

**Testimony of SIFMA
before the
House Judiciary Subcommittee on
Commercial and Administrative Law**

**Hearing on Straightening Out the Mortgage Mess:
*How Can we Protect Home Ownership and Provide Relief to Consumers in Financial
Distress? – Part II***

Tuesday, October 30, 2007

The Securities Industry and Financial Markets Association (SIFMA)¹ and the American Securitization Forum (“ASF”)² are pleased to submit this testimony on Section 3 of H.R. 3609, the “Emergency Home Ownership and Mortgage Equity Protection Act of 2007,” (the “Bill”).

The Bill proposes to eliminate the nearly three decades of protection that the Bankruptcy Code (the “Code”) has afforded to primary home mortgage lenders.³ Specifically, the bill would permit debtors in Chapter 13 bankruptcy to “strip down” liens secured by the debtor’s principal residence.⁴ As a result, lenders would only be entitled to receive the value of the secured property, as opposed to the full amount of the debt owed.

The Bill is inconsistent with the intended purpose of the Code to promote homeownership through lower interest rates by protecting home mortgages as secured debt. The bill would undermine the over six and one-half trillion dollar secondary

¹ The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers locally and globally through offices in New York, Washington D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public’s trust in the industry and the markets. (More information about SIFMA is available at <http://www.sifma.org>.)

² The American Securitization Forum is a broadly-based professional forum through which participants in the U.S. securitization market express their common interests on important legal, regulatory and market practice issues. ASF’s membership – over 350 organizations in all – includes securitization issuers, investors, servicers, financial intermediaries, trustees, rating agencies, legal and accounting firms, and other securitization market participants. ASF is an adjunct forum of SIFMA. (Additional information about the ASF, its members and activities is available at www.americansecuritization.com.)

³ See 11 U.S.C. §1322(b)(2) (enacted as part of the Bankruptcy Act of 1978).

⁴ The term “strip down” refers to the ability of a mortgagor to compel a mortgagee to relinquish its lien upon receipt of payment equal to the value of the property, as opposed to the full amount of the debt. *Dewsnup v. Timm*, 112 S.Ct. 773, 779 (1992).

mortgage market which provides valuable liquidity to our economy by linking mortgage originators with the global capital markets.

In 1978 Congress crafted an exemption for mortgages on primary residences from modification during Chapter 13 bankruptcy proceedings to encourage homeownership, to discourage home owners from rushing to file bankruptcy, and to ensure an availability of capital in the mortgage markets. Supreme Court Justice John Paul Stevens affirmed the intent of Congress in his concurring statement in *Nobelman v. American Savings Bank*, 113 S. Ct. 2106 (1993), stating “At first blush it seems somewhat strange that the Bankruptcy Code should provide less protection to an individual’s interest in retaining possession of his or her home than of other assets. The anomaly is, however, explained by the legislative history indicating that favorable treatment of residential mortgagees was intended to encourage the flow of capital into the home lending market.” The cram down provision in H.R. 3609 would negate this long-standing principle.

Before altering mortgage lenders’ contractual rights and taking action that would negatively affect the primary and secondary mortgage markets, Congress should ensure that the benefits of the action outweigh its cost, and also that the action is targeted at the root cause of the problem. While it is true that nationally the aggregate numbers of foreclosures are at record highs, the spike appears to be due in large part to a general decline in the real estate market, combined with increased investor speculation, and regional downturns in the employment market.⁵ Mortgage lending is, by its nature, a long term, cyclical industry, and stability in the manner of risk assessment, underwriting and contractual relations is critical for the industry to survive the troughs. A political response that would undermine thirty years of practice in the mortgage lending industry, as well as the stability of the financial markets that rely upon the packaging of mortgages for liquidity, should not be undertaken lightly. There are significant long term consequences for all borrowers from the hoped for “benefit” to a small set of subprime borrowers who may end up in bankruptcy because of the terms of their mortgage loans. This is especially true since many of these borrowers debts can be reworked outside bankruptcy.

If, pursuant to the Bill, bankruptcy judges could modify the terms of a loan on a homeowner’s principal residence, it would likely reduce the availability of mortgage credit for the very borrowers who need this credit most in order to refinance, result in

⁵ For the first quarter of 2007, the aggregate numbers of foreclosure increases were mostly attributable to four states: California, Florida, Nevada and Arizona. But for these states, foreclosure starts would have actually declined nationwide (including those on subprime ARMs). Twenty four states saw a decline in foreclosure starts, while the rest saw negligible increases. In the above four states, foreclosures were impacted by speculators walking away from properties after a decline in the market which impacted their ability to flip the property before the reset in their adjustable-rate mortgages. It is clear that §1322(b)(2) does not apply to such investment activity. The other major influence on foreclosures were the states of Ohio, Michigan and Indiana, which have suffered large declines in manufacturing employment, and account for 19.9% of the nationwide foreclosures. The problems extend across all loans types: Subprime ARM delinquencies are twice the national rate and prime fixed-rate loans are three times higher than the national rate. See <http://www.mortgagebankers.org/NewsandMedia/PressCenter/55132.htm>.

higher interest rates and costs for all home buyers, and may cause disruption in the financial markets because of the uncertainty it would introduce.

