Testimony of

Frank S. Alexander[*]
Professor of Law
Emory University School of law

Subcommittee on Domestic Policy
Oversight and Government Reform Committee

Committee Room 450 of the Georgia State Capital Building
206 Washington Street Southwest
Atlanta, Georgia
Monday, November 2, 2009

"Examining the Continuing Crisis in Residential Foreclosures and the Emerging Commercial Real Estate Crisis: Perspectives from Atlanta."

Lessons to Learn from the Current Mortgage Crisis

Chairman Kucinich, Representative Westmoreland, Members of the Subcommittee, it is my pleasure and honor to be invited to meet with you today to discuss the continuing crisis in residential foreclosures and the emerging commercial real estate crisis.

Over the past 18 months Congress has taken dramatic steps to respond to the most significant crisis in mortgage finance in our lifetimes. In the summer of 2008 it passed the Housing and Economic Recovery Act of 2008;[1] last February it passed the American Recovery and Reinvestment Act of 2009;[2] and last May it enacted the Helping Families Save Their Homes Act of 2009.[3] Each of these Acts has addressed in significant ways different parts of the current crisis, and many of the statutory provisions and new programs have already had and will continue to have strong positive impact on reducing the harmful effects of this current crisis. As a citizen, a taxpayer, a homeowner, I thank you for what Congress has done thus far.

Creating tactics and programs to respond to an immediate crisis is vital, but it is not the same as designing strategies and policies based upon an accurate understanding of what caused the crisis, and how the crisis can be prevented in the future. One of the most

---

[*] Professor of Law, Emory University School of Law. Director, Project on Affordable Housing and Community Development. Frank.Alexander@Emory.edu; 404.727.6982, author, GEORGIA REAL ESTATE FINANCE AND FORECLOSURE LAW 2009-2010 (5th ed. Thomson West, 2009).

[1] Pub. L. 110-289.

[2] Pub. L. 111-5.

[3] Pub. L. 111-22.

valuable components of this series of hearings by the Domestic Policy Subcommittee is to probe the questions of what went wrong, why did this occur, and what changes need to be made to prevent it from occurring in the future. It is indeed fair and wise to ask – before the crisis fades into distant memory – what lessons can we learn for the future.

The lessons we have to learn can be divided into three categories: (i) how to respond to the immediate foreclosure crisis, (ii) how to mitigate the impact of widespread foreclosures on our neighborhoods and local governments, and (iii) how to avoid this crisis from reoccurring in the future. These lessons require in part, but only in part, additional actions to be taken by Congress. In many instances the lessons to learn are best left to the individual states or to local governments. In some contexts actions are required by the federal government but in a way that preserves discretion in state or local governments to undertake additional actions.

I. Responding to the Immediate Foreclosure Crisis

1. Mortgage Amounts and Property Values. A major contributing factor to the current crisis is that borrowers and lenders made loans based on completely unrealistic assumptions about ever rising property values. It has also quickly become clear that in the face of rising delinquencies and foreclosures all of the programs and hopes for loan modifications were largely in vain. Whether found in the justifications for the original bailout bill one year ago,[4] or in the attempts by the Departments of Treasury and Housing & Urban Development to achieve large scale modifications of residential loans,[5] there are simply too many structural barriers in the nature and function of the secondary mortgage market to allow modifications to occur in significant volume. The presence of a second mortgage creates a virtually insurmountable obstacle to a voluntary modification of a first mortgage. The structure of most Pooling and Servicing Agreements creates major disincentives for more than minimal modifications of the mortgages in a loan pool. What lies behind all of these structural barriers and failed attempts is the refusal to acknowledge that the aggregate mortgage debt on a residence exceeds the fair market value of the property. When a property is "below water" every party with an interest in the property seeks to push the loss to other party and has no incentive to share in reallocating the losses and stabilizing the loan. When property values begin to decline it quickly becomes a spiral as parties push the losses to others.

The single most important lesson to learn is that loan modifications simply will not occur when the debt exceeds the value of the property. Single and multiple mortgagees must be given a reason to modify loan at current values, and the simplest and easiest method to accomplish this is by amending the Bankruptcy Code to grant authority

---

[4] Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343.

[5] See, e.g., the Home Affordable Modification Program, http://www.makinghomeaffordable.gov/

to bankruptcy courts to reduce the level of mortgage debt to the value of the property.[6] At the present time bankruptcy courts can modify reduce the value of loans on commercial property, on cars, on boats, but not on residential properties. This differential treatment does not protect homeowners or increase home loans; instead it creates precisely the crisis we face today – of massive residential mortgage foreclosures and futile attempts to modify the loans to acceptable levels. The lesson to learn is that the residential mortgage carve-out in bankruptcy law contributes to the crisis rather than solves the problem.

2. Lack of Accurate Data. One of the most surprising lessons to learn from the current mortgage crisis is that we simply know very little about the mortgages with high rates of delinquency, default, and foreclosure. Virtually all of the data is based on the characteristics of the mortgage at the time there were created, not as they exist at the time the mortgage goes into default or foreclosure. For example, there is simply no data available anywhere on the percentage of mortgages in foreclosure that are owner-occupied, are tenant occupied, or are entirely unoccupied s of default and foreclosure. We really don't know – of the tens of thousands of condominiums in Miami or the ten thousand properties scheduled for foreclosure tomorrow Atlanta, how many are today providing shelter to owners and tenants or are vacant investment properties. Due to the variations in foreclosure procedures between the states, we also have very little accurate data on the number of foreclosure sales that actually occur, and whether these are foreclosures of senior mortgages or junior mortgages. It is quite difficult to design appropriate responses to a crisis when we have so little empirical knowledge about the foreclosures that are occurring. The lesson to lean is that Congress and federal banking regulators need to require submission of accurate data about occupancy and ownership of the mortgages in foreclosure *as of the time of foreclosure*.

