OBAMA-BIDEN TRANSITION PROJECT

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Testimony

Of

Ms. Alys Cohen

On behalf of the
Low Income Clients of the
National Consumer Law Center
And
National Association of Consumer Advocates

Domestic Policy Subcommittee
Oversight and Government Reform Committee
Friday, November 14, 2008
2154 Rayburn HOB
10:00 a.m.

"Is Treasury Using Bailout Funds to Increase Foreclosure Prevention as Congress Intended?"

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TARP and Loan Modifications of Troubled Mortgages

I. Introduction and Summary of Recommendations

Chairman Kucinich, Ranking Member Issa, and members of the subcommittee, thank you for inviting me to testify at today's hearing on the Treasury Department's Troubled Asset Relief Program ("TARP") program. I am a staff attorney at the National Consumer Law Center and testify here today on behalf of the National Consumer Law Center's low-income clients[1] as well as the National Association of Consumer Advocates.[2]

On a daily basis, NCLC's attorneys provide legal and technical assistance on consumer law issues to legal services, government and private attorneys representing low-income consumers across the country. From this vantage point, we are seeing the devastating effects of escalating foreclosures on families and communities. There is no doubt: bold and immediate action is needed to save homes and repair neighborhoods.

Congress must insist that Treasury use the broad powers provided by TARP to mandate affordable modifications through every available means. It will take an extraordinary effort to stem the rising tide of foreclosures, save homes for families across the nation and, in turn, preserve the safety and value of America's communities. Treasury should develop a loan modification program that can be routinized and applied on a large-scale basis; condition any purchase of an equity interest in a financial institution on a rigorous loan modification plan; provide guarantees only for *affordable* loan modifications; and purchase a sufficient stake in assets to enable the implementation of an aggressive modification program through the purchase of whole loans, second mortgages, securities, or servicing rights.

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[1] 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, including *Truth In Lending*, (6th ed. 2007), *Cost of Credit: Regulation, Preemption, and Industry Abuses* (3d ed. 2005) and *Foreclosures* (1st ed. 2005), as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. 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 address 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. This testimony was written by Alys Cohen, Staff Attorney, Margot Saunders, Of Counsel, and Tara Twomey, Of Counsel.

[2] The **National Association of Consumer Advocates (NACA)** is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

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An effective TARP program for homeowners lies in the mechanics of its loan modification program. The following principles should be the basis for the federal loan modification program under TARP:

1. **A mechanized program is essential to process the many homeowners facing foreclosure**, and it also must include a safety valve for homeowners with special needs. In this way, the one size fits all approach is the default program applied to all homeowners, while those with special circumstances are still able to have their needs addressed. The modifications also need to be permanent and sustainable, to ensure that the foreclosure is not simply postponed to a later day.

2. **The affordability analysis in any loan modification program must be both objective and flexible**. It is essential to orient loan modifications toward an affordable debt to income ("DTI") ratio, such as 38%[3] including taxes and home-related insurance, and to do so as much as possible on a mechanized basis.

3. **Loan modifications should include principal reductions to 95% LTV.** While a homeowner with affordable payments who is underwater can retain the home, the homeowner will not, if circumstances require, be able to refinance to make needed repairs, obtain a reverse mortgage, or relocate.

4. **Second liens must be addressed.** Loan modifications that address first liens but omit any treatment of second liens simply are setting up homeowners for failed loans and lost equity. The holder of a sleeping second mortgage lien could, after years of good faith payments on the modified first mortgage, seek to collect on the lien, robbing the homeowner of any homeownership gains acquired through the loan modification process. Second liens should be bought out at a nominal price.

5. **Loan modifications should be available to homeowners in default as well as for those for whom default is reasonably foreseeable.** Many homeowners are scraping by on their payments – borrowing money from family members, draining savings, foregoing payment on other debt or utilities, running up their credit cards. These families also should have a chance to obtain sustainable loan terms and regain financial stability.

6. **Fees should be waived as part of the loan modification**. Late fees and all default servicing fees should always be waived in loan modifications. As servicers profit enormously from such fees, they often are out of

[3] While we believe that DTI analyses always benefit from the addition of a residual income analysis, in the context of mass loan modifications a front end debt-to-income analysis may be the most efficient way to provide relief to a broad swath of homeowners.

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proportion to the loan balance. When fees are capitalized into the loan balance, the loan principal increases substantially. Neither servicers nor homeowners benefit from a system that requires homeowners to challenge the legitimacy of default servicing fees in court proceedings in order to receive a sustainable and affordable loan modification.

7. **Any shared loss guarantee should favor the most-needed loan modifications**. Any loan modification guarantee should be based on the degree of concessions offered, with greater concessions leading to more significant guarantees.

In addition, as further detailed in Section IV in which we explain each elements of the loan modification recommendations, it is essential that Treasury adopt procedural rules to assure the integrity of the loan modification program, including:

- Specificity and transparency must be applied to the definition of net present value. Reimbursements to servicers for loan modifications should be equivalent or more than foreclosures.
- Data and reporting are essential. Any loan modification undertaken by the federal government should gather detailed records regarding loan modifications as well as re-defaults.
- Reimbursements to servicers should encourage loan modifications by ensuring that servicers are paid the same or more than when they pursue foreclosures.

Even if TARP, as well as Hope for Homeowners and the new GSE loan modification program, reach their maximum potential, further action must be taken by Congress to help homeowners keep their homes.[4] In addition to the steps below, Congress should consider legislation to facilitate the mass restructuring of loans, to the extent that further action is needed to expand the reach of modifications.[5]

1. Congress should allow bankruptcy courts to modify home mortgage loans just as they can do for virtually every other kind of secured and unsecured debt.
2. Congress should enact H.R. 5679, which aligns mortgage servicers' interest with those of homeowners and requires that reasonable loss mitigation efforts be made before a foreclosure can initiated.

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[4] These recommendations only address how to limit the millions of foreclosures on the horizon. This testimony does not address the steps policymakers will need to take to prevent such a crisis from happening again.

