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Essay

A New Proposal for Loan Modifications

Christopher Mayer,[†] Edward Morrison^{††} & Tomasz Piskorski^{†††}

We propose a new three-pronged plan to address the recent harmful flood of foreclosures. Our plan would address the major barriers that inhibit the ability of third-party servicers to modify mortgages the way portfolio lenders are now doing with greater success. The plan provides greater compensation for servicers to perform their duties, removes legal constraints that inhibit modification, and addresses critical second liens that often get in the way of effective mortgage modifications. Our plan has more modest costs than competing plans and is likely to be the most effective while still protecting the rights of investors in mortgage-backed securities.

Introduction

The recent flood of foreclosures has reached crisis levels, with 2.25 million foreclosures started last year¹ and 1.7 million foreclosures projected to start in 2009.² Foreclosures contribute to falling house prices and deteriorating communities. Policymakers have struggled to stem this rising tide. Despite good intentions and appreciable effort, public policy that encourages write-downs or other loan modifications by servicers has had limited success.

We offer a new approach to foreclosure prevention that focuses on what has been the most intractable part of the foreclosure problem: the behavior of third-party servicers who manage portfolios of securitized mortgages. Securitized subprime, alt-A, and prime/jumbo loans accounted for more than one-half of foreclosure starts in 2008 despite representing about fifteen percent

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1 Ben S. Bernanke, Chairman, Bd. of Governors, U.S. Fed. Reserve, Housing, Mortgage Markets, and Foreclosures, Speech at the Federal Reserve System Conference on Housing and Mortgage Markets (Dec. 4, 2008).

2 CREDIT SUISSE, FORECLOSURE UPDATE: OVER 8 MILLION FORECLOSURES EXPECTED (2008), <http://www.nhc.org/Credit%20Suisse%20Update%2004%20Dec%2008.doc>.

of all outstanding mortgages.³ While Fannie Mae, Freddie Mac, the Federal Housing Administration (FHA), and the largest private banks and portfolio lenders have announced their own aggressive programs to pursue mortgage modification, servicers of securitized mortgages lag behind.

We must act quickly to address the foreclosure problem among securitized mortgages because the forecast for 2009 is even bleaker. As of October 2008, more than one-third of the 2.8 million outstanding securitized subprime loans and seventeen percent of the 2.2 million securitized alt-A loans were sixty days or more delinquent.⁴ And many alt-A option Adjustable Rate Mortgages (ARMs)⁵ will hit their negative amortization limits between 2009 and 2011, resulting in rising payments and likely much higher default rates. Rumors suggest that some smaller servicers will soon face bankruptcy.

Our approach builds on recent research by Tomasz Piskorski, Amit Seru, and Vikrant Vig showing that portfolio lenders—lenders who service loans that they own—are significantly more successful in stemming foreclosures than third-party servicers, who service loans owned by other parties.⁶ The researchers show that portfolio lenders achieve foreclosure rates that are nineteen to thirty-three percent lower than the rates experienced by third-party servicers.

Third-party servicers face three principal barriers that prevent them from pursuing mortgage modifications even when they make economic sense.⁷ First, old contracts did not anticipate the extent of the current crisis. Mortgage servicers are not compensated appropriately to handle the current volume of delinquencies. As well, servicers have too few incentives to pursue loan modification instead of foreclosure, even when modification makes good economic sense for investors. Most securitization agreements compensate servicers for costs incurred during the foreclosure process, but not for expenses associated with loan modification. Even if modification is successful, it typically does not generate sufficient fees to cover the costs of modification.

3 According to the Mortgage Bankers Association, about 1.64 million loans started the foreclosure process as of the third quarter of 2008. Our calculations from Blackbox Logic, LLC data show that about 900,000 securitized loans began the foreclosure process as of October 2008.

4 Federal Reserve Bank of New York, Credit Conditions in the United States, <http://www.newyorkfed.org/regional/subprime.html> (last visited Apr. 24, 2009) (select “Subprime” spreadsheet under “United States Mortgage Conditions” for subprime statistics and the “Alt-A” spreadsheet under “United States Mortgage Conditions” for Alt-A statistics).

