MORTGAGE BANKERS ASSOCIATION®
Investing in communities

Senate Judiciary Committee
Hearing on
"Helping Families Save Their Homes, the Role of Bankruptcy Law"
November 19, 2008

Questions submitted by the Committee to David Kittle

1. Regarding my proposal to permit modification of mortgages on primary residences in bankruptcy court you testified: "If this legislation goes through, we will be putting a permanent tax on everybody that buys a house going forward of $295 a month, over $3,000 a year."

Please provide the data you have used to derive the figures you used in your claim.

Primary residence mortgage bankruptcy cramdown legislation as drafted today will change how lenders price for risk. Lenders price for risk based on the credit worthiness of the borrowers which is based on the idea that a borrower's past credit performance is the best indicator of future performance. Servicers also require appraisals to estimate the current value of the property relative to the loan size as a means to ensure that the collateral is a sufficient pledge for the loans. The future value of the property is not easily factored into the origination equation because lenders are ill equipped to estimate future real estate values, although GSEs have from time to time imposed declining market fees.

Under this proposed legislation, lenders will have to take potential changes in property values into account as a primary consideration in the lending process. Moreover, given that S.2136 renders mortgage insurance ineffective to offset principal losses due to cramdown, various parties financing or investing in the loan will have to price in default risk, recognizing the loss of credit enhancements. We believe the most immediately impacted markets will be those dependent on government loan programs and GSE loan programs. Government programs continue to operate reasonably well despite a relative freeze of credit in the private markets. This is due mostly to the presence of mortgage insurance and guarantees on these programs. Because mortgage insurance or guarantees effectively will be void in a lien strip, these programs lose their liquidity as few servicers will accept the risk of tens- or even hundreds-of-thousands of dollars of principal loss in exchange for a nominal 19 – 44 basis point servicing fee (i.e., $190 - $440 annual fee to service $100,000 loan). We fear that without a significant change to the bankruptcy legislation, the remaining liquid markets will dry up.

Also impacted by S.2136 are markets that have been served only by private banking and investing. These are loans to borrowers who have traditionally failed to meet the loan, credit or collateral standards of government or GSE programs. These programs are currently severely impacted by the lack of investor take outs. Few investors are willing to purchase non-government mortgage-backed securities of any quality due to a lack of confidence, performance and first dollar loss protection (such as mortgage insurance). Lending to poor credit borrowers is non-existent, while credit to high quality jumbo borrowers is effectively reduced to each lender's portfolio capacity. With capital and accounting restraints and severity of losses on loans in general, this capacity is severely reduced. Portfolio lenders are, therefore, inclined to lend only to the most creditworthy borrowers. With the addition of cramdown risk, lenders will further restrict their lending according to loan type, geography and property type. Most impacted in the private banking/label environment are properties subject to the greatest decline in property values, such as new subdivisions, inner city areas, rural areas, and regions with steady declines in population and employment. These borrowers will have limited access to credit and will be subject to higher rates, more fees at closing, restrictions in underwriting and, perhaps most importantly, subject to increased downpayment requirements to offset the risk of loss. To the extent the mortgage market can be competitive, different lenders will respond differently, and the degree to which rates and costs change will vary from market to market and by property type.

We expect that, taking into account all of the increased costs borrowers will face and capitalizing those costs into the rate alone (i.e., assuming continuation of zero or low downpayments), borrowers will be forced to pay approximately 1.5 percent more for their loan than if cramdown legislation were not passed. For some borrowers, this may be a low estimate; for others this may be high. But an additional 1.5 percent is on the low range of our estimates. The actual average will depend, for example, on how many new mortgages are financed without very large downpayments.

If one were to assume a 30-year fixed-rate mortgage for $300,000 at a 6 percent interest rate, and rates were to increase by 1.5 percent to 7.5 percent, the principal and interest payment for that loan would increase by $298.99. The increase attributable to cramdown would fluctuate with the loan amount.[1]

Our analysis is based on the fact that the mortgage market prices for risk. Cramdown legislation would introduce significant new risks for lenders, servicers and securitizers of

[1] Rates have declined in recent weeks. If one were to take the average loan size in November 2008 (according to the MBA Survey of Mortgage Applications) of $229,400 and apply a common interest rate in today's market, 5.54 percent, the principal and interest payment would be $1,308.27. If the interest rate were to increase to 7.04 percent, the new principal and interest payment would be $1532.37, a difference of $224.10 per month. A $300,000 mortgage at 6 percent is an example we have been using since debate on this issue began, as the numbers are easier to quickly understand and remember. The principal and interest payment on that loan would be $1,798.85. If that same borrower were then forced to pay an additional 1.5 percent on his rate, the payment would be 2,097.64.

primary residence mortgages. Higher default incidence rates, higher loss severity rates, higher administrative costs, increased political risk and increased market uncertainty combine to increase costs for consumers. To avoid or offset these risks, entities would alternatively, and most likely, increase the cost of a new mortgage through larger downpayments, tighten credit standards, if such loans are made at all in declining or volatile markets such as rural, urban and new property development areas.

