

TESTIMONY OF JOHN RAO

ATTORNEY,  
NATIONAL CONSUMER LAW CENTER

DIRECTOR,  
NATIONAL ASSOCIATION OF CONSUMER  
BANKRUPTCY ATTORNEYS

BEFORE THE SUBCOMMITTEE ON ADMINISTRATIVE AND COMMERCIAL  
LAW HOUSE OF REPRESENTATIVES JUDICIARY COMMITTEE

“Straightening Out the Mortgage Mess: How Can We Protect Home Ownership and  
Provide Relief to Consumers in Financial Distress”

SEPTEMBER 25, 2007

Chairwoman Sanchez, Ranking Member Cannon, and members of the Subcommittee, we thank you for holding this hearing and for inviting us to testify today regarding ways in which Chapter 13 can be improved to help homeowners avoid foreclosure. I testify here today on behalf of the low income clients of the National Consumer Law Center,<sup>1</sup> as well as on behalf of the National Association of Consumer Bankruptcy Attorneys.<sup>2</sup> The clients and constituencies of these groups collectively encompass a broad range of families and households who have been affected by the current foreclosure crisis.

A fundamental goal of chapter 13 has always been to provide an opportunity for consumers to repay their obligations. Unfortunately this has become exceedingly

---

<sup>1</sup> The National Consumer Law Center, Inc. (NCLC) is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of sixteen practice treatises and annual supplements on consumer credit laws and bankruptcy, including Consumer Bankruptcy Law and Practice (8th ed. 2006) Truth In Lending, (5th ed. 2003) and Cost of Credit: Regulation, Preemption, and Industry Abuses (3d ed. 2005) and Foreclosures (2d ed. 2007), as well as bimonthly newsletters on a range of topics related to consumer credit and bankruptcy issues. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low income people, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to deal predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of the all federal laws affecting consumer credit since the 1970s, and regularly provide extensive comments to the federal agencies on the regulations under these laws.

<sup>2</sup> The National Association of Consumer Bankruptcy Attorneys (NACBA) is the only national organization dedicated to serving the needs of consumer bankruptcy attorneys and protecting the rights of consumer debtors in bankruptcy. NACBA has more than 2,500 members located in all 50 states and Puerto Rico. NACBA has been actively involved in promoting reasonable and fair bankruptcy legislation since it was founded in 1992.

difficult in recent years because our bankruptcy laws have not kept pace with the enormous changes in the mortgage marketplace that have occurred since those laws were first enacted. New non-traditional loan products have challenged the ability of hard-working families who have fallen on difficult times to effectively use Chapter 13 to save their homes.

### **I. Saving Homes in Chapter 13.**

Since the enactment of the Bankruptcy Code in 1978, homeowners facing foreclosure have often turned to Chapter 13 as a last resort for saving their homes. One of the most significant provisions in Chapter 13 is the right to cure defaults on loans, even if the lender has called the loan due (“accelerated”) before the bankruptcy is filed and even if such right to cure does not exist under state law or the consumer’s loan contract. For long-term loans a consumer has fallen behind on and is not able to pay-off in full within the three to five years of a Chapter 13 plan, such as a home mortgage, section 1322(b)(5) permits the homeowner to cure the default within a reasonable time by making payments on the arrears together with the ongoing payments during the plan.

The cure right in Chapter 13 currently serves an important role because of the limitations of voluntary workout options. Some mortgage servicers are not permitted by the investors of the mortgage loans to approve repayment or forbearance plans longer than six to twelve months, which is too short a period for many borrowers to affordably cure a default. Those that do offer longer plans often impose restrictions and paperwork burdens that homeowners may not be able to satisfy in the frenzy of the foreclosure process. Other servicers have simply been too aggressive in pursuing foreclosure without offering workout options or may be the cause of the homeowner’s foreclosure problem

because of negligent servicing.<sup>3</sup> Chapter 13 makes long-term repayment plans available when mortgage lenders and their servicers have not been willing to negotiate reasonable similar plans.

The cure provisions in current law work best when homeowners have had a temporary loss of income (unemployment, illness, divorce, natural disaster, and so forth) which caused the default, and they now have sufficient income at the time the Chapter 13 case is filed to pay during the plan the arrears which have accumulated and the regular monthly payment. For this model to be successful, it goes without saying that the mortgage loan must have been affordable for the homeowner when the loan was made. Likewise the homeowner must be able to prospectively afford the regular monthly payments, taking into consideration any changes in terms permitted under the loan documents that would affect the monthly payment, during the three to five years of the plan.

