussion of discrimination in mortgage lending, see Stephen Ross and John Yinger, *The Color of Credit: Mortgage Discrimination, Research Methodology, and Fair-Lending Enforcement* (Cambridge, MA: MIT Press, 2002).

[12] Association of Community Organizations for Reform Now, *Separate and Unequal: Predatory Lending in America* (Washington, DC: ACORN, November 2002). Available at http://www.acorn.org/acorn10/predatorylending/plreports/SU2002/index.php [2/01/03]. See also Randall M. Scheessele, "1998 HMDA Highlights," Working Paper HF-009, HUD, Office of Policy and Research (September 1999). Available at http://www.huduser.org/publications/hsgfin/workpapr9.html

[13] HUD, *Unequal Burden.*

files for bankruptcy, credit card debt and medical debt, for example, receive only *pro rata* payments based on the debtor's limited assets.

Secured debt, by comparison, is protected in bankruptcy *up to the value of the collateral*. If a creditor lends $100,000, secured by a piece of property worth $120,000, the creditor will be repaid in full, plus interest, during the course of the bankruptcy. The loan might be rewritten as to terms—length of time for the payment, amount of the interest rate—but the lender will receive a commitment worth the present value of $100,000 because it held a fully secured mortgage. If the debtor cannot repay in full, then the collateral must be returned to trustee and sold. Either way, the creditor is paid in full.

If the creditor has a partially-secured loan, then bankruptcy law separates the loan into its two component parts—a secured portion and an unsecured portion. So, for example, if the creditor lends $100,000 and the collateral is worth only $80,000, the creditor will be entitled to payment in full of $80,000 (or return of the collateral) and *pro rata* treatment for the remaining, unsecured $20,000.

This procedure holds true throughout bankruptcy law for both consumer and business debtors. In the case of real estate, this is the treatment for vacation property, for rental property, for investment property, and for business property. The only secured loan that cannot be reworked is a mortgage secured by a family's primary residence. 11 U.S.C. § 1322(b)(2).

The reason for this exception may reflect nothing more than the lobbying power of home mortgage lenders. In any case, it is important to remember that when the bankruptcy laws were rewritten in 1978, there was no subprime, alt-A or other creative mortgage lending. In the mid-1970s, first-time home buyers put down, on average, 18 percent of the purchase price in order to get a mortgage.[14] Mortgages were fixed-rate, which meant that as incomes rose, they became more affordable over time. The high inflation rates of the 1970s made repayment even more manageable. When the modern bankruptcy laws were written, home mortgages tended to stabilize the family budget. Almost no one got into financial trouble because the mortgage itself caused a problem.

Recent research shows that permitting modification of principal residence mortgages in bankruptcy would not result in either higher mortgage rates or less mortgage credit availability.[15] Lender losses in bankruptcy are less than the losses lenders suffer in foreclosure; bankruptcy law guarantees lenders a recover of at least what they would receive in foreclosure. Accordingly, mortgage lenders will not price against modification of mortgages in bankruptcy because it is a better outcome for them than foreclosure.

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[14] U.S. Bureau of the Census, Data User Services Division, *Statistical Abstract of the United States 1993,* 113th ed. *The National Data Book,* compiled by Glenn W. King under the direction of Marie Argana (1993), p. 734, Table 1247, Recent Home Buyers—General Characteristics, 1976 to 1992.
[15] Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WISC. L. REV. (forthcoming).

Securitization, however, has resulted in servicers, rather than mortgage-backed securities investors, serving as the mouthpiece for the mortgage industry, and servicers can frequently make greater profits in foreclosure than modification.[16] Securitization has not only warped incentives for the origination and modification of loans, it has also warped the political representation of the mortgage industry's interests.

Today thousands of asset securitization pools and millions of mortgage investors hold interests that are partially secured and partially unsecured. If the laws were amended, bankruptcy law could be used to divide those mortgages into their secured portions (100% of the value of the collateral, paid in full over time) and their unsecured portions (the amount of the loan that exceeds the collateral value, to be paid *pro rata*). Lenders would get the value of their collateral, and the remainder of the debt—like credit card debt and medical debt—would be treated as general, unsecured debt, which is exactly what it is.

The new mortgages, written to 100% of the value of the property, would be long-term, fixed instruments that a family could afford today and tomorrow. If the family could not make the payments, then the family would have to leave the home, but before the new mortgage would be put in place, the bankruptcy court would determine that the family could afford the payments. More importantly, every payment the family would make would help pay down principal, giving the family a stake in the home that is missing when the loan far exceeds the value of the home. The stream of payments from these mortgages would be far steadier, and mortgage foreclosure rates would like drop back near their historic levels.

The Proposal

The amendment is relatively simple: the bankruptcy laws could simply eliminate the special exception in section 1322(b)(2) that prevents homeowners from having the same rights to deal with partially secured mortgages that vacation homeowners, rental property owners and business owners have always had. The laws would also need to make a provision for refinancing the mortgages to create long-term payments over thirty years.

The bankruptcy system is well-equipped to handle this crisis. There would be no need to create a new agency or to employ more bureaucrats. Currently, nearly 300 federal judges do nothing but hear bankruptcy cases. They have years of expertise built up in valuing property and sorting out secured and unsecured claims for families in financial distress. In anticipation of the 2005 amendments, more than two million families went to the bankruptcy courts to restructure their debts, with half a million filing in just the few weeks before the new law took effect. The courts handled the deluge professionally,

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[16] Adam J. Levitin & Tara Twomey, *Not Everyone Loses in Foreclosure: Principal-Agent Conflict in Mortgage-Backed Securities*, Georgetown University Law Center working paper (2008).

working long hours but managing the cases without incident. If called on to adjudicate the rights of mortgage lenders and homeowners, the bankruptcy courts would be ready.