The following are our underlying assumptions and a further explanation of the increased market costs of passing this bankruptcy legislation.

> *Higher default incidence rates would increase mortgage rates by 70-85 basis points.*

If cramdown legislation is approved, default rates would increase for two reasons. First, more mortgages would be drawn into consumer bankruptcy filings. The result would be that defaults would increase by the number of people who previously would default on everything except their mortgage. In addition, bankruptcy filings would increase due to the asymmetrical nature of the filing. Giving people the option to write-down their mortgage when values are at their lowest point, without the option of lenders recovering the lost principal when values go up, will increase bankruptcy filings, particularly if the debtor expects to sell the house in a few years. This option of wiping out part of the loan while keeping the house and its future appreciation would make bankruptcy more attractive and could subsequently drive up the number of defaults. These higher default rates would result in a 70-85 basis points increase in mortgage rates.

> *Higher severity rates would increase the cost of a mortgage by 20-25 basis points.*

Enactment of the current cramdown proposal would increase loss severity. Because mortgage insurance claims are in effect void in the event of bankruptcy cramdown, the loss associated with a cramdown is far greater than the loss associated with a foreclosure. For example, FHA offers 100% insurance for the risk of principal loss as a result of foreclosure. Conversely, if the loan is subject to the same principal loss through cramdown, the lender (servicer) receives no insurance benefits. The servicer must absorb the entire principal loss. Servicers are not equipped to accept this level of principal loss (as shown above servicers are not compensated to have the liquidity to absorb this loss) and we fear cramdown severity (and frequency) could increase the risk of defaults on Ginnie Mae mortgage backed securities obligations. Such defaults have a ripple effect, but most notably result in Ginnie Mae having to take over the financial responsibility of the servicer and thus the principal cram down risk. A Ginnie Mae MBS default also triggers defaults on all other securities, including Fannie Mae and Freddie Mac MBS. These entities may be forced to take over servicing of these obligations as well.

Even if these product types were carved out of the bankruptcy proposals, lenders and investors are likely to incur greater losses due to an intervening bankruptcy. Lenders would be required to accept reduced payments as a result of the bankruptcy cramdown. If, however, the borrower fails to pay according to the plan, the lender reverts to the original terms of the mortgage and the deferred principal and interest payments become due and payable. Unfortunately, these amounts accrue but rarely get paid back. Approximately 2/3 of all Chapter 13 plans fail and these loans progress to foreclosure with larger principal balances and accrued interest than without an intervening bankruptcy. Moreover, a delay in foreclosure could cause the lender to sell the REO in worsened market conditions than were present at the time of filing. Given that the borrower will be in the house for a longer period with little incentive to do maintenance or improvements, it is likely that repair costs will be much higher.

Bankruptcy administrative costs would add 10 basis points to mortgage rates.

When dealing with foreclosures, lenders face high administrative costs, which are not always recoverable from private mortgage insurers. In addition to the foreclosure costs, cramdown would force lenders to take on the additional cost of protecting their legal interests in the event of a bankruptcy filing. For example, lenders would have to order separate appraisals to defend against appraisals ordered by the bankruptcy judge or other claimants and hire attorneys. Such costs could run into thousands of dollars for one loan, but would vary as a percentage of the loan amount. In order to cover these new administrative costs, lenders would have to add an average of 10 basis points to individual mortgages.

Market uncertainty and increased political risk would result in an additional 50-60 basis points.

Market uncertainty over new default and severity rates would drive up interest rates until the market is reasonably comfortable with the incidence rates associated with the new legal regime. Mortgage interest rates would increase considerably for several years until investors have some comfort in the new overall loss rates. Rates might then narrow somewhat but would still remain above traditional levels. In the short-term, the market would overprice this risk. At a time when the real estate finance industry and mortgage rates are already under stress, this would be especially difficult on borrowers and mortgage originators.