[5] *See, e.g.,* Michael Barr & James A. Feldman, *Issue Brief: Overcoming Legal Barriers to the Bulk Sale of At-Risk Mortgages*, Center for American Progress (Apr. 22, 2008), *available at* http://www.americanprogress.org/issues/2008/04/reimc_brief.html; Robert Kuttner, *It's Time to Save the Housing Sector*, Boston Globe (January 24, 2008), available at http://www.boston.com/realestate/news/articles/2008/01/24/its_time_to_save_the_housing_sector/ (discussing the Home Owners Loan Corporation of the New Deal era).

3. Congress must continue the fix of the tax code, to ensure that loan modifications do not give rise to taxable income. Principal reductions, or, in some cases, interest rate reductions, can lead to imputed taxable income to the homeowner when the loan that is modified was *not* used to purchase or substantially improve the home. Congress should amend the Mortgage Debt Forgiveness Relief Act of 2007[6] to protect homeowners from tax consequences in all loan modifications.

II. The Foreclosure Crisis Calls For Bold Action

As is apparent from the constant stream of stories in the news, we are facing the greatest foreclosure crisis since the Great Depression. The statistics are grim. For the second quarter of 2008, foreclosure filings nationwide were up 121% over the second quarter of 2007.[7] In the same time period, nearly a quarter of a million properties were foreclosed.[8] As of July 2008, REO, or creditor-owned, property represented more than 16 percent of the inventory of existing homes for sale.[9] In some communities, creditor-owned properties make up nearly 40 percent of existing inventory.[10]

In the prime market as well as the subprime market, seriously delinquent[11] loans have continued to rise at an alarming rate, increasing three-fold since early 2006.[12] By mid-2008, nearly one-third of subprime ARMs were more than 90 days late or in foreclosure.[13] Nationwide, it is estimated that 6.5 million foreclosures may be completed by 2012.[14]

The consequences of this foreclosure crisis have not only ripped through Wall Street, they are taking a heavy toll on communities across America. The abuses in the

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[6] Pub. L. No. 110-142.
[7] RealtyTrac, Inc., *Foreclosure Activity Up 14 Percent in Second Quarter* (July 25, 2008), *available at* *http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=4891&accnt=64847*.
[8] *Id.* (reporting 222,391 REO properties for the quarter).
[9] RealtyTrac, Inc. has reported more than three quarters of a million properties are in its active REO database. *See* RealtyTrac, Inc., *Foreclosure Activity Increases 8 Percent in July* (Aug. 14, 2008), available at http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=5041&accnt=64847; National Association of Realtors, *July Existing-Home Sales Show Gain* (Aug. 25, 2008)(reporting total housing inventory at the end of July at 4.67 million existing homes for sale), *available at* http://www.realtor.org/press_room/news_releases/2008/july_ehs_show_gain
[10] Kelly Bennett, *Local Prices Down 30 Percent from Peak* (Aug. 27, 2008)(reporting 135 of 337 properties listed for sale on Aug. 21 and 22, 2008 in San Diego area were bank repossessions), available at http://www.voiceofsandiego.org/articles/2008/08/27/housing/869dataparty082708.txt.
[11] The category of seriously delinquent loans includes loans that are at least 90 days delinquent plus the loans in foreclosure inventory.
[12] National Delinquency Survey, Mortgage Bankers Association. The seriously delinquent rate for subprime loans, both fixed and adjustable in the first quarter of 2006, was 6.22%. By the second quarter of 2008 that number had grown to 17.85%. Similarly, in the prime market the number of seriously delinquent loans has climbed from .77% in the first quarter of 2006 to 2.35% in the second quarter of 2008.
[13] *Id.*
[14] Reuters, *Foreclosures to Affect 6.5 million by 2012* (Apr. 22, 2008), available at http://www.reuters.com/article/bondsNews/idUSN2233380820080422 (discussing Credit Suisse report based on Mortgage Bankers Association data).

subprime market have undermined the efforts of hardworking families to acquire and retain the dream of homeownership –

- Instead of building wealth, families are losing equity.[15]
- Worse yet, some foreclosed families are unable to find replacement shelter and become homeless.[16]
- Renters suffer, too, as lenders quickly evict tenants from foreclosed homes.[17]
- More and more Americans are being driven into bankruptcy.[18]
- Neighborhoods are deteriorating as foreclosed homes are boarded up and left vacant.[19]
- Crime in high-foreclosure neighborhoods is on the rise.[20]
- Overgrown lawns and trash-strewn yards symbolize growing community abandonment and disinvestment.[21]
- Not only is this a community issue, it is a civil rights issue. Subprime loan originations to borrowers of color have drastically outnumbered those to white borrowers. For example, in 2006 and 2007, African Americans and Latinos were approximately 2.5 times more likely than whites to receive subprime loans. African Americans alone comprise almost half of all subprime borrowers.[22]

While the servicing industry stands at the center of the foreclosure crisis, and thus is in the best position to turn the situation around, the basic structure of the servicing

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[15] Ellen Schlomer, et al., *Losing Ground, Foreclosures in the Subprime Market and Their Cost to Homeowners*, Center for Responsible Lending (Dec. 2006) at 3 (estimating that foreclosures will cost homeowners as much as $164 billion, primarily in lost home equity).

[16] *See* Erlenbusch, et al., *Foreclosure to Homelessness: The Forgotten Victims of the Subprime Crisis*, National Coalition for the Homeless (Apr. 15, 2008).