The following example demonstrates how the current Chapter 13 cure provisions can help a homeowner avoid foreclosure in comparison to a typical workout plan.

**Comparison between Workout and  
Current Chapter 13 Bankruptcy Plan**

The borrowers have a fixed-rate mortgage they obtained five years ago (\$185,000 principal). The interest rate is 7.50%, with monthly principal and interest payments of \$1,292. Due to unemployment of one spouse last year for a period of six months, they fell behind on the mortgage and other bills. They now have mortgage arrears and foreclosure fees of \$14,000. They are currently both employed, though at about 85% of their prior income. Their monthly gross income is \$4,500. Despite efforts to negotiate a workout plan modifying the mortgage, their mortgage servicer has only agreed to a

---

<sup>3</sup> See Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 Housing Policy Debate 753, 756–58 (2004).

12-month forbearance agreement.

**Status Under 12-month Workout Agreement**

\$ 14,000	total arrears
\$ 1,517	ongoing monthly mortgage payment (including taxes and insurance)
\$ 1,167	payment on arrears (assuming cure over 12 mos.)
<b>\$ 2,684</b>	monthly to keep current and cure the arrears

The couple can scrape together enough to make the first monthly payment but know that they will soon default on the workout agreement as the monthly payment represents 57% of their gross monthly income.

**Result After Addressing Problem in Chapter 13 Bankruptcy**

\$ 1,517	ongoing monthly mortgage payment (including taxes and insurance)
\$ 389	payment on arrears (assuming cure over 36 mos.)
\$ 46	interest on arrears payment each month (assuming required by mortgage documents)
\$ 44	trustee's fee each month (assuming plan permits regular monthly payments to be made directly to servicer and not considering other administrative costs, such as attorney's fees, or other payments under plan)
<b>\$ 1,966</b>	monthly to keep current and cure the arrears for 36 month plan (TOTAL)

With this chapter 13 plan, the couple will pay approximately \$718 less per month than a workout to cure the delinquency on the mortgage. This total housing payment during the plan will represent 44% of their gross income. The plan under current bankruptcy law will be difficult for them but is much more affordable than the workout.

**II. Problems with Cure Provisions and High Cost Loans.**

When Chapter 13 was enacted in 1978, a much different mortgage market existed than does today. The typical American pursuing the homeownership dream would have obtained a thirty-year mortgage with a fixed interest rate and monthly payment. This

loan would have been made by a bank using accepted underwriting guidelines which considered the homeowner's ability to repay the loan.<sup>4</sup> Risks to the lender and the homeowner were kept in check by ensuring that the loan amount did not exceed an appropriate loan-to-value ratio, typically no more than 80% LTV. The loan would likely have been kept in the bank's own portfolio of loans and not assigned to another entity, and it would have been serviced by that same bank.<sup>5</sup> Although a time of record-high interest rates, borrowers generally obtained loans within a small range of prevailing market rates and a subprime market for home borrowers was virtually nonexistent.

The 1990s saw the enormous growth in the use of asset-based securities to fund an ever increasing supply of mortgage credit.<sup>6</sup> Creating capital flow in this way,

---

<sup>4</sup> In considering potential borrower's ability to repay, lenders have traditionally considered the borrower's housing expense ratio and debt-to-income ratio. In the conventional mortgage market, lenders generally require that the borrower's housing expense ratio, which considers the principal, interest, taxes and insurance (PITI) on the loan in comparison to income, be less than 28%. Such lenders also require that the debt-to-income ratio, which is the PITI plus the sum of other recurring debt such as auto loans and credit card obligations in comparison to income, be less than 36%. In the case of government insured loan programs intended to promote home ownership by low and moderate income borrowers, different ratios may apply. For instance, lenders originating FHA loans generally have used qualifying benchmarks of 29% as a monthly housing expense ratio and 41% for a debt-to-income ratio. A similar 41% debt-to-income ratio has been used for VA mortgages.

<sup>5</sup> In 1990, Congress imposed new requirements on servicers of federally related mortgage loans through amendments to RESPA. *See* Cranston-Gonzalez National Affordable Housing Act, Pub. L. No. 101-625, 104 Stat. 4079 (1990) (codified at 12 U.S.C. § 2605). These amendments followed reports of a substantial number of consumer complaints about mortgage servicing problems particularly related to changes in the industry involving the transfer of servicing. *See* U.S. Gen. Accounting Office, Report, Home Ownership--Mortgage Servicing Transfers Are Increasing and Causing Borrower Concern (1989).