5 An option ARM is typically a 30-year ARM that offers the borrower a choice of monthly payment amounts, including the option to make a minimum payment that is less than the accruing interest. If borrowers choose to make this minimum payment, there is “negative amortization,” which means that the unpaid portion of the accruing interest is added to the outstanding principal balance. These mortgages typically have a limit to the amount of negative amortization, at which point the minimum required payment can rise rapidly.

6 Tomasz Piskorski, Amit Seru & Vikrant Vig, *Securitization and Distressed Loan Renegotiation: Evidence from the Subprime Mortgage Crisis* (Univ. of Chi. Booth Sch. of Bus. Research Paper No. 09-02, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1321646.

7 For a useful survey, see Anna Gelpern & Adam Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage-Backed Securities*, 82 S. CAL. L. REV. (forthcoming 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1323546.

Consequently, servicers often choose to foreclose, even when modification would be more profitable for borrowers and investors.

Second, servicers face explicit and implicit legal barriers to modifying mortgages successfully. Many pooling and servicing agreements (PSAs) place explicit limits on loan modifications. In other cases, vague provisions in the PSAs, and the consequent threat of lawsuits, serve to limit servicers' ability to modify loans successfully.

Finally, second liens can be a barrier to successful modifications of first mortgages. Modification of the first mortgage might yield greater recovery to first-mortgage lenders than a foreclosure. But there is little incentive to modify the first mortgage unless second-lien lenders agree to relinquish their claims. Otherwise, a modification of the first mortgage will just allow the borrower to allocate more of her income to the second lien. Even if the first mortgage exceeds the home's expected foreclosure value—implying zero recovery to the second-lien lenders in foreclosure—the second-lien holder has no incentive to agree to a modification that extinguishes the second lien. As long as there is some uncertainty surrounding foreclosure value, no matter how small, the second-lien holder will prefer foreclosure to loan modification. As well, by delaying, the second-lien lender might convince the first-mortgage servicer to “buy out” the second lien at a price above its true value. This is often called a “hold-up” problem.

These barriers could be overcome if investors agreed to rewrite their PSAs. A rewrite typically requires unanimous investor consent, especially if it would give servicers freedom to reduce principal or interest rates. However, the typical mortgage pool has issued many securities in as many as a dozen or more tranches, which have different priorities with respect to interest or principal, or both. The number of investors is so large—and their interests are so divergent—that consensus is a near impossibility. Put differently, mortgage securitization has dramatically increased the number of creditors to whom a homeowner is indebted. The typical securitization has as many creditors, and as complicated a capital structure, as many large corporations. No one is surprised when a distressed corporation—whether a small business or General Motors—is unable to convince creditors to rewrite their debt contracts. There are too many creditors with divergent interests. This is why we have Chapter 11, which gives corporations power to rewrite contracts. Today, securitizations face precisely the same problem as General Motors: there is no way (at reasonable cost) to reach a consensus among creditors. Homeowners bear the consequences of this standstill.

This is why government intervention is needed. We propose three steps to get around the barriers to successful loan modification: (1) an Incentive Fee structure that increases payments to servicers and better aligns their incentives with investors; (2) another set of Incentive Fees that encourage second-lien lenders to relinquish their claims when modification of the primary mortgage is optimal; and (3) a legislative proposal that removes explicit barriers to

modification in PSAs and that reduces the litigation exposure of servicers who do modify loans.

Our proposal will prevent as many as one million foreclosures among privately securitized mortgages. In addition, by reducing hold-up by second-lien lenders, our proposal facilitates hundreds of thousands of modifications among mortgages controlled by Fannie, Freddie, and the FHA (the government-sponsored enterprises or GSEs), as well as those controlled by portfolio lenders. The total cost of our program would be no more than \$12.35 billion, which can be funded by the U.S. Treasury's Troubled Assets Relief Program (TARP).