[17] It is estimated that 18% of the foreclosure started in the third quarter 2007 were not occupied by the owners. *See* Jay Brinkmann, An Examination of Mortgage Foreclosures, Modifications, Repayment Plans and other Loss Mitigation Activities in the Third Quarter of 2007, Mortgage Bankers Association (Jan. 2008), *available at* http://www.mortgagebankers.org/files/News/InternalResource/59454_LoanModificationsSurvey.pdf; *see also* Testimony of Sheila Crowley to the Financial Services Committee, U.S. House of Representatives (April 10, 2008)(discussing the affects of the foreclosure crisis on renters), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/crowley041008.pdf; John Leland, *As Owners Feel Mortgage Pain, So Do Renters, New York Times* (Nov. 18, 2007);

[18] The number of bankruptcy filings is projected to top more than one million filings for 2008—the highest number of filings since the 2005 amendments to the Bankruptcy Code. See Posting of Robert Lawless on *Credit Slips* blog, Bankruptcy Filings Reach New High in August, http://www.creditslips.org/creditslips/2008/09/bankruptcy-fili.html#more (Sept. 2, 2008).

[19] *See* Letter, Senator Dodd to Senator Reid (Jan. 22, 2008)(describing cycle of disinvestment, crime, falling property values and property tax collections resulting from foreclosures), *available at* http://dodd.senate.gov/multimedia/2008/012308_ReidLetter.pdf.; Brad Heath and Charisse Jones, *Mortgage defaults force Denver exodus*, USA Today (Apr. 1, 2008)(in some Denver neighborhoods as many as one-third of residents have lost their homes).

[20] *See, e.g.*, J.W. Elphinstone, *After foreclosure, crime moves in*, Boston Globe (Nov. 18, 2007)(describing Atlanta neighborhood now plagued by house fires, prostitution, vandalism and burglaries).

[21] *See* Daphne Sashin and Vicki Mcclure, *Foreclosure leave painful ripple effect*, Orlando Sentinel (Oct. 15, 2007) (describing a once safe neighborhood now dotted with empty homes and overgrown lawns).

[22] Center for Responsible Lending, 2008.

business requires us to recognize that we cannot leave it to this industry to lead the way out of this foreclosure nightmare; Congressional action is needed.

III. The Servicing Industry Cannot Be Relied upon to Meet the Needs of Homeowners.

Mortgage servicers are the link between mortgage borrowers and the mortgage owners. Since the 1990s, mortgage servicing has become an increasingly specialized and lucrative industry, driven in part by the need for one party to coordinate the distribution of mortgage revenues to the investors in securitized loans. Despite the important functions of mortgage servicers, borrowers have few market mechanisms to employ to ensure that their needs are met. Rather, in the interest of maximizing profits, servicers have engaged in a laundry list of bad behavior, *which has considerably exacerbated foreclosure rates*.[23] The most common abuses in loan servicing include misapplication of payments, use of suspense accounts, failure to make timely escrow disbursements, and cascading fees imposed upon homeowners in default.[24] These abuses exist because there are market incentives rather than deterrents for this type of behavior.[25] Any loan modification program must account for these dynamics and move beyond them.

A. Cutting Cost, Cutting Service.

As with all businesses, servicers add more to their bottom line to the extent that they can cut costs. Servicers have cut costs by relying more on voicemail systems and less on people to assist borrowers, by refusing to respond to borrowers' inquires and by failing to resolve borrower disputes. Recent industry efforts to "staff-up" loss mitigation departments have been woefully inadequate. As a result, servicers remain unable to provide affordable and sustainable loan modifications on the scale needed to address the current foreclosure crisis. Instead borrowers are being pushed into short-term modifications and unaffordable repayment plans. These "kick the can" approaches to solving the foreclosure crisis do not provide real solutions for those affected borrowers. Instead, they merely postpone the day of reckoning.[26] Moreover, creating affordable and sustainable loan modifications for distressed borrowers on a loan-by-loan basis is labor intensive.[27] Under many pooling and servicing agreements, additional labor costs incurred by servicer's engaged this process are not compensated by the loan owner. By

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[23] *See* National Consumer Law Center, *Foreclosures*, Ch. 6 (2d ed. 2007)(describing the most common mortgage servicing abuses).
[24] *Id.*
[25] *See* Kurt Eggert, *Comment on Michael A. Stegman et al.'s "Preventive Servicing Is Good Business and Affordable Homeownership Policy": What Prevents Loan Modifications?*, 18 Housing Pol'y Debate 279 (2007).
[26] *See* Jay Brinkmann, An Examination of Mortgage Foreclosures, Modifications, Repayment Plans and other Loss Mitigation Activities in the Third Quarter of 2007, Mortgage Bankers Association (Jan. 2008), *available at* http://www.mortgagebankers.org/files/News/InternalResource/59454_LoanModificationsSurvey.pdf. (tables 2 and 3 show that a large number of foreclosures result from failed repayment plans).
[27] Joseph R. Mason, *Mortgage Loan Modification: Promises and Pitfalls*, at 7(Oct. 3, 2007), *available from SSRN at* papers.ssrn.com/sol3/papers.cfm?abstract_id=1027470.

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contrast, most servicers are paid a fee to foreclose on a borrower. Under this cost and incentive structure, it is no surprise that servicers continue to push borrowers into less labor-intensive repayment plans or towards foreclosure.

B. Maximizing Income is a Servicer's Main Goal.

Customarily, the servicer collects a monthly fee in return for the services provided to the trust (or investors). The servicing fee provides the largest income stream for servicers. The fee is based on the unpaid principal loan balance and typically ranges from 25 basis points (prime loans) to 50 basis points (subprime loans). In addition, ancillary fees are imposed on borrowers to compensate servicers for the occurrence of particular events. The most common ancillary fee is a late fee, although a variety of other "servicer" fees exist. Such fees are a crucial part of the servicers' income because servicers are typically permitted under PSAs to retain such fees.