<sup>6</sup> The Asset-Back Securities Market: The Effects of Weakened Consumer Loan Quality, FDIC Regional Outlook, Second Quarter, 1997.

subprime mortgage lending took off during this period. In 1994, approximately \$10 billion worth of home equity loans were securitized.<sup>7</sup> By the end of 1997, the volume had leaped to about \$90 billion, and by 2002, more than \$134 billion in subprime mortgage-backed securities were issued.<sup>8</sup> Homeowners were encouraged (as they are today), often through aggressive marketing campaigns that deceptively tout lower payments and tax benefits, to use their home equity to consolidate non-mortgage debts.

The range of interest rates charged to subprime borrowers during this period was very broad, especially compared to the range in the conventional mortgage market. The rate range for subprime loans in the mid- to late-1990s, often on fixed-rate loans, was as much as 17 percentage points, as compared to the conventional market's range of no more than 2 percentage points.<sup>9</sup> I have reviewed loans from this period in which some of the most abusive subprime lenders made loans with APRs from 15% to 20%. Practices such as charging high points and fees and flipping loans through multiple refinancings often stripped homeowners of their most valuable asset, the equity in their homes.

Thus, even before the advent of today's more dangerous "exotic" subprime mortgages, Chapter 13 was becoming less viable as a safety net for the growing numbers

---

<sup>7</sup> Daniel Immergluck & Marti Wiles, *Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development*, at 12, Woodstock Institute (Nov. 1999).

<sup>8</sup> Inside Mortgage Finance Publications, *The 2003 Mortgage Market Statistical Annual* (2003); Glenn B. Canner, Thomas A. Durkin & Charles A. Luckett, *Recent Developments in Home Equity Lending*, 84 Fed. Res. Bull. 241, 250 (April 1998).

<sup>9</sup> See Cathy Lesser Mansfield, *The Road to Subprime "HEL" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. Rev. 473 (Spring 2000)(based on loan data for over 1 million loans securitized between 1995 and 1999).

of homeowners in foreclosure. In my experience working with housing counselors and bankruptcy attorneys who assist homeowners facing foreclosure during this period, a common concern I would hear was that options for curing a mortgage default, whether under a Chapter 13 plan or workout agreement, were becoming increasingly incapable of helping homeowners with high-cost loans, especially those made without proper consideration of the homeowner's ability to pay.

Not surprisingly, the ability of homeowners in the above example to cure their mortgage default would be seriously undermined if they had a higher interest rate loan:

**Workout and Current Chapter 13 Plan  
with High-Cost Loan**

Assume that the borrowers have a fixed-rate subprime mortgage with an interest rate of 10.50%. Their monthly principal and interest payment is \$1,692. Once again, they have not been able to negotiate a reasonable workout agreement with the lender. Since the loan was made based on an inflated appraisal the originating lender had obtained, and the loan includes a prepayment penalty, the borrowers have also not been able to refinance their loan.

**Current Status Under 12-month Workout Agreement**

\$ 14,000	total arrears
\$ 1,917	ongoing monthly mortgage payment (including taxes and insurance)
\$ 1,167	payment on arrears (assuming cure over 12 mos.)
<b>\$ 3,084</b>	<b>monthly to keep current and cure the arrears</b>

The monthly payment under the workout agreement represents 69% of their gross monthly income and is completely unaffordable.

**Result After Addressing Problem in Chapter 13 Bankruptcy**

\$ 1,917	ongoing monthly mortgage payment (including taxes and insurance)
\$ 389	payment on arrears (assuming cure over 36 mos.)
\$ 46	interest on arrears payment each month (assuming required by mortgage documents)

\$	44	trustee's fee each month (assuming plan permits regular monthly payments to be made directly to servicer and not considering other administrative costs, such as attorney's fees, or other payments under plan)
\$	<b>2,396</b>	monthly to keep current and cure the arrears for 36 month plan (TOTAL)
This total housing payment during the plan will represent 53% of their gross income. The plan under current bankruptcy law will likely fail.		

**III. Specific Limitations under Current Law.**

The right to cure a mortgage default under section 1322(b)(5) has several significant limitations. Taken alone, this provision does not permit the homeowner to change the amount and timing of installment payments, the interest rate, and other similar terms of the mortgage. It also does not give the homeowner the right to reduce the mortgage creditor's lien to the value of the collateral as compared with the outstanding balance owed on the secured debt.