Additionally, a change to the bankruptcy laws would increase political risk and further alienate international investors. The U.S. has always been a safe haven for international investment because contracts are honored and are free from political influence. It would take the markets years to reverse the effects of Congress stepping in to alter financial contracts ex post for perceived short-term benefits. Not only would it have an effect on the appetite for mortgage paper, it would raise the question of what other steps Congress might take and would add a political risk premium to all U.S. debt.

In order to protect against an increase in political risk and market uncertainty, international and domestic investors would likely demand an additional risk premium that would add an additional 50-60 basis points to each mortgage.

Using the low end of the range from these factors, we arrive at 150 basis points (assuming zero or low downpayment requirements). The number is an approximation, as there is no market parallel from which we can make exact comparisons. Cramdowns on non-primary residences are not fair comparisons because such debt if modified must be repaid in it entirety within 3-5 years. This drastically limits frequency and severity of cramdowns to almost zero. Legislation proposed to date on primary residences removes this critical creditor protection thus allowing more borrowers to qualify and thus greater loss frequency and severity from cramdown. Many of our member companies' risk officers, credit specialists, economists and production experts believe this number is too conservative. Others believe that our number is too large. Again, the actual number will be a function of property type and downpayment. We believe that the range we have presented is based on today's market and supportable assumptions about how the market will respond.

2. Over the past 15 months since I introduced the Helping Families Save Their Homes in Bankruptcy Act, the Mortgage Bankers Association has claimed at various times that the change would lead to a mortgage rate increase for all borrowers equal to 200 or 150 basis points.

(a) What is your current position regarding the impact my legislation would have on mortgage rates?

The Mortgage Bankers Association estimates there would be an increase in cost in the range of 150-200 basis points to borrowers if S. 2136, the "Helping Families Save their Homes in Bankruptcy Act of 2008," is enacted.

As you are aware, the costs of a mortgage are determined by a number of factors, including a borrower's credit profile, their payment history on other debts, employment status. A borrower's mortgage rate is also influenced by the amount of funds available for a downpayment, market conditions and any points or fees they may pay to buy-down that rate.

Enactment of S. 2136 could result, for example, in an increase in downpayment requirements and smaller increases in interest rates, similar to the case in today's market for second homes and investment properties. Some riskier borrowers who in today's market depend on mortgage insurance (either public or private), may not have access to mortgage credit at all, if insurance is not available for the amount of the cramdown. In particular, FHA and VA programs were created by Congress to encourage lending for those borrowers who do not have the financial means to provide a larger downpayment. These programs do not protect lenders against a cramdown (also known as a lien-strip). These factors create uncertainties and risks that lenders will pass on to borrowers in the form of higher costs.

MBA is not alone in its analysis that cramdown will increase the cost of mortgages. Following the December 5, 2007, hearing on S. 2136, Professor Joseph Mason was asked: "*Do you have any statistical evidence to support your claim that higher interest rates would result from bankruptcy code changes?*" Professor Mason's response was:

> The increased cost of providing credit to affected consumers can result in a variety of outcomes, none of which are favorable to the consumer. Lenders may respond by increasing interest rates or collateral levels (that is requiring higher downpayments) or they may just choose instead to ration credit, that is, avoid lending to borrowers that may qualify under S. 2133 or S. 2136, as enacted. While it is not clear which combination of responses will occur, *a priori*, from a financial economic perspective it would be foolish to expect the effect to be benign[2].

The Chief Economist of Fiserv Lending Solutions, the company that produces the Case-Shiller Home Price Index, David Stiff, determined that:

> During market downturns, home prices fall the least in the most desirable areas of a metropolitan region. As housing affordability improves, homebuyers who were previously priced out of their preferred towns and neighborhoods will be able to purchase properties in these areas. So, even as overall sales volume drops, relatively stronger demand for housing will limit price declines in neighborhoods with shorter work commutes, better schools, and easier access to parks, recreation, and retail centers…[T]his shift in preferences will mean that prices for homes in outlying neighborhoods will continue their more rapid decline and will be slower to rebound when housing markets finally start to recover.[3]

Should cramdown legislation pass, lenders would need to examine a number of new factors in their underwriting analysis. No longer would they simply have to assess whether the borrower will be able to repay the loan, they will have to assess the future price of the home. If an assessment is made that the price of the home could go down, the lender will be unlikely to make a loan for more than the possible future value of the property. Lenders will be unwilling to originate loans with little to no money down without mortgage insurance or guarantees. Government lending, GSE programs and

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[2] The Looming Foreclosure Crisis: Hearing Before the Senate Committee on the Judiciary, 110th Congress (2007) (statement of Joseph R. Mason, Associate Professor, Drexel University). Accessed at http://judiciary.senate.gov/hearings/testimony.cfm?id=3046&witlid=6812 .