IV. Despite Recent Governmental Measures More Needs to Be Done.

A. HERA's Modest Steps

In July 2008, the President signed into law a wide-ranging housing bill, the "Housing and Economic Recovery Act of 2008."[28] A key component of the law is the "HOPE for Homeowners Act of 2008."[29] The HOPE for Homeowners Act creates a new, temporary program authorizing FHA to refinance homeowners into 30-year fixed rate FHA mortgages. The bill also included a safe harbor for servicers of residential mortgage securitizations clarifying that, where the servicer owes a duty to maximize recoveries, this duty is owed equally to all investors in the pool rather than any specific investors, and that a servicer is deemed to act in the best interests of all investors if it agrees to a modification or workout plan where default has occurred or is reasonably foreseeable, the property is owner occupied, and the anticipated recovery under the modification or workout exceeds on a net present value basis, the anticipated recovery through foreclosure. The program has been expected to serve approximately 400,000 homeowners. Unfortunately, the pitfalls are also large and so far business has been slower than expected. The largest obstacle to achieving the promise of HOPE for Homeowners is that industry participation in the program remains entirely voluntary.

B. Voluntary Measures Can Not Stand Alone

For the last couple of years, the financial services industry has been encouraged to meet the growing foreclosure crisis by scaling-up voluntary loan modification efforts. In May 2007, Senate Banking Committee Chairman Dodd announced a set of servicing principles aimed at long-term affordability.[30] In June 2007, Chairman Sheila Bair of the

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[28] Pub. L. No. 110-289 (2008). Certain new disclosure provisions for real estate loans also were included in the bill, as well as an increase in statutory damages for TILA claims on real estate loans.
[29] Title IV, Pub. L. No. 110-289 (2008).
[30] Senator Dodd Unifies Industry Members, Consumer Representatives to Help Preserve the American Dream of Homeownership (May 2, 2007), *available at* http://dodd.senate.gov/index.php?q=node/3863/print

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FDIC called for automatic loan modifications for borrowers with subprime ARMs.[31] Like Senator Dodd's servicing principles, Chairman Bair emphasized the importance of providing sustainable loan modifications. A report from the Joint Economic Committee also suggested that automatic loan modifications were needed.[32] In September 2007, the federal and state banking regulators issued a joint statement on loss mitigation strategies, referencing earlier guidance and encouraging use of loss mitigation authority available under pooling and servicing agreements.[33] In October 2007, Treasury Secretary Paulson sought voluntary commitments from servicers to contact borrowers and explore new loan modification approaches.[34] Then in December, 2007, Secretary Paulson announced a plan for "fast track" loan modifications.[35]

The data available thus far support the conclusion that little is being done by the financial services industry to help homeowners facing foreclosure. While loan modifications are increasing, they are still outpaced by foreclosures. Moreover, few permanently change the loan terms and many actually increase payments for homeowners.[36] A report by Credit Suisse finds that loan modification progress is slow and that plans with higher payments are more common than modifications with lower payments. As of August 2008 modifications accounted for just 3.5 percent of the loans that are delinquent for sixty days or more. Moreover, after modifications that freeze the interest rate at the pre-reset amount, the most common form of modification was one where the payment *increased*. These higher-payment modifications had a re-default rate of 44%. In contrast, reset modifications re-defaulted at a 15% rate and principal reduction modifications re-defaulted at a 23% rate.[37]

Mortgage modifications that do not reduce principal balances, and certainly those that do not even reduce monthly payments delay, do not prevent foreclosures. While voluntary measures may be able to help some borrowers, structural barriers inherent in the mortgage servicing industry will hamper the effectiveness of any voluntary programs, including the HOPE for Homeowners program. While limiting the reductions in loan principals ("haircuts") under the H4H program is apparently under consideration, such a

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[31] Remarks of FDIC Chairman Sheila C. Bair, American Securitization Forum (ASF) Annual Meeting (June 6, 2007).

[32] *The Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues, and How We Got Here*, Report and Recommendations by the Majority Staff of the Joint Economic Committee (Oct. 2007)(one of the key policy recommendations put forth in the report was to direct servicers and lenders to make safe and sustainable loan modifications).

[33] Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages (Sept. 2007), *available at* http://www.occ.treas.gov/ftp/bulletin/2007-38a.pdf.

[34] Associated Press, *Paulson to Mortgage Industry: Help Curb Defaults* (Oct. 31, 2007), *available at* http://money.cnn.com/2007/10/31/real_estate/paulson_housing.ap/.

[35] American Securitization Forum, *Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans*, Executive Summary (Dec. 6, 2007), *available at* http://www.treas.gov/press/releases/hp706.htm.

[36] *See* Alan M. White, *Rewriting Contracts: Wholesale: Data on Voluntary Mortgage Modifications from 2007 and 2008 Remittance Reports*, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1259538.

[37] Rod Dubitsky et. al, *Subprime Loan Modifications Update*, Credit Suisse Fixed Income Research (Oct. 1, 2008) at 1-2.

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measure will not change barriers to participation related to servicer incentives. The need for further action is urgent.

V. EESA/TARP Must Prioritize Effective, Sustainable Assistance to Homeowners.

The Emergency Economic Stabilization Act of 2008 ("EESA") provides the Treasury Department with broad authority to remove distressed assets from financial institutions and resell those assets without typical market constraints or to guarantee such assets. Treasury should –

- Develop a loan modification program that can be routinized and applied on a large-scale basis; [38]
- Condition any purchase of an equity interest in a financial institution on a rigorous loan modification plan;
- Provide guarantees only for *affordable* loan modifications; and
- Purchase a sufficient stake in assets to enable the implementation of an aggressive modification program through the purchase of whole loans, second mortgages, securities, or servicing rights.

An effective TARP program for homeowners lies in the mechanics of the loan modification program. The following principles should be the basis for the federal loan modification program under TARP:

1. **A mechanized program is essential to process the many homeowners facing foreclosure,** and it also must include a safety valve for homeowners with special needs. In this way, the one size fits all approach would be the default program applied to all homeowners, while those with special circumstances would still be able to have their needs addressed. Further, loan modifications need to be geared toward providing real and permanent relief for homeowners, with the goals of minimizing the disruption of families, maximizing their return on investment, and promoting long term stability of neighborhoods. Servicers and lenders should be required to design long-term sustainable loan modifications that allow families to remain in place and preserve their investment in their home.