Other provisions of the Bankruptcy Code do however provide the right to "modify" secured claims to debtors in Chapter 11, 12 and 13 cases.<sup>10</sup> This ability to modify secured claims is possible for virtually every type of debt except for the mortgage on the borrower's primary residence.<sup>11</sup> This well-entrenched principle of bankruptcy law generally permitting modification of secured claims and the exception for home mortgages in Chapter 13 cases can be summarized as follows:

---

<sup>10</sup> See 11 U.S.C. §§ 1123(b)(5), 1222(b)(2), 1322(b)(2).

<sup>11</sup> Chapter 12 "family farmers" are permitted to modify home mortgages.

**Bifurcation and Modification.** In determining the allowed amount of a creditor's secured claim, section 506(a) of the Code provides that the claim is secured only to the extent of the value of the collateral and that any amount of the claim in excess of the collateral will be treated as an unsecured claim. This "bifurcation" or "cram down" of the creditor's claim means that the unsecured portion of the claim will be paid with other unsecured claims the debtor may have, based on the plan's treatment of unsecured claims. In addition to this claim bifurcation, section 1322(b)(2) permits the plan to modify the rights of holders of secured claims, such as by extending the payment term or adjusting the interest rate and installment payment amount under the underlying contract.

**Cram Down Limitation.** Although section 1322(b)(2) generally authorizes the modification of allowed secured claims in a Chapter 13 plan, an exception preventing modification is provided for those claims secured "*only by a security interest in real property that is the debtor's principal residence.*" While four Circuit Courts had found that this language in the 1978 Bankruptcy Code did not prevent a cram down of a mortgage lender's lien when considered with section 506(a),<sup>12</sup> the Supreme Court in *Nobleman v. American Savings Bank*, 113 S.Ct. 2106 (1993) held that modification of home mortgage lender's rights, including the cram down of its lien, is impermissible.

---

<sup>12</sup> *In re Bellamy*, 962 F.2d 176 (2d Cir. 1992); *In re Hart*, 923 F.2d 1410 (10th Cir. 1991); *Wilson v. Commonwealth Mortgage Corp.*, 895 F.2d 123 (3d Cir. 1990); *In re Hougland*, 886 F.2d 1182 (9th Cir. 1989).

While there is scant legislative history directly addressing the anti-modification clause in section 1322(b)(2),<sup>13</sup> it may have been intended to promote the flow of capital into the residential mortgage market at a time when such lending was experiencing pressures from record-high interest rates. Congress enacted other laws at approximately the same time, for example, to assist lenders in making market-rate loans despite state usury caps.<sup>14</sup>

As mentioned earlier, however, efforts to expand the availability of credit at that time were soon replaced by serious concerns about the explosive growth in the residential mortgage lending and abusive lending practices. In 1994, Congress passed the Home Ownership and Equity Protection Act (HOEPA) to prevent some predatory lending practices after reviewing compelling testimony and evidence presented during a number of hearings that occurred in 1993 and 1994. This law created a special class of regulated closed-end loans made at high rates or with excessive costs and fees.<sup>15</sup> It was hoped that HOEPA would reverse the trend of the prior decade, which had made abusive home equity lending a growth industry and contributed to the loss of equity and homes for many Americans.

---

<sup>13</sup> See *Grubbs v. Houston First American Savings Assn.*, 730 F.2d 236 (5th Cir. 1984).

<sup>14</sup> Depository Institution Deregulation and Monetary Control Act (“DIDMCA”), 12 Pub. L. No. 960221, 94 Stat. 161 (1980), and the Alternative Mortgage Transaction Parity Act (“AMTPA”) (1982), 12 U.S.C. §3801. The legislative history for these laws suggests that Congress was concerned about the solvency of the savings and loan industry, as well as concerns about the general viability of consumer lending. See Cathy L. Mansfield, *The Road to Subprime “Hel” was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C.L. Rev. 473, 495 (2000).

<sup>15</sup> 15 U.S.C. § 1602(AA)(1)(B).