[3] "Housing Bubbles Collapse Inward," (2008) David Stiff, Chief Economist, Fiserv Lending Solutions. Accessed at http://www2.standardandpoors.com/spf/pdf/index/052708_Housing_bubbles_collapse.pdf .

areas that experience the greatest fluctuation in home values – rural areas, inner cities and new developments -- would be impacted most. Lenders would be forced to offset this risk by increasing the loan's cost and/or requiring higher downpayments.

(b) Can you provide a detailed justification for your past and current positions?

MBA's position has been consistent throughout the debate. MBA has consistently said that the costs of a loan will increase by 150 to 200 basis points. That estimate represents all of the possible costs (higher downpayments, higher rates, higher fees, etc.) capitalized into the rate alone.

Bankruptcy is enshrined in the Constitution to help borrowers and lenders work together through a disinterested third party (the judge) to clear the record for someone who can no longer meet his or her obligations. When Congress specifically exempted primary residence mortgages from the bankruptcy estate, they did so to keep the cost of credit as low as possible. Adding bankruptcy risk into the risk equation for home lending will result in higher costs. At his June 17, 1999, confirmation hearing, Treasury Secretary Nominee Lawrence H. Summers, was asked, "[*w]ould you agree that debt discharged in bankruptcy results in higher prices for goods and services as businesses have to offset losses?*" Mr. Summers responded:

> I think the answer is -- it's a complicated question, but certainly there's a strong tendency in that direction and also towards higher interest rates for other borrowers who are going to pay back their debts.[4]

In addition, the impact that the Chapter 12 bankruptcy laws had on family farms is clear. A United States Department of Agriculture (USDA) study found that a change in the treatment of family farms led to an increase in costs:

> Lenders have adopted tiered interest rate structures and increased the interest rate spread to riskier borrowers partially in response to Chapter 12.[5]

S. 2136 would have the same impact on primary residence mortgages – an increase in costs. The bill would permit a judge to reduce the loan principal to the current market value of the home, lower interest rates and lengthen the payment term. In order for a loan to be subject to a cramdown (lien-strip), the value of the home must be less than the outstanding balance of the mortgage contract. To protect against future home

[4] NOMINATION OF LAWRENCE SUMMERS TO BE TREASURY SECRETARY: Hearing Before the Senate Committee on Finance, 106th Congress (June 17, 1999).

[5] "Do Farmers Need a Separate Chapter in the Bankruptcy Code?," Jerome Stam (October 1997) United States Department of Agriculture, Economic Research Service.

depreciation, lenders would require larger downpayments. With this larger equity stake, the home would not be subject to a cramdown until the home value dropped below what percentage the borrower initially put down.

Downpayments are one of the biggest obstacles to home ownership. In today's market, the only low-downpayment options available to many borrowers are through FHA insurance and VA guarantee programs. These credit enhancements provide lenders with the insurance protection should the borrower default on the loan. Congress created these programs to encourage the lending community to provide affordable credit to first-time and low-income borrowers and, in return, the federal government provides insurance should the borrower default. These programs do not cover the lender's losses from a lien-strip (cramdown), and S. 2136 would remove the key incentive for using the FHA and VA programs.

The same is true for private mortgage insurance (PMI). This is a similar private market protection that lenders and the GSE's require for loans without a 20 percent downpayment. PMI, FHA and VA programs only provide lenders/investors with protection from default, therefore lenders would not recover their losses from a lien strip. Without the protection from PMI, FHA or VA programs, lenders would be less willing to make low-downpayment loans. Congress specifically created FHA and VA programs to encourage the mortgage industry to provide affordable options to homeownership. The same programs that Congress created to promote home ownership, would no longer provide the incentive or protection should bankruptcy cramdown legislation pass.

(c) Is there mortgage interest rate data (for primary residences and, separately, for investor properties) from before and after the implementation of the 1978 bankruptcy code that validates your claim?

(d) Is there default rate data (for primary residences and, separately, for investor properties) from before and after the implementation of the 1978 bankruptcy code that validates your claim?

The data requested in Question 2(c)(interest rate) and (d)(default rate) related to investor properties have not historically been compiled and recorded by MBA. After an exhaustive search of MBA files, Federal Reserve databases and a number of other sources, we were unable to find interest rate or default rate data regarding investor properties dating before and/or after the 1978 Bankruptcy Code. Additionally, default rate data on primary residences has not been recorded or maintained prior or subsequent to 1978 and is therefore not available. While there are interest rate data on primary residences for the time period requested, the 1978 changes to the Bankruptcy Code did not impact primary residences (their treatment was not altered under the statute).