2. **The affordability analysis in any loan modification program must be both objective and flexible**. It is essential to orient loan modifications toward an

[38] While claims have been made that various accounting and contractual issues stand in the way of engaging in loan modifications en masse, these claims are not clearly supported. For example, while servicers have claimed that Pooling and Servicing Agreements generally limit loan modifications to 5% of a pool, a Credit Suisse report indicated that most PSAs actually don't have such a limitation. *See* Rod Dubitsky, *The Day After Tomorrow: Payment Shock and Loan Modifications,* Credit Suisse Fixed Income Research (Apr. 5, 2007) at 5, 7. Two thirds did not limit the percent of loans that could be modified and almost half had no restrictions on loan modifications at all. There is no empirical evidence to support the claim that most PSAs contain such a limitation. To the extent that concerns regarding structural issues, such as PSAs and accounting rules, themselves present barriers to loan modifications, Congress or Treasury should address these issues directly.

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affordable debt to income ("DTI") ratio, such as 38%[39] including taxes and home-related insurance, and to do so as much as possible on a mechanized basis. Such an approach provides administrative ease, consistency, transparency and fairness. Interest rate reductions, waiver of late fees and default servicing charges, and principal reductions can turn many currently unaffordable loans into affordable ones. Nonetheless, even after these measures, the payments on some loans may still exceed 38% of the homeowners' income. While some homeowners may be facing job loss or other devastating life changes that limit their ability to make any reasonable payments on the loan, others may be able to make the payments at a slightly higher DTI ratio and should be given an opportunity to show that the payment would be affordable. A mechanized program is essential in order to process the many homeowners facing foreclosure; it must also have a safety valve for those homeowners who otherwise could obtain an affordable loan modification. Thus, homeowners whose payments would fall into some slightly higher range, for example 39% to 45%, should be eligible for a trial loan modification, which could be made permanent after three months of payments. In addition, a homeowner who could not qualify for a loan modification but who later was able to obtain employment or was otherwise able to afford a modification after the initial analysis and before the foreclosure process was final, should not be barred from reapplying for a loan modification. A mechanized process may also produce instances where homeowners are offered a modification that, while feasible on paper, is not sustainable in practice. In these cases, if the servicer did not exhaust its tools for making the loan affordable, the homeowner should be eligible for a second look.

3. **Loan modifications should include principal reductions to 95% LTV.** While a homeowner with affordable payments who is underwater can retain the home, the homeowner may have less financial incentive to remain in the home and will not, if circumstances require, be able to refinance to make needed repairs, obtain a reverse mortgage, or relocate. Principal reduction is more likely to lead to successful foreclosure avoidance. As Federal Reserve Board Chairman Bernanke has noted:

> With low or negative equity . . . a stressed borrower has less ability (because there is no home equity to tap) and less financial incentive to try to remain in the home. In this environment, principal reductions that restore some equity for the homeowner may be a relatively more effective means of avoiding delinquency and foreclosure.[40]

[39] While we believe that dti analyses always benefit from the addition of a residual income analysis, in the context of mass loan modifications a front end debt-to-income analysis may be the most efficient way to provide relief to a broad swath of homeowners.
[40] Statement of Federal Reserve Chairman Ben Bernanke on March 4, 2008, reprinted by Bloomberg.com and available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=apeU.0IaETdM ("Bernanke statement").

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A related issue is the question of whether loan terms should be stretched to 30 or to 40 years. While a 40 year mortgage may be a last resort to get to affordability, it substantially decreases a homeowner's chance at increasing equity. Consider the relatively *small* amount of monthly savings achieved from a 40 year mortgage at a 7% interest rate compared to a 30 year loan, especially in light of the huge extra expense in the long run incurred in interest and lost equity.

Comparison Between 30 and 40 year Terms

	Loan Amount	Interest Rate	Monthly Payments	Finance Charge	Balance end Year 5	Balance end Year 10	Balance end Year 20
30	$200,000.00	7%	$1,330.60	$279,017.80	$188,263.18	$171,624.77	$114,600.16
40	$200,000.00	7%	$1,242.86	$396,574.03	$194,544.91	$186,811.65	$160,307.53

In this example, the 40 year amortization only yields a savings in the monthly payment of $87, but will cost over $100,000 over the life of the loan. Indeed, just for saving $87 a month, this homeowner will make an extra ten years of payments – totaling over $138,000 (even after the monthly savings are counted). However, the benefits of a 40 year mortgage over a 30 year term do improve when the interest rate is lowered. The difference in the monthly payment rises, and the difference in the balance at points along the term is reduced. In sum, we strongly urge 40 year terms only be used when accompanied by very low interest rates. Otherwise, the extra costs in the long run outweigh the minimal immediate benefits.

4. **Second liens must be addressed.** Loan modifications that address first liens but omit any treatment of second liens simply are setting up homeowners for failed loans and lost equity. If a homeowner is offered a loan modification on her first mortgage, where she is currently underwater and where the second lien holder therefore has no reasonable expectation of repayment, a second lien holder could block the modification, even where it has no foreseeable recovery in foreclosure, where it views its position as impaired, for example in recapitalization of arrears. In addition, if a second lien holder doesn't block the modification, it could choose to forgo collection until the property value rises and then seek to collect or foreclose based on years of accumulated interest and fees. Thus, a sleeping lien could awake just in time to rob the homeowner of any homeownership gains acquired through the loan modification process and the subsequent years of good-faith payments. Loan modifications that ignore second liens could do long-term damage to housing stability and equity. Subsequent lien holders should be bought out at a nominal rate for a complete release of the claim, comparable to the

expectancy interest matrix used pursuant to Hope for Homeowners.[41] The buyout would ensure that no junior liens—secured or unsecured—remain and that a homeowner could truly benefit from a loan modification on the primary lien.