Other proposals do not address the barriers that servicers face. As well, our proposal would cost taxpayers considerably less money than other programs currently under consideration, with no requirement to provide costly loan guarantees. Losses for bad loans remain with private investors rather than taxpayers.

Below we describe our approach in more detail. A complete Proposal is available online.⁸ We put forward this Proposal on January 7, 2009. Since then, elements of it have become part of federal law and policy. Variants of our proposed Incentive Fees are now part of President Obama's "Making Home Affordable Program."⁹ And a safe harbor became part of federal law on May 20, 2009.¹⁰

I. Our Proposal in Detail

A. *Servicer Incentive Fees*

We believe that servicers need greater resources and stronger incentives to modify loans. We propose that servicers of privately securitized mortgages be paid a monthly Incentive Fee equal to ten percent of all mortgage payments made by borrowers, with a cap for each mortgage of \$60 per month (\$720 per year). The servicer would also receive a one-time payment equal to twelve times the previous month's Incentive Fee if the borrower prepays the mortgage. These payments would be in addition to the normal servicing fees as specified by the PSA. The program would be limited to any securitized mortgage that is below the conforming loan limit at the origination date. We estimate that Incentive Fees would total about \$9 billion.¹¹ The Incentive Fees should remain

⁸ Christopher Mayer, Edward Morrison & Tomasz Piskorski, *A New Proposal for Loan Modifications, Real Estate: Mortgage Market Proposals* (2009), <http://www4.gsb.columbia.edu/realestate/research/housingcrisis/mortgagemarket> [hereinafter Full Online Proposal].

⁹ For more information about the program, see *Road to Stability, Making Home Affordable*, <http://www.financialstability.gov/roadtostability/homeowner.html> (last visited June 5, 2009).

¹⁰ *Helping Families Save Their Homes Act of 2009* § 201, Pub. L. No. 111-22 (2009).

¹¹ See Mayer et al., *supra* note 8, at app. 2.

in place for a period of three years, after which improvements in the economy will likely reduce the need for the incentive program.

Our Incentive Fee program would substantially encourage servicers to modify mortgages. Servicing fees would now more than cover the direct costs of modifications, estimated to be as much as \$750 to \$1000.¹² Equally important, the Incentive Fee program better aligns servicers' interests with those of investors by giving them a percentage of all cash flow. By paying an Incentive Fee only when borrowers make payments, we reward successful modifications. A servicer whose loan modifications are unsuccessful and result in a quick re-default would collect few Incentive Fees.¹³ Our proposal, therefore, rewards servicers for keeping future payments as high as possible without putting the homeowner in a position where he or she is likely to re-default soon after modification. This is exactly the tension that a portfolio lender addresses in its own loans. Of course, there will still be circumstances in which costly foreclosure will be unavoidable, but the Incentive Fee will encourage servicers to look for other options.

Our proposal also encourages short sales if they make economic sense. If a borrower prepays a mortgage for any reason, the servicer would receive a one-time Incentive Fee equal to twelve times the previous month's Incentive Fee. A prepayment could occur for two reasons: the borrower may refinance the mortgage, or he or she may pursue a short sale (selling the property and turning over the proceeds to the lender, often in full satisfaction of the mortgage debt). The one-year Incentive Fee encourages a lender to accept a short sale when the alternative is a more expensive foreclosure. The lump sum Incentive Fee also ensures that loan modification costs are covered for borrowers who eventually prepay.

Importantly, our Incentive Fee program would apply only to securitized mortgages that fell below the conforming loan limit in the year in which the loan was originated. So-called jumbo mortgages do not face the same incentive problems as subprime and alt-A mortgages with lower loan balances. Because the average mortgage balance exceeds \$500,000, servicers receive much greater financial benefits when they modify a jumbo mortgage. Keeping a jumbo mortgage in the securitized pool instead of foreclosing can result in annual payments of \$1250 or more, enough to justify substantial effort, if necessary, to modify a troubled mortgage. As well, the volume of jumbo mortgage defaults is lower, enabling servicers to give these loans more attention. Servicers of jumbo loans, however, would still see substantial benefits from other parts of our proposal.