Regulators had also begun to express alarm at the practice of making high loan-to-value (LTV) mortgages.<sup>16</sup> In issuing a warning to lenders in 1998 about the risks involved with such loans in comparison to traditional mortgage loans, the Office of Thrift Supervision described the practice as follows:

An increasing number of lenders are aggressively marketing home equity and debt consolidation loans, where the loans, combined with any senior mortgages, are near or exceed the value of the security property.... Until recently, the high LTV home mortgage market was dominated by mortgage brokers and other less regulated lenders. Consumer groups and some members of Congress have expressed concern over the growth of these loans, and the mass marketing tactics used by some lenders.<sup>17</sup>

Unfortunately, as is apparent from the current foreclosure crisis, HOEPA and limited regulatory efforts have not stopped abusive lending practices. Indeed, the problem has only grown worse. Bankruptcy attorneys, legal services offices, housing counselors, and attorneys who assist homeowners in foreclosure now routinely see clients with mortgages whose terms are so oppressive that traditional tools for dealing with foreclosures such as workout agreements and Chapter 13 cure plans are no longer effective. Many of these non-traditional loans which predominate in the subprime market take the form of adjustable rate mortgages (ARMs), such as payment-option ARMs or the more common the 2/28 hybrid ARMs. These loans have an initial short-term fixed rate for the first twenty-four months that is followed by annual or six-month rate adjustments

---

<sup>16</sup> In 1995, home equity lenders had made \$1 billion in such loans. By 1997, the amount of these loans had increased to \$8 billion. High-Loan-To-Value Lending, General Accounting Office, GAO/GGD-98-169, August, 13, 1998; "Paines's High LTV Specialist is Out", National Mortgage News, October 27, 1997, 1997 WL 12863567.

<sup>17</sup> Thrift Bulletin TB 72, Office of Thrift Supervision, Department of the Treasury, August 27, 1998, at 1.

for the balance of the loan term. By mid-year 2006, hybrid ARMs made up 81 percent of securitized subprime loans.<sup>18</sup>

Almost all 2/28 loans include terms by which the interest rate that applies for the initial fixed period of the loan is the *lowest* rate that can ever be charged. In other words, the interest rate can climb, but even if the index upon which the interest rate is based drops, the interest rate charged the borrower can never go down. Many of these loans have an initial rate set lower than the fully indexed rate when the loan was made, often referred to a “teaser” rate.

The interest rates and payments can rise significantly on these loans. Almost all of the subprime ARM loans I have reviewed are based on the six month LIBOR index. During the past eight years, the six month LIBOR index has had peaks and valleys from a low of 1.12% (in June, 2003) to a high of 7.06% (in May, 2000).<sup>19</sup> The first rate change on these loans is generally in the 24<sup>th</sup> month, with the change payment rate occurring in the 25<sup>th</sup> month. Subsequent rate changes occur every six months thereafter. Typically, there is a cap on the increase in the first adjustment of 200 basis points, and caps on subsequent adjustments of 100 basis points.

---

<sup>18</sup> Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs, Fitch Ratings Credit Policy (August 21, 2006).

<sup>19</sup> HSH Associates Financial Publishers,  
<http://www.hsh.com/indices/fnmalibor-2007.html>.

Consider the following changes in interest based on the six month LIBOR history and the effect on the payments on a loan for \$185,000 made in December 2002.<sup>20</sup> Note that this example is based on a loan *without* a teaser rate, so the payment shock is *less* than many borrowers are experiencing.

<b>Months</b>	<b>LIBOR rate</b>	<b>LIBOR + index</b>	<b>Payment</b>
1-24	1.38% (Nov. 2004)	7.38%	<b>\$1,278.39</b>
25-30	2.63% (May 2004)	8.63%	<b>\$1,433.40</b>
31-36	3.51% (Nov. 2005)	9.51%	<b>\$1,545.70</b>
37-42	4.58% (May 2006)	10.58%, but capped at 10.51%	<b>\$1,674.80</b>
43-48	5.32% (Nov. 2006)	11.32%	<b>\$1,781.14</b>
49-54	5.35% (May 2007)	11.35%	<b>\$1,785.08</b>

Such rate increases and changing payment amounts can cause serious affordability problems for many homeowners who do not have the flexibility to make adjustments to their household expenses. In a Chapter 13 plan, there is even less flexibility because the consumer's disposable income based on his or her expenses is fixed at the time of confirmation for the duration of the plan, and must be paid to the trustee to satisfy creditors' claims and other obligations under the plan.<sup>21</sup> In effect, every dollar the family earns is accounted for and whatever small cushion the family has in

---

<sup>20</sup> This example assumes a \$185,000 principal amount in a standard sub-prime 2/28 adjustable loan, with an initial rate based on the LIBOR rate plus a margin of 6, and applicable rate caps.