5. **Loan modifications should be available to homeowners in default and for those for whom default is reasonably foreseeable.** Many homeowners are scraping by on their payments—borrowing money from family members, draining savings, foregoing payment on other debt or utilities, running up their credit cards. These families also should have a chance to obtain sustainable loan terms and regain financial stability. Understandably, those in default may be the first homeowners to receive loan modifications, but the program should not stop there. Borrowers for whom default is reasonably foreseeable could make an application for a loan modification in which they would explain their particular circumstances, how they have been able to make payments, and why default is on the horizon. Many families would benefit from such a program. For example, we recently spoke with one family that spends 75% of its monthly income on its mortgage payment. It spends another 10% on its monthly car payment. The family is paying for basic expenses with credit cards. This is an unsustainable loan that warrants a decent loan modification.

   The definition of for whom default is reasonably foreseeable must include, and look beyond, the group of homeowners facing resets and recasting of Option ARMs. Borrowers with ARMs suffer a high rate of foreclosure prior to reset; default and foreclosure in many instances may be independent of payment shock.[42] This problem is compounded by the fact that most borrowers facing resets are not actually receiving rate freezes. In one analysis, half of those with impending resets received loan modifications with higher payments.[43] Any homeowner currently paying more than 60% of income for a house payment should per se be regarded as one for whom default is reasonably foreseeable.

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[41] Under the Hope for Homeowners rules, second lien holders obtain 9 for CLTVs above 135% or 12% for those below 135%. 73 FR 58418, 58419 (Oct. 6, 2008) (Hope for Homeowners Program Regulations).

[42] Morgan J. Rose, Predatory Lending Practices and Subprime Foreclosures – Distinguishing Impacts by Loan Category 25, 32 (Dec. 2006), *available at* http://www.chicagofed.org/cedric/2007_res_con_papers/car_62_morgan_j_rose_foreclosures_draft.pdf (average purchase money ARM that entered foreclosure did so only 12.4 months after origination); Anthony Pennington-Cross & Giang Ho, *The Termination of Subprime Hybrid and Fixed Rate Mortgages* 15-17 (Federal Reserve Bank of St. Louis, Working Paper No. 2006-042A, 2006) (hybrid 2/28 ARMs have a higher probability of default at any age and the rate of default increases during the first two years, even before any payment shock); Susan E. Barnes, Patrice Jordan, Victoria Wagner & David Wyss, Standard & Poor's, Standard & Poor's Weighs in on the U.S. Subprime Mortgage Market 12 (Apr. 5, 2007), *available at* http://www2.standardandpoors.com/spf/pdf/media/TranscriptSubprime_040507.pdf (increase in early payment defaults within four months of origination); Lynne Dearborn, Mortgage Foreclosures and Predatory Practices in St. Clair County, Illinois, 1996-2000, at 23 (July 2003) (from 1996 to 2000, the proportion of foreclosure judgments attributable to ARMs increased from 11% to 30%; at the same time, the median age of the loan entering foreclosure declined from 4.1 years to 2.06 years, with default occurring three months typically before the initiation of foreclosure).

[43] Alan White, *Rate Freeze Mods—Not So Much*, Public Citizen Consumer Law and Policy Blog (Oct. 31, 2008), *available at* http://pubcit.typepad.com/clpblog/2008/10/rate-freeze-mod.html (based on research that will appear in a forthcoming paper).

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6. **Fees should be waived as part of the loan modification**. When structuring a loan modification, late fees and other fees charged pursuant to default should be waived. While late fees are being waived in various loan modification programs now, waiver should include all default servicing fees. Such fees, even more than ordinary late fees, are the product of the unsustainable loan and its resulting default. Therefore, they are obvious candidates for exclusion in developing a fair and sustainable loan modification. Moreover, as discussed above, servicers profit enormously from such fees and thus they often are quite out of proportion in comparison to the loan balance. Where fees are capitalized into the loan balance, the loan principal could increase substantially**.** Many of these fees have a questionable legal basis; often, when a homeowner is able to challenge the fees in a court proceeding, the servicer will withdraw the fees. Neither servicers nor homeowners benefit from a system that requires homeowners to challenge the legitimacy of default servicing fees in court proceedings in order to receive a sustainable and affordable loan modification.

7. **Any shared loss guarantee should favor the most-needed loan modifications**. One pitfall in any program offering guarantees for loan modifications is that if loan guarantees are provided on a uniform basis while the magnitude of concessions for loan modifications varies widely, it could incentivize more limited concessions. Accordingly, any loan modification guarantee should be based on the degree of concessions offered, with greater concessions leading to more significant guarantees. All guarantees should be provided within pre-established boundaries of affordability and sustainability to ensure that any guarantee is provided in exchange for a meaningful, sustainable loan modification. This would promote those modifications most needed by borrowers rather than favoring those that are the easiest and least risky for servicers to provide.

8. **Specificity and transparency are needed in defining net present value.** Sections 109 and 110 of EESA temper the emphasis on providing loan modifications with a requirement to consider net present value to the taxpayers. Accordingly, the government's definition of net present value, and the extent of its application, should be made available to the public. To the extent that re-default rates are being used to define net present value, they should not be based upon re-default rates for existing modifications that have not been tested for affordability. As noted above, loan modifications with higher payments are prevalent and they re-default almost half of the time.[44]

   Moreover, as part of defining net present value, it is essential to properly define the value of the proceeds from the foreclosure, compared to the value of the loan with a loan modification. This begins with the foreclosure value of the home. Historically, this has been determined using a percentage of the current market

[44] Rod Dubitsky et. al, *Subprime Loan Modifications Update*, Credit Suisse Fixed Income Research (Oct. 1, 2008) at 1-2.