As a market participant in 1978, however, I can assure you that my experience in dealing with first and second properties was that there were no differences. The increased costs of obtaining a mortgage for a second property occurred on enactment of the 1978 Bankruptcy Code.

3. You testified that "From July 2007 to September 2008, the mortgage industry has helped an estimated 2.47 million borrowers avoid foreclosure through repayment plans and loan modifications."

(a) How many of those homeowners have had their mortgage principal reduced?

(b) How many of those homeowners ended up with a modification or repayment plan that simply reallocates debt to the back of the loan?

As of the date of submission of these answers, these more specific and detailed numbers have not been compiled by the HOPE NOW Alliance. MBA remains in constant contact with leadership of the HOPE NOW Alliance and has been informed they are currently in the process of collecting data for a significant number of new fields. We expect this more comprehensive data to be available in the coming months. The industry continues to improve its data collection in these areas and is working on more specific loan level information. As soon as MBA is apprised of this and more specific data, MBA will ensure it is transmitted to you.

4. If the law is changed to permit modifications of mortgages on primary residences in bankruptcy court:

(a) Do you believe that this would provide incentive for your member banks to negotiate voluntary workouts for troubled homeowners out-of-court, rather than go through the time and expense of bankruptcy proceedings?

We do not believe that cramdown will provide further incentive to negotiate voluntary workouts. Servicers would be unable to compete with the benefits of proposed cramdown legislation. Today, servicers reach affordability through interest rate reduction, extensions of maturity dates and deferral of principal. These options simply cannot compete with the lure of a principal write down. Despite the fact that interest rate reductions can have a greater impact on reducing monthly payments than a substantial principal write down, the bankruptcy legislation forces lenders and investors into the most damaging resolution – a principal write down. The option is punitive in nature especially combined with the removal of all creditor protection offered on other debts in Chapter 13. Because borrowers will seek out bankruptcy over loss mitigation, we anticipate loss mitigation requests will slow down substantially and servicing personnel will be necessarily transferred to bankruptcy administration.

Also, cramdown could encourage lenders to move toward foreclosure more quickly, to avoid the possibility that a borrower's financial condition will deteriorate further to the point of bankruptcy.

MBA member banks and servicers measure success through their efforts to avoid foreclosure and by helping borrowers remain current on their mortgage. Servicers have no incentive to foreclose, because they incur a financial loss on each foreclosure. In the case of an FHA loan, the servicer would lose anywhere from $2500 to $4000 in attorney fees alone during a foreclosure. They also would not get the full reimbursement of interest advances to the bond holders. In addition, servicers have added incentives to provide loss mitigation efforts under FHA, VA and GSE loans. They are paid a fee for performing loss mitigation, because it is recognized as labor and cost intensive. Current incentives are aligned to provide assistance to borrowers who can afford reasonable mortgage payments. Companies maintain their profitability by collecting payments. In the case of a foreclosure, lenders not only lose money on attorney's fees, but they must also pay real estate taxes and upkeep of the foreclosed home until it is sold. Most importantly, they lose the economic value of the loan.

In cases where a borrower's financial situation has deteriorated to a point where they cannot afford a reasonable mortgage payment, foreclosure becomes inevitable. Reasons for this continue to be the economy, job loss, death in the family, divorce or taking on additional debt.

The industry has been engaged in unprecedented efforts to assist distressed homeowners, and we believe these have proven successful in stemming foreclosures. We agree more programs can be implemented to provide additional loan modification assistance, however bankruptcy cramdown is not such a program.

It is worth noting the efforts industry has been engaged in to date:

- Servicers have assisted a record number of borrowers through various loss mitigation efforts. From July 2007 to September 2008, an estimated 2.47 million repayment plans and modifications have been executed. Foreclosure sales for the same period were approximately 1 million, resulting in a 71 percent workout-to-foreclosure ratio.

- The Federal Housing Finance Agency and the HOPE NOW Alliance announced a major streamlined loan modification program for GSE and financial institutions' portfolio loans to get struggling homeowners affordable mortgage payments.

- Investors and mortgage insurers are introducing a greater number of helpful options including Fannie Mae's HomeSaver Advance, which allows the borrower to cure a delinquency by placing the arrearage in a subordinate loan that carries no interest or a low interest rate. Mortgage insurers and FHA also have similar programs.