<sup>21</sup> While modification of the plan may be possible, doing so every six months would be impractical and costly, and other requirements the debtor must satisfy under § 1322 and § 1325 may prohibit it.

their budget will cover only minimal additional expenses. A change in mortgage payment of over \$500 per month (or \$700 or more for loans with initial teaser rates) can be more than an average family spends on their entire food budget.

Bankruptcy courts are currently powerless to defer or change these payment increases as that would be a modification of the mortgage not permitted under section 1322(b)(2). Quite simply, while consumers outside of bankruptcy have great difficulty absorbing the payment shock from ARMs, the problems are compounded in Chapter 13 resulting in almost certain plan failure.

Using the examples above, it becomes obvious that an ARM, even with modest reset adjustments and no initial teaser rate, will make it impossible for the borrowers to propose a feasible Chapter 13 plan.

### **Current Chapter 13 Plan with ARM**

Assume that the borrowers now have a subprime 2/28 ARM mortgage with an initial interest rate of 7.38%. Their monthly principal and interest payment is \$1,278 for the first 24 months. The borrowers file Chapter 13 bankruptcy in the eighteenth month to stop a foreclosure sale. To cure the arrears and maintain current payments based on rate adjustments, they would need to make the following payments using the historical example above. This assumes that taxes and insurance will remain constant during the plan.

#### **Result Addressing Problem in Chapter 13 Bankruptcy**

\$	389	payment on arrears (assuming cure over 36 mos.)
\$	46	interest on arrears payment each month (assuming required by mortgage documents)
\$	44	trustee's fee each month (assuming plan permits regular monthly payments to be made directly to servicer and not considering other administrative costs, such as attorney's fees, or other payments under plan)
<b>\$</b>	<b>1,982</b>	monthly to keep current and cure arrears for first six months of plan (including taxes and insurance)
<b>\$</b>	<b>2,137</b>	monthly to keep current and cure arrears for months 7-12

\$ 2,250	of plan monthly to keep current and cure arrears for months 13 - 18 of plan
\$ 2,379	monthly to keep current and cure arrears for months 19 - 24 of plan
\$ 2,485	monthly to keep current and cure arrears for months 25 - 30 of plan
\$ 2,489	monthly to keep current and cure arrears for months 31 - 36 of plan

By the third year of the plan, the total housing payment will represent 55% of the couple's gross income. The monthly payment in year three will also be \$986 more than what the borrowers were paying for their total housing expense (\$1503) before filing bankruptcy.

**IV. Proposals for Change.**

To help families save their homes from foreclosure, we propose an amendment to the Bankruptcy Code to give bankruptcy courts the same authority to modify home mortgage loans as they have for virtually every other kind of secured and unsecured debt. Our recommendation does not attempt to revisit the changes to the Code made by the 2005 amendments. Rather, it addresses the limitations in current Chapter 13 based on the special protection afforded to home mortgage lenders by the 1978 Bankruptcy Code.

With respect to this issue, we suggest the following changes:

**Repeal Special Protection for Home Mortgages in Section 1322.** This change will permit some borrowers who were provided unaffordable loans to lower their monthly payment to an amount they can pay and to keep that payment amount permanent by converting their ARM to a fixed rate mortgage. It will help borrowers blunt the devastating effect of future rate adjustments which were often not properly considered by lenders when assessing ability to repay at the time the loans were made. For high LTV

loans made based on the lender's careless underwriting decisions and inflated or fraudulent appraisals, and which have prevented borrowers from refinancing out of unaffordable loans, borrowers who file Chapter 13 to deal with a foreclosure would have the right to reduce the mortgage claim to the value of the property. This change will extend to low- and middle-income consumers the same protections that are afforded family farmers, corporations, and wealthy individuals who own investment properties.

**Amend Section 1322 to Permit Reamortization.** Permitting modification by itself does not fully address the problem based on the current structure of the Code. This is because modified secured claims in Chapter 13 must be paid in full during the three to five years of the plan. For home mortgages with large outstanding balances, this is impossible for most borrowers and they would not benefit from the change permitting modification. To address this, we propose a solution which Congress has already provided for family farmers in Chapter 12 cases. Section 1322 should be amended to include a provision similar to section 1222(b)(9) which permits the borrower's loan to be reamortized based on the modified terms and paid over a period beyond the plan term, generally up to thirty years.