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value. In this environment, however, determining current value, and then the appropriate percentage, is difficult. One approach could be to look at comparable properties and the amount they yielded at a foreclosure sale. From the foreclosure value of the home, several items would be subtracted: all amounts owed to the servicer for default servicing and other fees; all costs associated with executing the foreclosure; and all costs associated with the REO status of the property. It is this final number that should be compared to the proceeds expected from a loan that has received a loan modification. In our experience, borrowers seeking loan modifications often face huge obstacles obtaining a decent deal, even when it is clear that the net present value would be maximized by such a modification rather than by proceeding to foreclosure. This may be in part because the basis of most servicer income is a percentage of the outstanding balance owed on the loan. Thus, even when a rigorous net present value analysis would dictate a principal reduction, many servicers may be reluctant to offer a principal reduction. Care must be taken to ensure that servicers' incentives are aligned with the stated goals of EESA.

9. **It should not cost a servicer more to provide a loan modification than it does to execute a foreclosure.** As discussed above, servicers now have numerous incentives to move homeowners toward foreclosure rather than to provide loan modifications. One way to address this is to ensure that loan modifications do not cost more than foreclosures. This could be accomplished both through direct payments for loan modifications that are competitive with those for foreclosures and short sales, and by addressing how servicers recover advance payments that are made to the investors when the loan is in default and foreclosure. While such fees are recoverable early on in the context of foreclosure, when a loan modification is provided, repayment of those advances occurs over a longer period. While these issues could be addressed in new servicer legislation, they also could be included in guidelines under the TARP program.

10. **Data and reporting are essential.** Any loan modification undertaken by the federal government should gather detailed records regarding categories of loans or borrowers for which modifications are offered or not offered, and obtained or not obtained, and the types of terms associated with any loan modifications that are finalized, including the length and terms of the modifications. Studies of re-default also are crucial. Such information is not currently and freely available to the public from any source.

VI. Congress Also Must Take Further Action.

Because of systemic problems in the mortgage servicing industry, voluntary, large-scale, affordable loan modifications are an aspiration rather than a reality. While the TARP program potentially can have some real impact if used aggressively, it will provide only limited assistance if the breadth of direct assistance to homeowners is narrow or if the programs developed do not ensure affordable loan modifications. If the

loan modifications are temporary or unaffordable, the program could potentially harm homeowners and their communities.

Even if TARP, as well as Hope for Homeowners and the new GSE loan modification program, reach their maximum potential, further action must be taken aimed more directly at helping homeowners keep their homes.[45] NCLC recommends several steps that can be taken to address the still growing foreclosure crisis; these steps allow homeowners to act directly to save their homes and address various incentive issues related to loan modifications. In addition to the steps below, Congress should consider legislation to facilitate the mass restructuring of loans, to the extent that further action is needed to expand the reach of modification programs.[46]

A. Congress should allow bankruptcy courts to modify home mortgage loans just as they can do for virtually every other kind of secured and unsecured debt.
B. Congress should enact H.R. 5679 that aligns mortgage servicers' interest with those of homeowners.
C. Congress must continue the fix of the tax code, to ensure that loan modifications do not give rise to taxable income.

A. Congress Should Allow Bankruptcy Courts To Modify Home Mortgage Loans, As They Can Do For Virtually Every Other Kind of Secured and Unsecured Debt.

To help families save their homes from foreclosure, Congress must amend 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. This 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. Importantly, a foreclosure moratorium or deferment only will be effective if, in the meantime, measures such as this bankruptcy relief are passed so that homeowners will be able to obtain affordable loans as the moratorium or deferment expires.

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

[45] These recommendations only address how to limit the millions of foreclosures on the horizon. This testimony does not address the steps policymakers will need to take to prevent such a crisis from happening again.
[46] *See, e.g.,* Michael Barr & James A. Feldman, *Issue Brief: Overcoming Legal Barriers to the Bulk Sale of At-Risk Mortgages*, Center for American Progress (Apr. 22, 2008), *available at* http://www.americanprogress.org/issues/2008/04/reimc_brief.html; Robert Kuttner, *It's Time to Save the Housing Sector*, Boston Globe (January 24, 2008), available at http://www.boston.com/realestate/news/articles/2008/01/24/its_time_to_save_the_housing_sector/ (discussing the Home Owners Loan Corporation of the New Deal era).

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.[47]

Generally, section 1322(b)(2) of the Bankruptcy Code permits debtors to modify the rights of secured and unsecured creditors. Some of the ways that secured claims may be modified include altering the payment schedule, reducing the contract interest rate, or "stripping down" the amount of the claim.[48] These modifications can be applied to loans secured by cars, boats, second homes and vacation homes. However, an exception to this general rule restricts modification of "a claim secured only by a security interest in real property that is the debtor's principal residence."[49] This limitation can make it nearly impossible for debtors with unaffordable mortgage payments to save their homes from foreclosure through the bankruptcy process.[50] To bring the treatment of family homes in line with the provisions applicable to cars, boats and vacation homes we recommend the following:

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

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[47] *See* John Eggum, Katherine Porter and Tara Twomey, *Saving Homes in Bankruptcy: Housing Affordability and Loan Modification*, 2008 Utah L. Rev. __ (forthcoming September 2008).

[48] "Stripping down" or bifurcating a secured creditor's claim means to divide the claim into two parts: the secured portion, which is equal to the value of the collateral, and the unsecured portion represented by any amount owed over the value of the collateral. 11 U.S.C. § 506(a). Through this process, the secured creditor's rights in the collateral are preserved, but its rights to the debtor's property other than the collateral are limited and no greater than those of other creditors. Thus, the Code prevents the secured creditor from obtaining an unfair advantage in the bankruptcy case over the unsecured creditors out of proportion to the true value of its security interest.

[49] 11 U.S.C. § 1322(b)(2); *Nobleman v. Am. Sav. Bank*, 508 U.S. 324, 332, 113 S. Ct. 2106 (1993).

[50] In order to retain a home in bankruptcy, the Code generally requires debtors to make ongoing monthly mortgage payments as well as additional monthly payments to make up any arrearage on the mortgage loan.

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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 reamoritized based on the modified terms and paid over a period beyond the plan term, generally up to thirty years.