12 See, e.g., BARCLAYS CAPITAL, 2008 GLOBAL SECURITIZATION ANNUAL 14.

13 Evidence suggests that, among loan modifications performed during the first quarter of 2008, more than one-half re-defaulted within six months. It is therefore important only to reward servicers for pursuing successful loan modifications. See OFFICE OF THE COMPTROLLER OF CURRENCY, OFFICE OF THRIFT SUPERVISION, OCC AND OTS MORTGAGE METRICS REPORT: DISCLOSURE OF NATIONAL BANK AND FEDERAL THRIFT MORTGAGE LOAN DATA, THIRD QUARTER 2008, at 5 (2008), <http://files.ots.treas.gov/482028.pdf>.

Finally, our proposal changes the economics of mortgage servicing from being a loss leader to a profitable business: it becomes a profitable business instead of a loss leader. By doing so, we substantially reduce the likelihood of highly disruptive bankruptcies among smaller, so-called monoline servicers, who now manage about one-third of all securitized mortgages. We also relax the liquidity constraints faced by smaller servicers, who now are barely able to cover the costs of a substantial mortgage modification program. As well, by making mortgage servicing profitable, we encourage larger servicers to purchase smaller servicers. Such consolidation could provide important economic benefits. There are substantial economies of scale in mortgage servicing, particularly given the large fixed costs and the benefits from learning in pursuing mortgage modification.

B. *Second Lien Incentive Fees*

We propose compensating second-lien lenders who voluntarily surrender their mortgages in order to permit modification by first-mortgage servicers. If a first-mortgage servicer proposes a loan modification and, in response, the second-lien servicer relinquishes its claims against the home and the borrower, the second-lien lender will receive payment equal to five percent of the outstanding second-lien balance, with payment not to exceed \$1500 per property. If multiple second liens exist, this payment will be split among the liens.

In order to limit taxpayer costs, and focus primarily on foreclosure prevention, the Incentive Fee will be available only to a second-lien lender that relinquishes its claims in response to a decision by a first-mortgage servicer to conduct a significant modification of the primary mortgage, reducing the borrower's monthly payments by at least ten percent. This program will apply only to primary residences subject to first and second liens that are held by different lenders. Finally, our proposal will apply to all second liens, because the hold-up problem applies beyond just privately securitized mortgages.

C. *A Litigation Safe Harbor*

We propose two kinds of legislated changes to PSAs. First, Congress should enact legislation that eliminates explicit limits on modification, including both outright prohibitions and provisions that constrain the range of permissible modifications. The legislation should be temporary, lasting only three years. Second, Congress should create a "litigation safe harbor" that insulates servicers from costly litigation, provided they modify loans (or surrender second liens) in a reasonable, good faith belief that they are acting in the best interests of investors as a group. The safe harbor is an affirmative defense, which servicers can assert in the event of litigation. Importantly, the defense is based on evidence regarding the servicer's reasonable expectations, not on evidence that the modification was in fact successful or not. If investors

bring suit, but a servicer successfully invokes the safe harbor, the investors will pay the servicer's actual legal costs, including attorney and expert-witness fees.

Most PSAs do not explicitly limit modifications, but instead contain vague language that can paralyze servicers. With respect to these securitizations, our proposal can best be viewed as clarifying the interpretation of the PSAs. For example, the typical PSA advises the servicer to act in the "best interests" of the securitization trust. Yet the contracts do not specify what counts as "best interests." Modification could reduce the cash-flow rights of some investors, particularly junior-tranche investors, relative to foreclosure. These investors can often expect a share of coupon payments during the foreclosure process, which can last eighteen months. Modification might eliminate these cash-flow rights. Indeed, some junior-tranche holders have sued servicers that actively pursue modifications. Our Legislative Proposal (1) clarifies that servicers' primary duty is to act in the economic interest of investors as a group and (2) provides protection against lawsuits when the servicer can show that its actions were consistent with this duty.

