

ABI Directors Testify Before Congress

Editor's Note: Two members of the ABI Board of Directors were invited to testify before the House Committee on the Judiciary this fall. John Rao (National Consumer Law Center; Boston) testified on Sept. 25 on legislation to allow debtors to modify residential home mortgages. Judge Eugene Wedoff (N.D. Ill.) testified on Oct. 2 at an oversight hearing on the U.S. Trustee Program. Excerpts from their written statements are reprinted below.

Testimony of Hon. Eugene R. Wedoff

Madam Chairman Sánchez, Ranking Member Cannon and Members of the Subcommittee: Thank you for inviting me to testify before you today on the question of how the U.S. Trustee Program has been exercising its responsibility to administer our bankruptcy system—specifically, whether it has been acting in an overaggressive fashion—like an attack dog—rather than as a protector of the system's integrity—like a guard dog.

BAPCPA made substantial changes in bankruptcy practice—particularly in consumer bankruptcy practice—and these changes required a host of new and amended rules and forms for their implementation. One fundamental change made by BAPCPA was a limitation on the right of debtors to obtain a “fresh start” discharge under chapter 7 of the Bankruptcy Code (Title 11, U.S.C.), freeing their future income from the claims of creditors. The limitation I refer to is the new presumption of abuse, added to §707(b) of the Code. This presumption of abuse—generally referred to as “the means test”—arises under §707(b)(2)(A) if the debtor's income, less allowed deductions for living expenses and specified debt payments, exceeds defined amounts. Section 707(b)(2)(C), in turn, specifically requires chapter 7 debtors to file “a statement of...the calculations that determine whether a presumption of abuse arises.” BAPCPA emphasized the importance of this “means test statement” by amending §2075 of Title 28—the provision that authorizes the Supreme Court to prescribe bankruptcy rules and forms—to provide: “The bankruptcy rules promulgated under this section shall prescribe a form for the statement required under §707(b)(2)(C)...” Thus, BAPCPA mandated creation of a means test form.

In this process, I was assigned to a working group of three persons to create a draft means test form that the Advisory Committee [on Rules of Practice and Procedure] could consider. The other two members of the working group were Eric Frank—now himself a bankruptcy judge in Philadelphia, but then an attorney in private practice with an extensive career in representing consumer debtors—and **Mark Redmiles**, then the National Civil Enforcement Coordinator of the Executive Office for U.S. Trustees (EOUST).

Throughout the process of creating these forms, it was never my impression that Mr. Redmiles and the EOUST saw their role as one of attacking debtors or making the process of obtaining bankruptcy relief more difficult than BAPCPA requires. To the contrary, Mr. Redmiles operated with integrity and fairness, giving each of the many issues that arose his independent judgment as to the best way of implementing the requirements of BAPCPA. His work was completely supported by the EOUST's

huge impact for below-median income debtors. Section 707(b)(2)(C), as I noted earlier, requires chapter 7 debtors to file “a statement of...the calculations that determine whether a presumption of abuse arises.” In order to show that their income does not exceed the applicable median, a debtor has to complete a maximum of 14 lines—less than a page and a half of the form. If that showing of below-median income conclusively establishes that a presumption of abuse does not arise, then the debtor would not have to complete the remaining four and a half pages of detailed deductions for living expenses and debt payments. However, if there can be a presumption of abuse even though no one can assert it, then every debtor, regardless of income level, would have to complete the entire form. This latter view has been advocated by major creditor groups that supported BAPCPA. In a comment submitted to the Rules Committee on Feb. 15, 2007 (06-BK-055), the American Bankers Association, the American Financial Services Association, America's Com-

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senior leadership, including its then-acting director, Cliff White.