Based on the above example, these changes would permit the homeowners to save their home from foreclosure by obtaining an affordable reamortized loan and still return to the lender the value of its lien with reasonable interest.

### **Proposed Chapter 13 Plan with Mortgage Modification**

The borrowers propose to extend the mortgage term, so that it has another 360 months to run, to reduce the interest rate going forward at a fixed rate of 8.5%, and to reduce the current loan balance to \$165,000 based on the fair market value of the property.

\$165,000 current loan balance  
360 month term  
8.5% interest

\$ 1,494	ongoing monthly mortgage payment (including taxes and insurance)
\$ 60	trustee's fee each month (assuming mortgage payments are made by the trustee under the plan and based on a reduced commission of 4%)
<b>\$ 1,554</b>	monthly to keep current for 3 year duration of plan
<b>\$ 1,494</b>	monthly to keep current for remaining 27 years of mortgage term (subject to adjustment only for taxes and insurance)

These changes allow debtors to repay their mortgages on fair and reasonable terms that fully protect the mortgage holder. Like any secured creditor, the mortgage holder would be entitled to adequate protection of its property interest during the Chapter 13 case. Lenders will receive at least as much as they would realize if the property were foreclosed, even if there is a cram down based on the property's value. For lenders who make high LTV or no equity loans based on risky underwriting practices, they can hardly expect a different outcome since they did not take a security interest in the consumer's home based on its true economic value.<sup>22</sup>

---

<sup>22</sup> This was clearly recognized by the Office of Thrift Supervision in its 1998 announcement to lenders:

When the combined LTV exceeds 90 percent, however, the proceeds from the sale of the security property will likely not be sufficient to fully liquidate the

These changes will also provide borrowers with an opportunity for loan modifications similar to those which many lenders have said they are willing to make. However, for many homeowners, these workout offers have been illusory. Some of the pooling and servicing agreements of securitized loans which control the mortgage servicer's loss mitigation practices place restrictions on the servicer's ability to offer loan modifications.<sup>23</sup> Homeowners are often unable to get through to someone in the servicer's operation with authority to negotiate such deals, or may find out at the last minute just before a scheduled foreclosure sale that the modification has not been approved or that some additional paperwork requirement is needed. Because of these practices, bankruptcy attorneys and other attorneys who assist homeowners are often contacted just days before a scheduled sale when servicers may no longer be willing to negotiate reasonable workouts.

Incorporating this modification right in Chapter 13 will provide needed assistance to families who for one of many possible reasons have not been able to obtain workouts which include loan modifications. It will also provide an incentive for many lenders and servicers to work with homeowners and their representatives early in the foreclosure process and to make good on their claims that loss mitigation options are available. In

---

home equity loan and any outstanding senior liens. The portion of such loans that exceeds 100% of value is effectively unsecured, ... High LTV lenders state that they recognize that these loans are more or less unsecured, and it is not likely they will benefit from foreclosure.

Thrift Bulletin TB 72, Office of Thrift Supervision, Department of the Treasury, August 27, 1998, at 1.

<sup>23</sup> In one review of such agreements, it was found that one-third of the agreements included a limit on the percent of loans that may be modified, typically requiring that no more than 5 percent of the loans in the original loan pool may be modified. *See* "The Day After Tomorrow: Payment Shock and Loan Modifications," CreditSuisse Fixed Income Research, April 5, 2007.

my experience, consumers are never eager to file Chapter 13, so a change that encourages the availability of reasonable modifications will help many homeowners actually avoid filing Chapter 13 bankruptcy.

Suggestions that these changes will deter investment in mortgage-backed securities or drive up costs to homeowners are unfounded. Simply put, the number of residential mortgages that would realistically be subject to cram down is so insignificant in comparison to the total mortgages made that such an impact is highly unlikely. As mentioned, these changes could cause fewer Chapter 13s to be filed. But even if current filings remain constant or even modestly increase, the number of potential Chapter 13 filings will be small. Given the difficulties of living under a strict court-supervised plan in which all of disposable income must be dedicated for a three to five year period, only homeowners who have no other option for dealing with foreclosure can reasonably be expected to seek a loan modification in Chapter 13. And consumers in Chapter 13 cases do not receive the benefit of any cram down of secured debts until they have completed their plans at the end of a three- to five-year period.