Our Legislative Proposal is slightly more complicated for the minority of PSAs that contain explicit provisions barring modifications. These provisions can include outright prohibitions on modification, caps on the number of mortgages that can be modified (for example, five percent of the pool), limits on the frequency of modifications (for example, no more than once during a twelve month period), limits on the range of permissible modifications (e.g., the modified interest rate cannot fall below a set floor), and requirements that a servicer purchase any modified loans—at par value—from the securitization trust. Our proposal will abrogate provisions like these. It is important to note, however, that our legislation enables modification only when it increases overall investor value. To be sure, some junior-tranche holders might be harmed. But this effect likely raises no constitutional concerns, as we explain below. Moreover, we believe that our proposal makes sense given the economic crisis we are facing in the housing market. The benefits from modification far outweigh the burdens on a small class of investors. Nonetheless, we believe that policymakers should provide compensation to investors who suffer economic losses. Note, however, that compensation to junior-tranche investors will be necessary only when legislation abrogates contractual provisions that would have guaranteed, absent abrogation, cash-flow rights to these investors. We estimate that this compensation would cost about \$1.7 billion.

Investors will, however, need information about modifications in order to assess their reasonability. Our proposal therefore requires servicers to make public the details of any modification. This reporting requirement will not only help investors understand and evaluate modifications, but will also provide useful information to other servicers and lenders, who can study previous modifications, assess what works and what does not, and thereby develop successful standards for the future.

D. *Costs and Benefits*

Our program will avert more than one million foreclosures at a cost of \$12.35 billion. Among privately securitized mortgages, Incentive Fees will avoid between 675,000 and one million foreclosures at a cost of about \$9 billion, or \$10.7 billion if we include compensation to junior-tranche investors. Incentive Fees for second liens will cost approximately \$1.65 billion and facilitate hundreds of thousands of modifications, both among privately securitized mortgages and among mortgages controlled by the GSEs and private lenders.¹⁴

E. *Constitutional Analysis*

Because the securitization market crosses state lines and has a major impact on interstate commerce, Congress has authority under the Commerce and Spending Clauses to enact the proposed legislation. But because the legislation alters the terms of existing contracts, it raises other constitutional concerns. The most important is that our proposal might violate the Takings¹⁵ and Due Process¹⁶ Clauses of the Fifth Amendment, because it abrogates vested contractual rights.

The Takings Clause prohibits the federal government from taking private property for public use without just compensation. The Clause “is designed not to limit the governmental interference with property rights *per se*, but rather to secure *compensation* in the event of otherwise proper interference amounting to a taking.”¹⁷ Even assuming our legislative proposal amounts to a taking, it is not an unconstitutional taking because investors are compensated, in kind, for the legislative interference. Servicers will be given discretion to modify loans (or surrender second liens) and incentive to do so only when it *improves* payments to investors as a group. Relative to foreclosure, modification will only increase expected returns to investors. Supreme Court caselaw makes clear that no taking occurs when a government policy causes no economic loss.¹⁸ That will be the case for most investors here. Put differently, our Legislative Proposal makes securitized mortgages more valuable to investors. Although it impairs property rights, it impairs rights that are—in the current environment—*destroying* value.

To be sure, some investors may suffer a reduction in expected payoffs. This is most likely to be true for junior-tranche investors, who are often entitled

14 For a detailed cost-benefit analysis, see Full Online Proposal, *supra* note 8, apps. 2 & 4.

15 U.S. CONST. amend. V (“[N]or shall private property be taken for public use, without just compensation.”).

16 U.S. CONST. amend. V (“No person shall be . . . deprived of . . . property, without due process of law . . .”).

17 *Lingle v. Chevron U.S.A. Inc.*, 544 U.S. 528, 536-37 (2005) (quoting *First English Evangelical Lutheran Church v. County of L.A.*, 482 U.S. 304, 315 (1987)).