The safe harbor. Section 707(b)(7) of the Code, added by BAPCPA, provides, in effect, that only debtors with above-median income can be subject to a means test presumption of abuse. However, it accomplishes this result in what might be seen as a roundabout way: If a debtor's income is equal to or below the median, §707(b) denies all standing to assert the presumption. Specifically, for those whose income does not exceed the median, no one—not judges, U.S. trustees or bankruptcy administrators, case trustees or any other party in interest—is allowed to file a motion under §707(b)(2), the paragraph that sets out the means test presumption. But creating the safe harbor from the means test deduction in this indirect way, by denying standing, left a question for the means test forms. Like the proverbial question about whether a tree falling in the forest makes a noise if no one is there to hear it, the question for the means test form was whether a presumption of abuse can arise if no one is able to assert it.

The answer to this question had a

community Bankers, the Consumer Bankers Association, the Financial Services Roundtable and the Independent Community Bankers of America advocated that “Form 22A [should] require all debtors to provide the need-based calculations,” because the §707(b)(7) safe harbor “contains no exemption from the requirement that the needs-based calculation be completed.”

From the beginning of the process of adopting the means test forms, the EOUST took the contrary position—that if a presumption cannot be asserted it effectively does not arise—thus allowing lower-income debtors to avoid substantial additional collection and reporting of expense and debt payment data. The EOUST adhered to this position despite critical comments from the credit industry. The forms that went into effect in October 2005, and those in effect now, direct debtors not to complete the balance of the form if their income does not exceed the median.

To conclude my testimony today, let me put my observations in the blunt language of the title of this hearing: The process of developing the means test

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forms provided a clear opportunity to “attack” debtors with what I believe would have been substantially greater reporting requirements than those now in the means test forms. The United States Trustee Program did not mount this attack. To the contrary, the program took principled and independent contrary positions. Mark Redmiles, in particular, worked constructively and creatively with Eric Frank and me to read BAPCPA fairly and devise forms that would—to the extent of our ability—both honor its language and produce workable results. I came away from the process with great respect both for Mark—and the work of the EOUST generally—in assisting the Advisory Committee on Bankruptcy Rules.

The Testimony of John Rao

Chairman Sanchez, Ranking Member Cannon, and members of the Subcommittee, we thank you for holding this hearing and for inviting us to testify today regarding ways in which Chapter 13 can be improved to help homeowners avoid foreclosure. 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 first enacted. New nontraditional 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.

Since the enactment of the Bankruptcy Code in 1978, homeowners facing foreclosure have often turned to chapter 13 as a last resort for saving their homes. One of the most significant provisions in chapter 13 is the right to cure defaults on loans. Section 1322(b)(5) permits the homeowner to cure the default within a reasonable time by making payments on the arrears together with the ongoing payments during the plan. The cure right in chapter 13 currently serves an important role because of the limitations of voluntary workout options. Some mortgage servicers are not permitted by the investors of the mortgage loans to approve repayment or forbearance plans longer than six to twelve months, which

is too short a period for many borrowers to affordably cure a default. Chapter 13 makes long-term repayment plans available when mortgage lenders and their servicers have not been willing to negotiate reasonable similar plans.

The cure provisions in current law work best when homeowners have had a temporary loss of income (unemployment, illness, divorce, natural disaster, and so forth) which caused the default, and they now have sufficient income at the time the chapter 13 case is filed to pay during the plan the arrears which have accumulated and the regular monthly payment. For this model to be successful, it goes without saying that the mortgage loan must have been affordable for the homeowner when the loan was made.

When chapter 13 was enacted in 1978, a much different mortgage market existed than does today. The typical American pursuing the homeownership dream would have obtained a 30-year mortgage with a fixed interest rate and monthly payment. This loan would have been made by a bank using accepted underwriting guidelines which considered the homeowner’s ability to repay the loan. Risks to the lender and the homeowner were kept in check by ensuring that the loan amount did not exceed an appropriate loan-to-value ratio, typically no more than 80 percent LTV. The loan would likely have been kept in the bank’s own portfolio of loans and not assigned to another entity, and it would have been serviced by that same bank. The 1990s saw the enormous growth in the use of asset-based securities to fund an ever increasing supply of mortgage credit. Creating capital flow in this way, subprime mortgage lending took off during this period. Homeowners were encouraged (as they are today), often through aggressive marketing campaigns that deceptively tout lower payments and tax benefits, to use their home equity to consolidate non-mortgage debts. The range of interest rates charged to subprime borrowers during this period was very broad, especially compared to the range in the conventional mortgage market. The rate range for subprime loans in the mid- to late-1990s, often on fixed-rate loans, was as much as 17 percentage points, as compared to the

conventional market’s range of no more than 2 percentage points. Thus, even before the advent of today’s more dangerous “exotic” subprime mortgages, chapter 13 was becoming less viable as a safety net for the growing numbers of homeowners in foreclosure.