- HOPE NOW in concert with NeighborWorks and the Homeownership Preservation Foundation have assisted in promoting the HOPE™ Hotline, a national counseling network which is available 24 hours a day, 7 days a week, and 365 days a year. The Homeowner's HOPE™ Hotline receives an average of more than 6,000 calls a day. There is no cost to homeowners for contacting a nonprofit counselor.

- Servicers and many of their investor partners are paying for borrowers to have one-on-one counseling sessions with HUD-approved counselors.

- Servicers implemented the American Securitization Forum's (ASF) Streamlined Foreclosure and Loss Avoidance Framework for Securitized Adjustable Rate Mortgages which provides systematic criteria that servicers can use to streamline the evaluation of borrowers in subprime hybrid ARMs in private label mortgage backed securities facing interest rate resets. Approximately 111,000 subprime ARMs have been modified with over 73 percent of these modifications having duration of five years or longer.[6]

- Participants in the HOPE NOW Alliance announced Project Lifeline, which is a targeted outreach to seriously delinquent homeowners (90 days or more late) who are currently facing the greatest risk of losing their home. Servicers under this program have agreed to "pause" foreclosure for 30 days while loan modification packages are evaluated.

(b) Once bankruptcy judges establish a template for how to sensibly modify mortgages, do you expect that servicers would follow that template to craft voluntary workouts out-of-court?

The mortgage industry continues to work diligently with borrowers, the Treasury Department, the Federal Reserve and a number of consumer groups to help borrowers stay in their homes. During the past year, there have been a number of successful streamlined modification proposals that have been and are currently being used. Federal Deposit Insurance Corporation Chairman Sheila Bair has used a template to modify loans currently held my IndyMac Federal Bank and the industry continues to examine her approach in their efforts. The government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, have updated their templates and process for assisting troubled borrowers. We welcome any and all assistance in determining the best way possible to help keep families in their homes. Should the judges devise a workable system, we would, of course, work with our servicer members to implement it.

[6] HOPE NOW Alliance Data Release, October 27, 2008.

5. In your testimony, you predict that if my proposed change is made to the bankruptcy law, bankruptcy filings will overwhelm courts.

The President of the National Conference of Bankruptcy Judges has submitted a letter for the record that states:

> **In my personal opinion, which I am confident is shared by nearly all of my 338 colleagues, if Congress determines to allow modification of home mortgages, the bankruptcy courts would be able to implement that policy efficiently, and, in contrast to other proposals for dealing with this issue, without imposing new costs, without requiring a new structure and without incurring any delay in implementation… we would not anticipate an unworkable volume of new activity in our courts as a result of the mortgage modification provisions.**

Do you agree?

We do not agree, particularly in the short term, and would suggest that there is little consensus on this point. For example, at a Senate Committee on the Judiciary hearing held on December 5, 2007[7], when asked a similar question, U.S. Bankruptcy Judge Thomas Bennett indicated that "on the volume in the short term it would be difficult," though in the longer-term the courts would eventually be able to handle the caseload.

The letter you reference goes on to indicate that "we would not anticipate an unworkable volume of new activity in our courts as a result of the mortgage modification provisions." However, in a February 5, 2008 Congressional Budget Office report[8] discussing the budget impact of cramdown legislation, the proposal would "result in a 4 percent to 5 percent increase in annual filings over the number expected under current law," suggesting filings would increase by 15,000 per year.[9] Others have said that this legislation would help 600,000 borrowers, which would represent a 75% increase in Chapter 13 filings. We believe both estimates are understated. We are attempting to quantify this numbers and would appreciate sharing it with you; however, we note above that borrowers are likely to favor bankruptcy over lender offered workouts. Given that 25% of the 72 million loans outstanding are underwater (loan exceeding the current fair

[7] Senate Judiciary Hearing on "The Looming Foreclosure Crisis: How to Help Families Save Their Homes," December 5, 2007.

[8] Congressional Budget Office Report, February 5, 2008.

[9] The most recent report for the U.S. Courts reports that "Chapter 13 filings rose 14 percent, from 310,802 in FY 2007 to 353,828 in FY 2008." http://www.uscourts.gov/Press_Releases/2008/BankruptcyFilingsDec2008.cfm

market value of the property) and protections against abuse of creditors are removed, estimates stated above deserve additional scrutiny.

Regardless of how many new bankruptcy cases would occur at a national level, it is certain that the caseload would not be distributed evenly. Given that mortgage delinquencies are highest in such states as California, Florida and Nevada, it could reasonably be expected that some courts would be overwhelmed while others would see little new activity.