Unlike the hundreds of billions of dollars that are proposed for other financial realignments, this proposal would cost the taxpayers nothing. The courtrooms, the judges, the filing system—all the tools are already in place. The bankruptcy amendment is not about a taxpayer bailout; it is about allocating losses between the homeowners and the investors, making sure that the homeowners pay the full value of the secured loan, but that investors absorb the losses for the portion of their loans that exceed the value of the homes.

To be sure, a change in the bankruptcy laws will not be a panacea. After the 2005 Amendments pushed through by the credit industry, not all families in need of bankruptcy relief will be eligible. A larger problem is likely to be the resistance that some families will have to filing bankruptcy. Many people will give up everything rather than make a public declaration of financial collapse. Bankruptcy can help, but only if people are willing to try it.

Even if many families remain resistant to filing for bankruptcy, the effect of changing the laws would be powerful. For the first time, families—not mortgage servicers—would have some power in negotiations. If families could make a credible threat that they would file for bankruptcy to deal with the mortgage by federal law, perhaps fewer servicers would be inclined, as Attorney General Coakley described, to "brush off" the homeowners or those trying to help them. In short, a change in the laws would create a powerful change in negotiations in the shadow of the law.

The Benefits of Changing the Law

The benefits of this amendment would be immediate. They would go far to undo the harm created by unregulated asset securitization. The most immediate effect would be to stabilize the housing market. Currently foreclosures are driving prices down further than the ordinary laws of supply and demand. Homeowners forced out by foreclosure have no reason to care for the property, and some destroy property or rip out plumbing and other assets to sell off what they can before they lose the house. When a property is posted for a foreclosure sale, by law, potential buyers have no access to the property, no ability to check the condition of the property or to see the layout of the rooms. As a result, bids a notoriously low. The legal steps for foreclosure are expensive, imposing costs on the investor who holds the mortgage. In short, foreclosure destroys value. By leaving families in the homes so that they can pay 100% of its current market value, the home mortgage market would have a chance to stabilize. Instead of foreclosure fears, supply and demand would drive this market again.

The benefits to neighbors and communities would also be apparent immediately. Because each foreclosure brings an estimated decline in housing value for the fifty

closest neighbors,[17] the value of foreclosure prevention is enormous. Similarly, halting a rise in foreclosures will have beneficial effects on tax revenues to support community services or on condominium associations where neighbors are often forced to pick up the expenses when a homeowner sits vacant.[18]

The biggest beneficiary would be worldwide financial markets. Because foreclosures depress real estate prices, creating additional downward pressure on prices, they make it less likely that homeowners who cannot meet monthly payments will be able to sell their properties. This means more homeowners are likely to go into foreclosure—thus expanding the downward price cycle and further weakening the balance sheets of financial institutions and investors who hold mortgage backed securities.

Permitting families to restructure their mortgages through bankruptcy would have immediate positive benefits for financial markets. By halting the ruinous cycle of foreclosures, the markets could stabilize. By re-writing mortgage instruments to amounts that families could pay, the stream of income on mortgage backed securities would be more certain.

To be sure, mortgage servicers, who often stand to gain more if a home goes through foreclosure, have strongly resisted any change to the bankruptcy laws. They prefer the current circumstances to one that would force them to come to the bargaining table for workouts with troubled families. Similarly, some mortgage investors have resisted forced write downs of their mortgages. Perhaps some are hoping to avoid confronting the true value of the mortgages and mortgage backed securities on their balance sheets, and they are willing to continue their ruinous foreclosure practices. Whether they are waiting for a government bailout or waiting with no plan at all, it is clear that the time has come for those holding mortgages to come clean—to write down what must be written down and to value their assets realistically.

Conclusion

Eventually the losses that stem from years of imprudent lending must be recognized. If we continue to delay that time of recognition, the losses will mount, as foreclosures pile on foreclosures. In the meantime, millions of families will be torn from their homes and properties will be left vacant, creating hazards for neighbors and blights on communities.

Eventually the price of real estate will respond to supply and demand like any other market. Real estate markets need to find their true price, a price that is not distorted by crazy mortgages that push prices skyward or by a tidal wave of foreclosures that force

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[17] Dan Imergluck & Geoff Smith, The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values, 17 Housing Policy Debate 57 (2006).
[18] Mark Duda 7 William Apgar, Mortgage Foreclosures in Atlanta: Patterns and Policy Issues, A Report Prepared for NeighborWorks America, December 2005, at www.nw.org/Network/neighborworksprogs/foreclosuresolutions/documents/foreclosure1205.pdf

prices sharply downward. When families are paying the actual market value of their homes, then we will begin the process of rebuilding real estate markets and rebuilding the balance sheets of the businesses and investors that have relied on mortgage backed securities. We will also begin the process of strengthening the balance sheet of American families—homeowners and renters alike—all of whom will suffer in a deepening recession.

Changing bankruptcy laws to give homeowners an important tool to restructure their mortgages is an important first step in the important work of rebuilding a strong America and a strong middle class.