Banks and other lenders pool and sell mortgage debt into mortgage backed securities (MBS) to investors through securitization. Securitization allows lenders to move loans off of their balance sheets, thus freeing up capital for further lending. Home mortgage credit has become more widely available at a lower cost because of securitization and the secondary mortgage market. Homeownership rates have increased to nearly 70 percent, due in part to the increased financing provided to lenders by the secondary market for mortgage debt.

Investors gauge the safety of mortgage-backed securities by the predictability of the cash flows on the underlying pools of mortgages. There are a variety of factors that can introduce risks into the predictability of those cash flows, and each of those factors is a source of risk for MBS investors. For example, most mortgage loans allow the borrower to prepay their loan at any time without penalty. Or, borrowers can default on their loans, which can affect both the timing of cash flows and the overall repayment of principal. The risks faced by MBS investors are reflected in borrowing rates for home buyers. The more risk of uncertainty for investors, the higher the borrowing costs for home owners.

By introducing a new source of risk for MBS investors—the risk that a bankruptcy court could reduce the secured balance of a mortgage loan—this legislation raises significant concerns for investors in MBS. If investors cannot be sure of the principal amount of a contract backing a security, those investors cannot estimate the value of the security. Such uncertainty would likely cause market participants, including MBS investors, to “reprice” the risk associated with their MBS investments at higher yields—interest rates—to compensate for this additional risk. Higher yields for MBS investors translates into higher borrowing costs for home buyers. While this risk would prevail for all mortgage borrowers, the effect would be particularly pronounced for those borrowers who are perceived to pose the greatest risk for entering bankruptcy during the life of their mortgage. In the context of the current downturn in the subprime mortgage market, high-risk borrowers have already suffered significantly and many are having extreme difficulty refinancing out of subprime loans made during the height of the real estate boom. This bill would make it even more difficult and expensive for those borrowers to obtain new financing.

An example of what may occur if this bill is passed may be found in the market for mortgages on second homes and vacation properties. Unlike mortgages on primary residences, mortgages on second homes and investment properties can be modified in bankruptcy court. As a result, mortgages on second homes and investment properties generally require greater down payments and have higher interest rates than others. The difference in rates is generally on the order of 1-2 percentage points. If the Code was amended to treat mortgages on primary residences like mortgages on second homes and investment properties, one would expect that lenders and investors would require higher down-payments or additional mortgage insurance coverage for not only subprime

mortgages, but *all* primary residence mortgages, including *prime* mortgages, and charge higher interest rates for those loans. This result naturally follows because a borrower's credit would have less bearing on the lender's decision to extend credit than would the value of the asset (the primary residence). The greater down-payments required and higher interest rates charged by lenders could exclude some home buyers from qualifying for a mortgage.

Moreover, only approximately nine percent of second home mortgage originations are securitized.⁶ By comparison, roughly eighty-four percent of primary home mortgage originations are securitized.⁷ If the Bill were adopted, it could reduce the ability of mortgage originators to securitize loans on principal residences, again making those loans less available and more expensive.

Finally, to the extent the Bill incents consumers to file for bankruptcy in order to reduce the balance of their outstanding mortgages, the Bill may also encourage consumers to recast all of their debts, not just those relating to their homes. Were this to occur, bankruptcy-related losses could be expected to increase on all asset types including, for example, credit cards and auto loans.

In sum, the Bill introduces a significant degree of uncertainty to the process of valuing the collateral that supports mortgage-backed securities, as well as potential delay to lenders in accessing proceeds from loans of Chapter 13 debtors. These uncertainties generate risks that would operate as a significant drag on the availability, pricing and efficiency of mortgage credit and the secondary mortgage markets. This result would not serve the best interests of consumers, lenders, investors or the U.S. capital markets and would be particularly harmful to those borrowers most negatively affected by the subprime downturn.

In the end, the Bill would do more harm than good, even for those it is designed to help, subprime borrowers. Instead of policies that would shrink mortgage lending during such a particularly soft period in real estate lending, Congress should explore other alternatives to help subprime borrowers in need. For example, industry participants are collaborating in new ways to create comprehensive education efforts. Specifically, lenders and servicers are reaching out to troubled homeowners, and assisting borrowers through community programs such as NeighborWorks® America, HOPE NOW and 888-995-HOPE. Many lenders have also increased other loss mitigation efforts including loan modifications, enhanced counseling programs and increased staffing to assist borrowers.

⁶ Second mortgages include home-equity lines of credit and closed-end seconds; some second mortgages are also securitized in subprime and other MBS products. "Securitization Rate Slips in Second Quarter Despite Lag in Nonprime MBS Process," *Inside MBS & ABS* (September 7, 2007).

⁷ Primary mortgages include subprime, prime jumbo, conforming, and FHA/VA in the first half of 2007. *Inside MBS & ABS* (September 7, 2007)

Given the current conditions in the mortgage market—lenders tightening credit standards, or lenders going out of business entirely—it is already becoming difficult for some borrowers to access mortgage credit. Amending the bankruptcy code will only serve to exacerbate this problem. This bill will have the unintended consequence of harming those whom it intends to help—borrowers who are currently struggling to repay their mortgage.

As the Subcommittee continues to explore appropriate solutions to assist troubled borrowers and homeowners, we look forward to working with you.