The right to cure a mortgage default under §1322(b)(5) has several significant limitations. Taken alone, this provision does not permit the homeowner to change the amount and timing of installment payments, the interest rate, and other similar terms of the mortgage. It also does not give the homeowner the right to reduce the mortgage creditor’s lien to the value of the collateral as compared with the outstanding balance owed on the secured debt. Other provisions of the Bankruptcy Code do however provide the right to “modify” secured claims to debtors in chapter 11, 12 and 13 cases. This ability to modify secured claims is possible for virtually every type of debt except for the mortgage on the borrower’s primary residence. While there is scant legislative history directly addressing the anti-modification clause in §1322(b)(2), it may have been intended to promote the flow of capital into the residential mortgage market at a time when such lending was experiencing pressures from record-high interest rates.

Bankruptcy attorneys, legal services offices, housing counselors, and attorneys who assist homeowners in foreclosure now routinely see clients with mortgages whose terms are so oppressive that traditional tools for dealing with foreclosures such as workout agreements and chapter 13 cure plans are no longer effective. Many of these nontraditional loans which predominate in the subprime market take the form of adjustable rate mortgages (ARMs), such as payment-option ARMs or the more common the 2/28 hybrid ARMs. These loans have an initial short-term fixed rate for the first twenty-four months that is followed by annual or six-month rate adjustments for the balance of the loan term. By mid-year 2006, hybrid ARMs made up 81 percent of securitized subprime loans.

The interest rates and payments can rise significantly on these loans. During the past eight years, the six-month LIBOR index has had peaks and valleys from a low of 1.12% (in June, 2003) to a

high of 7.06 percent (in May, 2000). The first rate change on these loans is generally in the 24th month, with the change payment rate occurring in the 25th month. Subsequent rate changes occur every six months thereafter. Typically, there is a cap on the increase in the first adjustment of 200 basis points, and caps on subsequent adjustments of 100 basis points. Such rate increases and changing payment amounts can cause serious affordability problems for many homeowners who do not have the flexibility to make adjustments to their household expenses. In a chapter 13 plan, there is even less flexibility because the consumer's disposable income based on his or her expenses is fixed at the time of confirmation for the duration of the plan, and must be paid to the trustee to satisfy creditors' claims and other obligations under the plan.

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

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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. Permitting modification by itself does not fully address the problem based on the current structure of the Code. This is because modified secured claims in chapter 13 must be paid in full during the three to five years of the plan. For home mortgages with large outstanding balances, this is impossible for most borrowers and they would not benefit from the change permitting modification. To address this, we propose a solution which Congress has already provided for family farmers in chapter 12 cases. Section 1322 should be amended to include a provision similar to §1222(b)(9) which permits the borrower's loan to be reamortized based on the modified terms and paid over a period beyond the plan term, generally up to thirty years. These changes would permit the homeowners to save their home from foreclosure by obtaining an affordable reamortized loan and still return to the lender the value of its lien with reasonable interest.

Lenders will receive at least as much as they would realize if the property were foreclosed, even if there is a cram down based on the property's value. For lenders who make high LTV or no equity loans based on risky underwriting practices, they can hardly expect a

different outcome since they did not take a security interest in the consumer's home based on its true economic value. Incorporating this modification right in chapter 13 will provide needed assistance to families who for one of many possible reasons have not been able to obtain workouts which include loan modifications. It will also provide an incentive for many lenders and servicers to work with homeowners and their representatives early in the foreclosure process and to make good on their claims that loss mitigation options are available.

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