18 *Brown v. Legal Found. of Wash.*, 538 U.S. 216 (2003).

to a share of coupon payments during the foreclosure process, which can last eighteen months. Because it avoids the lengthy foreclosure process, loan modification will eliminate the investors' rights to these payments. This deprivation, however, is not an unconstitutional taking. Investors are losing contractual rights—a share of coupon payments, set by contract—not real property rights. Different rules (“regulatory takings”) apply to the former rights. Most importantly, with respect to our proposal, the Supreme Court has emphasized repeatedly that the subject matter of almost every contract is susceptible to government regulation.¹⁹ Therefore, any party to a contract is or should be aware that future government regulation could reduce the value of contractual rights.²⁰ Here, the securitization contracts give investors interests in mortgages. The market for mortgage loans, as noted above, is one that Congress can regulate. If the government uses regulation to take contractual rights for its own benefit, a takings issue could arise.²¹ But that is not the case here: our proposal nullifies some contractual rights in order to avert premature foreclosures. The direct beneficiaries are homeowners, investors, and servicers, not the federal government.²² Nonetheless, we propose compensation to aggrieved investors—with compensation delivered by an administrative agency—to eliminate lingering constitutional doubts, smooth the modification process, and ensure a quick resolution of the crisis.

For similar reasons, there is no violation of the Due Process Clause. The standard test for assessing the constitutionality of economic and social legislation—that it must bear a “rational relationship” to a legitimate governmental objective²³—is notoriously lenient²⁴ and easily met here.²⁵ First, our proposal serves a legitimate state interest—minimizing the foreclosure crisis. Second, it is rational response to the crisis. Our proposal offers a temporary, incentive-based program that encourages modifications that serve the best interests of investors. Although contract rights are curtailed, most investors will benefit. If they are harmed, our program offers compensation.

19 See, e.g., *Lucas v. S.C. Coastal Council*, 505 U.S. 1003, 1027-28 (1992); *Connolly v. Pension Benefit Guar. Corp.*, 475 U.S. 211, 223-24 (1986) (quoting *Norman v. Balt. & Ohio R.R. Co.*, 294 U.S. 240, 307-08 (1935)); see also *Gelpert & Levitin*, *supra* note 7 (discussing Supreme Court case law upholding federal legislation that invalidated gold clauses in private contracts).

20 See, e.g., *Lucas*, 505 U.S. at 1027-28 (1992); *Connolly*, 475 U.S. at 223-24 (1986).

21 *Connolly*, 475 U.S. at 224.

22 Additionally, our legislative proposal would abrogate a relatively minor provision (the right to coupon payments during the foreclosure process) in contracts between securitization trusts and junior-tranche investors. Because our proposal does not destroy all of the investors' contractual rights, it is unlikely to be viewed as a taking. See, e.g., *Andrus v. Allard*, 444 U.S. 51, 65-66 (1979); *Penn Cent. Transp. Co. v. New York City*, 438 U.S. 104, 131 (1978).

23 *Village of Belle Terre v. Boraas*, 416 U.S. 1, 8 (1974); see also *Gen. Motors Corp. v. Romein*, 503 U.S. 181, 191 (1992); *Exxon Corp. v. Governor of Md.*, 437 U.S. 117, 124-125 (1978).

24 See *Williamson v. Lee Optical*, 348 U.S. 483, 487-88 (1955).

25 See *Lingle v. Chevron U.S.A. Inc.*, 544 U.S. 528, 542 (2005).

II. Alternative Proposals

Alternative proposals generally fall into four categories: (1) allowing judges to modify mortgages and “cram down” principal amounts in bankruptcy; (2) making explicit payments or offering loan guarantees to servicers on all mortgages that they modify; (3) allowing homeowners to take on second liens from the government, with personal liability for the loan balances; and (4) appointing blind trustees to administer loan modifications in place of servicers.

A. *Bankruptcy Cramdown*

Proponents of bankruptcy reform believe it would impose no (or minimal) costs on taxpayers. That is untrue. Cramdown may be no more costly than *doing nothing* about the foreclosure crisis, but doing nothing is not the only alternative. Relative to our proposal, cramdown exposes taxpayers to significant losses.