Yet another issue deals with the experience level of judges in this particular field. During the December 2007 hearing, Judge Bennett responded to a question about the proposed legislation "putting a lot of police pressures on bankruptcy judges to make decisions that that's not their training or their normal requirement." His response included the following:

> "….Lawyers and judges are not professionals in these areas. What we are, are professionals at arguing positions for our clients and resolving positions. The function of the legal system is not necessarily solely to get it right—hopefully we do most of the time— but is to bring finality to an issue. From that point of view, our training is not in other things. I would suggest that if you look at the car issues and the real market rates that would be paid out on these, that the cram-downs on cars are effectively well below market rates of comparable credit risk. That same thing will happen in the context of mortgages, which means that the risk of loss for those that hold a residual portion of the cram-down mortgage will be under-paid and will be a further diminution of the value, if that answers your question."

The Honorable Jacqueline P. Cox, a Bankruptcy Judge for the U.S. Bankruptcy Court for the Northern District of Illinois offered an additional comment responding to a question for the record from the same hearing: "Do you typically order appraisals on your own to assess the value of a property? Or, do you typically review the two competing appraisals that the lender and borrower have already ordered to judge the value of the property?"

> "I have never ordered an appraisal of real estate in a Chapter 13 matter and the debtors and lenders generally do not submit appraisals of the value of the homes that secure mortgage debt. On occasion, the Chapter 13 Trustee suspects that there is equity sufficient to require the debtor to increase the percentage by which unsecured debt is to be repaid. The debtor will then be required to present a report of comparables, the selling price of similar homes in the area. The websites of Zillow.com, Housevalues.com and Domania.com provide much of the information free of charge. Realtors testify to value based in large part on this data for nominal fees, or without charge in anticipation of securing the listing to sell the home. This issue is rarely contested because strip down of a mortgage

> debt is not now permitted, as lenders are entitled to full payment of the mortgage obligation without regard to the value of the home"

Some may point to Chapter 13 treatment of second or vacation property as an area that has given Courts experience that would be required to implement primary residence cramdown. Judge Cox, responding to another question said the following:

> "You ask if cram down is rarely permitted on second homes and vacation home … cram down rarely occurs on second homes or vacation homes because few debtors have two homes… Where debtors have multiple properties, they generally sell them. I require that the sale proceeds be given directly to the Chapter 13 Trustee at closing and that they be applied to the debtor's Chapter 13 plan obligations."

While current law permits second property cramdown, because it is not essential, bankruptcy judges often require the sale of the property or the borrower would sell it before he or she even enters bankruptcy. Moreover, few borrowers in bankruptcy can afford to pay off non-primary residential loans in 3-5 years. As a result, those assets are lifted from the stay and proceed to foreclosure. Therefore, the courts have little experience or expertise in evaluating properties and dealing with the 600,000 or more borrowers that proponents of cramdown legislation claim. Becoming expert enough to handle these new responsibilities and dealing with the valuation disputes that will ensue will require additional administrative resources for the courts.

6. You claim in your testimony that if the rules regarding mortgages in bankruptcy are loosened, it will increase the cost of credit.

(a) When the bankruptcy code was <u>tightened</u> in 2005, did that directly produce <u>lower</u> costs of credit for borrowers?

The 2005 changes to the Bankruptcy Code did not change the previous modification treatment of primary residences. As such, there would not have been a corresponding change, in either direction, for interest rates on primary residence mortgages.

(b) Can you demonstrate that changes to the costs of credit are directly attributable to changes in bankruptcy law, or is it possible that other factors in the financial markets play a much more determinative role?

The market for primary residence mortgages is very different from how it looked when this debate began. In today's market, subprime lending has been virtually eliminated. In addition, virtually all loans today have some sort of government backing, whether through Fannie Mae or Freddie Mac, currently being overseen through federal conservatorship, or through the FHA and VA. The "private label" mortgage market has seized up and as a result, mortgage rates have not behaved as would have been predicted previously.

Many different factors play a role in the cost of credit. There are two major drivers for pricing: the cost of capital and risk. Cramdown legislation would introduce significant new risks for lenders, servicers and securitizers of primary residence mortgages. Higher default incidence rates, higher loss severity rates, administrative costs, increased political risk and additional market uncertainty represent new risks and those risks will be passed on to consumers in the form of higher mortgage costs, including larger down payments, higher rates and other fees, tighter credit standards and possibly the loss of credit opportunities in declining or volatile markets.

(c) How do you explain the lack of a mortgage rate differential between single-family and two-family owner-occupied properties, despite the difference in bankruptcy modification risk?