B. Congress Should Enact H.R. 5679 To Align Mortgage Servicers' Interests With Those of Homeowners.

Congresswoman Waters has introduced a bill that recognizes the shortcomings of the mortgage servicing industry and that would align mortgage servicer interests with those of homeowners trying to save their homes. Passage of this measure would serve to reform mortgage servicing practices as we move ahead and would ensure that servicers to provide reasonable loss mitigation prior to foreclosure.

Getting to Affordable Loan Modifications Takes Work. Creating affordable and sustainable loan modifications for distressed borrowers is labor intensive. It is no surprise, then, that servicers continue to push borrowers into less costly repayment plans and short-term modifications. H.R. 5679 would align mortgage servicer incentives with those of the homeowner seeking to prevent a foreclosure. Section 2(a) of the bill creates a duty to provide reasonable loss mitigation prior to any foreclosure and prioritizes "home-saving" loss mitigation options over those that result in loss of the home. Any loss mitigation must be based on an affordability analysis that considers the borrowers debt to income ratio and residual income—to ensure enough actual dollars for non-housing expenses—as well inclusion of the borrower's full debt profile, including junior liens on the property.

Mandating Borrower Access to a Decision Maker. From the homeowner's perspective one of the biggest obstacles to loan modification is finding a live person who can provide reliable information about the loan account and who has authority to make loan modification decisions. H.R. 5679, section 2(a) requires mortgage servicers to provide borrowers with contract information for a real person "with the information and authority to answer questions and fully resolve issues related to loss mitigation activities for the loan."

Requiring Information and Dispute Resolution Prior to Foreclosure. While the Real Estate Settlement Procedures Act currently requires servicers to respond to borrowers' request for information and disputes within 60 days, in practice many such inquires go unanswered. Despite this failure to respond, servicers are still permitted to proceed to collection activities, including foreclosure. H.R. 5679 ensures that borrowers facing foreclosure are no longer at the mercy of their servicer. Section 2(c) provides transparency to the servicing process by allowing the homeowner to obtain key information about the loan and its servicing history. The section also prohibits servicers from initiating or continuing a foreclosure proceeding during the period in which and outstanding request for information or dispute is pending.

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Curbing Opportunities for Abuse. Loan modification or forbearance agreements often contain a waiver of claims provision that purports to release the servicer and holder from any past or future claims that the borrower may have. Broad release language potentially cuts off all claims the borrower may have related to the origination or servicing of the loan and is inappropriate in the context of a loan modification or forbearance agreement. H.R. 5679, Section 2(a) nips this pernicious practice in the bud by banning such waiver of rights in loan modification or forbearance agreements. The section also prohibits the equally abusive practice of forcing borrowers to arbitrate any disputes with the lender or servicer.

C. Loan modifications should not give rise to taxable income.

Loan modifications can create adverse and unexpected tax surprises for homeowners. Principal reductions, or, in some cases, significant interest rate reductions, can lead to imputed taxable income to the homeowner. This is often the case even if, as is the case under Hope for Homeowners, the homeowner may have a future obligation to repay some of the forgiven debt. Loan modifications when the homeowner is near default should not give rise to taxable income and should be excluded both from taxable income and from all reporting requirements.

The Mortgage Debt Forgiveness Relief Act of 2007[51] did not, contrary to popular belief, protect homeowners from tax consequences in all loan modifications. A majority of the subprime loans are home equity loans, for refinance purposes, and not to purchase the home.[52] The Act only applies to the amount of purchase money debt forgiven. While, under the Act, refinanced purchase money mortgage debt may be eligible for exclusion from taxable income, this only applies to the amount of principal refinanced, not any of the fees and costs associated with the refinancing. Few homeowners are likely . to have the documentation years later of their principal balance immediately before the refinancing. Moreover, before any refinanced forgiven debt is exempted from taxable income under the Act, all other debt consolidated with the purchase money mortgage, whether for routine home repairs, medical expenses, or student loans, and all fees, must first be forgiven. Nor does all purchase money debt forgiven come in for exclusion—it must be forgiven either because of the homeowner's financial status or a decline in the property value. While this covers many situations, it does not cover the all too common situation where the home was initially overappraised or cases where the house is underwater due to a negative amortization feature on the loan rather than a market decline.

Even for homeowners whose discharged debt fits into the narrow coverage of the Act, the Act's relief is chimerical. The Act does not excuse homeowners from filing a

[51] Pub. L. No. 110-142.
[52] Souphala Chomsisengphet & Anthony Pennington-Cross, *The Evolution of the Subprime Mortgage Market*, 88 Fed. Res. Bank of St. Louis Rev. 31, 41-43, (2006); Ctr. for Responsible Lending, Subprime Lending: A Net Drain on Homeownership 5 (CRL Issue Paper No. 14, Mar. 27, 2007), *available at* http://www.responsiblelending.org/pdfs/Net-Losership-3-26.pdf (in 2006, even at the height of the subprime market, only 44% of all subprime lending was for purchase money mortgages).

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special form, Form 982, with the IRS in order to exclude the discharged debt. The IRS estimates that it will take most homeowners upwards of 10 hours to complete Form 982, including record keeping and learning about the law. Despite recent revisions to the form, it remains cumbersome and unfamiliar to most homeowners. The IRS forbids its free tax preparation sites, the Tax Assistance Centers, Volunteer Income Tax Assistance sites, and Tax Counseling for the Elderly sites, from assisting with discharge of indebtedness issues.[53] Thus, for many homeowners the reporting requirement is a nearly impossible hurdle to clear even if they are eligible to exclude forgiven debt under the Act.

VI. Conclusion

Thank you for the opportunity to testify before the Committee today. The foreclosure crisis is continuing to swell and the need to act is great. A strong loan modification program under TARP is essential, as is passage of legislation to allow for loan modifications in bankruptcy, to reform the servicing industry, and to address the tax consequences of loan modifications. Together, these measures will save many homes and stabilize the market. We look forward to working with you to address the economic challenges that face our nation today.

[53] 2007 Nat'l. Taxpayer Advocate Ann. Rep. 28.