First, cramdown would likely apply to all mortgages, including the 35 million outstanding mortgages (over \$5.5 trillion in value) guaranteed by Freddie Mac, Fannie Mae, and the FHA. The government can already ensure fair modifications for these mortgages, which represent about seventy percent of all mortgages. Cramdown could pit federal judges against the GSEs.

Second, cramdown would likely impose excessive losses on lenders. Judges would routinely reduce a homeowner’s principal balance to the current appraised value of the home. This kind of mortgage modification is far more aggressive than the strategies now being developed by lenders. Some strategies, such as forbearance, do not involve principal write-downs at all. The FDIC/IndyMac program, for example, provides for reductions in interest rates and forbearance on principal payments.²⁶ Different modification strategies, in other words, will be appropriate for different borrowers, in order to simultaneously avoid foreclosure and minimize losses to lenders. Bankruptcy cramdown does little to tailor modifications to the needs and abilities of borrowers. It instead applies a costly, one-size-fits-all approach.

Equally important, once cramdown is an option, it may prevent other kinds of modifications that are less costly but equally effective. Borrowers may have little incentive to accept a lender’s modification proposal when they can go to bankruptcy court and have a judge cramdown their principal balances. When house prices rise again, as they eventually will, the borrower will enjoy all of this appreciation. Cramdowns will have eliminated the possibility that a lender can ever recover its losses on borrowing.

Finally, cramdown legislation could prolong the foreclosure crisis and generate a massive number of bankruptcy filings. Two-thirds of Chapter 13

²⁶ Forbearance reduces the amount of principal to which a lender applies interest when computing monthly mortgage payments.

plans fail.²⁷ There is, therefore, a large risk that bankruptcy judges will permit cramdown in many cases where it is inappropriate: the homeowner will ultimately default, the Chapter 13 plan will fail, and the home will go through foreclosure. Cramdown also imposes excessive burdens on bankruptcy judges and trustees, whose already massive caseload has prompted congressional hearings.²⁸ Cramdown could prolong the current crisis for years.

Equally devastating, third-party servicers might find it more attractive to deal with a homeowner in bankruptcy than to attempt a loan modification outside of bankruptcy. Proponents argue that bankruptcy reform would give borrowers a tool to fight back against servicers. Yet, the opposite could be the case. Servicers might prefer bankruptcy to loan modification for the same reason that servicers now prefer foreclosure to modification. Under most PSAs, servicers would likely be able to recover expenses incurred in connection with a homeowner's bankruptcy filing, just as they now recover expenses incurred in connection with a foreclosure. There is no reimbursement for costs incurred in performing a loan modification. This set of incentives could result in millions of Chapter 13 bankruptcy filings that harm consumer credit and appreciably delay a resolution of the crisis.

Finally, the cost of future credit could rise significantly, especially for individuals with imperfect credit records. Empirical evidence suggests that borrowing costs are higher and mortgage amounts are smaller when mortgages are subject to cramdown.²⁹

B. *Payments for Mortgage Modification*

The FDIC has proposed that the government pay servicers \$1000 every time they modify a loan, and have taxpayers share up to fifty percent of losses from post-modification default.³⁰ This proposal shares features with ours. However, the mortgage guarantee imposes a potentially large burden on taxpayers instead of investors, and would not appreciably increase the

27 Wenli Li, *What Do We Know About Chapter 13 Personal Bankruptcy Filings*, FED. RES. BANK PHILA. BUS. REV., Fourth Quarter 2007, at 19, available at http://www.philadelphiafed.org/research-and-data/publications/business-review/2007/q4/li_chapter-13-filings.pdf. A Chapter 13 bankruptcy filing is a way for individuals to undergo a financial reorganization supervised by a federal bankruptcy court. Under Chapter 13, the debtor proposes a plan to pay creditors over a three- to five-year period, during which time creditors cannot attempt to collect the individual's previously incurred debt except through the bankruptcy court. If successful, the individual keeps his or her property, and creditors end up with less money than they are owed.