Mortgage costs come in different forms, such as interest rate, points/fees and downpayment. There is a significant cost difference to the borrower between a single-family and two-family owner-occupied property. The loan-to-value (LTV) minimum requirements for Freddie Mac conforming mortgage purchases effective January 2, 2009 are illustrative (http://www.freddiemac.com/sell/factsheets/ltv_tltv_200901.html detail of which is transposed below).

A borrower could receive a mortgage on a single-family owner-occupied property that would be purchased by Freddie Mac, with a 5 percent downpayment, or a 95 percent loan-to-value (LTV). If that same borrower were to purchase a 2-unit owner-occupied property, he or she would be required to make a minimum 20 percent downpayment (80 percent LTV). That is a significant cost difference to the borrower. On a $200,000 loan, in the case of a single-family property, the borrower would only need to have $10,000 for the downpayment. In the 2-unit scenario, the borrower would need a downpayment of $40,000 to purchase the property.

By examining the entire cost of the mortgage, and not just the interest rate, it is clear that there is a significant increase in cost to the borrower. A number of borrowers would be completely priced out of the ability to afford a home if downpayment requirements were to increase to 20 percent.

In addition, the risk from a bankruptcy lien-strip is greatly reduced by having the 20 percent downpayment requirement. With 20 percent down, should the owner file for bankruptcy, the home value would need to decline 21 percent before a bankruptcy judge would have the ability to cramdown the mortgage. By requiring 20 percent down, lenders would be protecting themselves from the possibility of cramdown.

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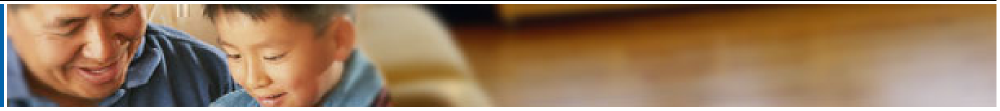

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- Service Loans
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MULTIFAMILY

DEBT SECURITIES

MORTGAGE SECURITIES

VENDORS AND SUPPLIERS

LTV/TLTV/HTLTV Ratio Requirements for Conforming Mortgages

Effective for Freddie Mac Settlements On and After January 2, 2009

Updated on October 17, 2008

NOTE: these minimum Indicator Score requirements do not apply to super conforming mortgages. Please view requirements for super conforming mortgages.

PURCHASE AND "NO CASH-OUT" REFINANCE MORTGAGES**
(Fixed-Rate [Other Than 40-Year Mortgages], ARMs and 5- or 7-Year Balloon/Reset Mortgages)
*** See chart below for LTV/TLTV/HTLTV ratios and other requirements for a "no cash-out" refinance of a mortgage currently owned or securitized by Freddie Mac.*

Mortgage Purpose and Property Type	Max LTV w/o sec. fin.	Max LTV w/sec. fin.	Max TLTV w/sec. fin.	Max HTLTV w/sec. fin.
1-unit Primary Residence	95%	90%	95%	95%
2-4 unit Primary Residence	80%	75%	80%	80%
Second Home	85%	80%	85%	85%
Purchase transaction Mortgage secured by 1-unit Investment Property	85%	80%	85%	85%
"No cash-out" refinance Mortgage secured by 1-unit Investment Property	75%	70%	75%	75%
Purchase transaction Mortgage secured by 2-4 unit Investment Property	75%	70%	75%	75%
"No cash-out" refinance Mortgage secured by 2-4 unit Investment Property	75%	70%	75%	75%

For the complete Freddie Mac Ratio Requirements, go to (http://www.freddiemac.com/sell/factsheets/ltv_tltv_200901.html)

As a final matter, it is important to point out that the modification risk proposed by S. 2136 is not the same as applied to investor properties. As stated in our testimony, a modified investor property loan must be fully repaid in 3-5 years of the Chapter 13 plan. The modified debt cannot be repaid over the origination term of the loan (i.e., 30 years). This substantially curbs the frequency of cramdowns and their losses on investors properties.

Yet current legislation would remove this key creditor protection and allow only home mortgage debt to survive discharge despite being modified. As a result, the lender experiences the loss of cramdown and remains subject to foreclosure loss if the loan redefaults after the Chapter 13 is complete. No other asset is treated this badly in bankruptcy. In fact other assets such as car loans have major creditor protections including a prohibition against cramdown for 2 ½ years from loan origination. This ensures that the car loan and the depreciating asset are effectively correlated. A home loan is historically an appreciating asset and yet provides no recapture or other protection to avoid windfall profits to the borrower at the expense of the lender.