While there are other changes to Chapter 13 not discussed here which we would welcome the opportunity to discuss with the Subcommittee, we also urge consideration of the following:

**Lender Fees During Bankruptcy.** Another necessary change is a provision to control the enormous problem of mortgage creditors adding unauthorized or excessive fees to the accounts of debtors who are in Chapter 13. Many of these debtors emerge from a Chapter 13 case after three to five years of struggling to cure an arrearage only to have the lender begin foreclosure anew based on claims of unpaid fees for such items as

attorney's fees, property inspections, broker price opinions, and other charges allegedly incurred during the Chapter 13 case. These fees and charges are added to mortgage accounts without notice to the borrower, trustee or bankruptcy court while the case is pending. Many bankruptcy courts have decried these abuses, but usually they go unremedied because the bankruptcy case is over and the debtor has no money to litigate about them. A provision to remedy this problem could provide that all fees and charges based upon occurrences during the pendency of a chapter 13 case must be disclosed to the debtor and trustee, who may then have an opportunity to file an objection with the court.

**Prebankruptcy Credit Counseling for Consumers in Foreclosure.** The requirement of a prebankruptcy credit counseling briefing added by the 2005 Bankruptcy Code amendments often causes a delay that borrowers facing bankruptcy cannot afford, and could make these proposed amendments meaningless for borrowers who need them most. Several courts have also held that a pending foreclosure is not a sufficient "exigent circumstance" which would merit a deferral of the counseling under the procedure Congress adopted in the 2005 law to presumably deal with emergencies such as foreclosures. Credit counselors deal primarily with unsecured debts and generally do not assist borrowers with foreclosures. The services they offer, debt management plans and budget advice, cannot stop a foreclosure. Thus, the requirement should be eliminated for debtors who are responding to a scheduled foreclosure. Of course, these debtors would remain subject to the requirements of section 1328(g) that they complete an instructional course in personal financial management.

**Mandatory Arbitration Clauses.** Mandatory arbitration clauses are found in many consumer contracts, including home mortgages. The enforcement of these arbitration agreements under the Federal Arbitration Act is often in direct conflict with the goal of bankruptcy jurisdiction to have one centralized forum for the prompt resolution of disputes affecting the bankruptcy estate. In order to protect homeowners, both Fannie Mae and Freddie Mac have prohibited the use of arbitration clauses in home loans they purchase. This conflict between the Bankruptcy Code and the Federal Arbitration Act has led most courts to hold that, at least as to core proceedings such as claims and defenses raised as objections to a creditor's proof of claim, a bankruptcy judge may refuse to enforce an arbitration agreement and may stay any pending arbitration proceedings. Unfortunately, two Circuit Courts have recently held that the bankruptcy courts in those cases did not have discretion to decide claims asserted by the debtors in core proceedings.<sup>24</sup> An amendment which clarifies that bankruptcy courts may properly exercise discretion in core proceedings to deny a referral to arbitration will assist borrowers who may need to challenge an abusive mortgage loan as part of the bankruptcy claims process.

---

<sup>24</sup> *In re Mintze*, 434 F.3d 222 (3d Cir. 2006); *MBNA America Bank, N.A. v. Hill*, 436 F.3d 104 (2d Cir. 2006).

**John Rao** is an attorney with the National Consumer Law Center, Inc. Mr. Rao focuses on consumer credit and bankruptcy issues and has served as a panelist and instructor at numerous bankruptcy and consumer law trainings and conferences. He is a contributing author and editor of NCLC's *Consumer Bankruptcy Law and Practice*; co-author of NCLC's *Bankruptcy Basics*; *Foreclosures*; and *Guide to Surviving Debt*; and contributing author to NCLC's *Student Loan Law*; *Stop Predatory Lending*; and NCLC Reports: *Bankruptcy and Foreclosures Edition*. He is also a contributing author to *Collier on Bankruptcy* and the *Collier Bankruptcy Practice Guide*. Mr. Rao serves as a member of the federal Judicial Conference Advisory Committee on Bankruptcy Rules, appointed by Chief Justice John Roberts in 2006. He is a member of the board of directors for the National Association of Consumer Bankruptcy Attorneys and the American Bankruptcy Institute. Before coming to NCLC, Mr. Rao served as a managing attorney of Rhode Island Legal Services and headed the program's Consumer Unit. His practice included a broad range of cases dealing with consumer, bankruptcy and utility issues, requiring representation of low-income clients before federal, state and bankruptcy courts, and before administrative agencies. Mr. Rao is a graduate of Boston University and received his J.D. in 1982 from the University of California (Hastings).