28 See, e.g., *Bankruptcy Judgeship Act of 2003: Hearing on H.R. 1428 Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary*, 108th Cong. 6-14 (2003) (statement of Michael J. Melloy, J., Court of Appeals of the Eighth Circuit).

29 See Adam J. Levitin & Joshua Goodman, *The Effect of Bankruptcy Strip-Down on Mortgage Markets* 21 tbl.2a, 25 tbl.4a (Georgetown Univ. Law Ctr., Bus., Econ. & Regulatory Policy Working Paper Series Research Paper No. 1087816, 2008), available at http://works.bepress.com/adam_levitin/11/; see also Karen Pence, *Foreclosing on Opportunity: State Laws and Mortgage Credit*, 88 REV. ECON. & STAT. 177 (2006).

30 FDIC, *FDIC Loss Sharing Proposal to Promote Affordable Loan Modifications*, <http://www.fdic.gov/consumers/loans/loanmod/index.html> (last visited Apr. 24, 2009).

program's effectiveness. It also encourages servicers to "modify" as many loans as possible, reducing ultimate payments to investors, with no guarantee of successful modification. Additionally, servicers would still be hamstrung by existing legal barriers without our "safe harbor" provision.

C. *Second Liens with Personal Liability*³¹

A third group of proposals suggests that borrowers take on full-recourse second mortgages to help work out of the crisis. We believe that this alternative sets a dangerous precedent that would allow homeowners to permanently take on debts to stay in their homes. Under such a plan, homeowners could subsequently re-default on their mortgages, be kicked out of their homes, and face debts that could not be discharged by a court. This scenario resembles debtor's prison. Given psychological evidence that some consumers have difficulty weighing the consequences of their decisions, we do not believe that personal liability is the right solution.

D. *Blind Trustee*

John Geanakoplos and Susan Koniak have proposed forcing servicers to transfer troubled mortgages to a government-appointed trustee, who would be charged with managing the workout and foreclosure process.³² We believe that such a plan runs many of the same risks as bankruptcy cramdowns, and could even be worse for mortgage investors. Local trustees would have no incentive to maximize payments by the borrower, would be subject to limited oversight, and—as a result—would be likely to propose plans that are overly generous to homeowners and impose unnecessary losses on investors and taxpayers. The trustee might, for example, excessively reduce mortgage payments for a borrower who has large credit card bills even though the trustee (unlike a bankruptcy judge) has no power to reduce the credit card debt payments as well. The Geanakoplos-Koniak plan also has no provisions for dealing with excessive second liens. Finally, implementing their plan would be time-consuming and fraught with start-up questions because the plan anoints a fleet of new trustees with limited experience doing this kind of work.

III. Conclusion

We are witnessing an unprecedented housing and foreclosure crisis. Two problems are driving the crisis: (1) legal and economic barriers deter servicers from modifying privately securitized mortgages and (2) second liens are

31 See, e.g., Martin Feldstein, *How To Help People Whose Home Values Are Underwater*, WALL ST. J., Nov. 18, 2008, at A21.

32 John D. Geanakoplos & Susan P. Koniak, *Why the Blind Trustee Plan Is Cheaper and Better than Alternatives* (Feb. 13, 2009) (unpublished manuscript), available at <http://www.law.yale.edu/cbl/8818.asp>.

holding up sensible modifications of primary mortgages. We propose a comprehensive solution to this crisis. First, the government should compensate servicers who modify mortgages. Second, it should compensate second-lien lenders who surrender their claims when primary mortgage servicers perform substantial modifications. Third, the government should remove legal constraints that now inhibit modification and will continue to inhibit it even if servicers and second-lien lenders are given appropriate economic incentives.

We estimate that, over the next three years, our plan will prevent nearly one million foreclosures among privately securitized mortgages and facilitate hundreds of thousands of modifications among mortgages controlled by GSEs or portfolio lenders. Our plan would cost no more than \$12.35 billion, far less than competing proposals, and would raise no constitutional concerns.