3. Who is Foreclosing? The dramatic growth in the secondary mortgage market, both through the government sponsored enterprises and private label securitizations, has led a striking lack of accurate information on one of the most basic points: When a mortgage goes into foreclosure who has legal authority to enforce the mortgage? The Mortgage Electronic Registration System (MERS) was created over a decade ago by Fannie Mae, Freddie Mac and large private banks to facilitate secondary mortgage market transactions. Unfortunately, however, it was created largely without regard to state real property laws and the requirements applicable to mortgage transfers and foreclosures. The presence of MERS, together with the highly fractured nature of the secondary mortgage market, result in foreclosures being initiated by entities that lack the legal authority to foreclosure, by parties that have no knowledge of who owns the promissory note or where it is, and by parties that have no accurate records of payment histories. In state courts throughout the country and in federal bankruptcy courts in every

[6] At present a bankruptcy court lacks the authority to modify the basic terms of a residential mortgage. 11 U.S.C. §13322(b)(2).

judicial district, borrowers and judges can't get simple answers to this direct question of who has legal authority to foreclose? This lesson points to a straightforward solution of requiring – as a precondition to foreclosure proceedings – that the entity seeking to foreclose be able to demonstrate either ownership of the promissory note and the security instrument in a manner consistent with state law requirements, or full authority to act on behalf of the owner, also in a manner consistent with state law requirements.

4. Foreclosure Notices to Occupants. The majority of states in this country permit nonjudicial foreclosures which are accomplished primarily by publishing notice in a newspaper and selling the property at an auction. Though mortgage documents and state laws may require that notice be given to the debtor, actual notice of the default and pending foreclosure is rarely if ever given to the individuals and families who may live in the property as tenants. Last May Congress enacted the Protecting Tenants at Foreclosure Act of 2009,[7] in recognition of the harsh consequences of foreclosures upon tenants. What this federal act failed to do, and what most state laws fail to provide, is that notice of a pending foreclosure be given not just to the debtor under the mortgage but to all persons occupying the property as well.

The federal Protecting Tenants at Foreclosure Act is in many ways the most direct federal restructuring of mortgage foreclosure law in our history. It is the clearest example of Congress setting a national minimum standard for the protection of the rights of innocent parties who have no responsibility whatsoever for the financial transaction, yet who bear the brunt of the tragedy of foreclosure by eviction. While an important step to be taken, this federal act needs further clarification in the months and years to come. For example, clarification is needed of the form of notice to be given to tenants, the timing of commencement of the ninety-day period for the notice, and the terms and conditions of the lease that survive the foreclosure sale. In a manner that is a most positive and constructive example of the proper relationship between federal law and state law, this Act only sets a minimum floor on tenant protections and expressly permits states to apply greater or more extensive protections in the discretion of the state.[8]

II. Mitigating the Impact of the Foreclosure Crisis on Others

5. Neighborhood Stabilization. Congress has now provided almost $6 billion dollars in assistance to state and local governments for the acquisition of vacant foreclosed properties.[9] Though it may have made sense in light of the perceived

[7] Title VII of Helping Families Save Their Homes Act of 2009, Pub. L. 111-22 (701), 123 Stat. 1632 (701).

[8] Sec.702(a), Title VII, Title VII of Helping Families Save Their Homes Act of 2009, Pub. L. 111-22 (701), 123 Stat. 1632 (701).

[9] Of this amount, $3.92 billion was allocated through the Housing and Economic Recovery Act of 2008, and an additional $1.98 billion through the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5.

economic conditions at the time of its passage, the increased magnitude of the mortgage foreclosure crisis reveals that the statutory constraints on the use of these Neighborhood Stabilization Program funds is far too limited. For example, restricting the use of the funds to foreclosed properties only, and not properties that have been abandoned without foreclosure, severely constrains the flexibility of some jurisdictions to use the funds most effectively. The lesson to learn here is that the Secretary of Housing & Urban Development must be granted authority and discretion to modify the program requirements as most appropriate to meets the needs of a local jurisdiction.

6. <u>Require HUD Properties to Comply with Local Laws</u>. The inventory of properties owned by HUD has grown significantly as a result of the mortgage foreclosure crisis. As local governments seek to reduce the harmful effects of vacant and abandoned properties they are increasing their efforts at enforcement of their ordinances aimed at properties that fail to comply with minimum nuisance abatement and housing and building codes. The question that remains surprisingly open today is whether HUD will take action to ensure that its own inventory of foreclosed properties complies with these local laws. Thus far Congress has only expressly declared all property taxes must be paid on HUD properties,[10] and has delegated to the Secretary of HUD discretion on whether to comply with local property maintenance and property condition ordinances.[11] In its present form the HUD policy handbook provides only that field offices *may* undertake property repairs,[12] but it imposes no obligation to bring the properties into compliance with local laws. The lesson to learn is that if HUD is to pursue its stated goal of supporting community development,[13] it must be part of the solution rather than part of the problem, and this can be accomplished either by an exercise of the Secretary's delegated discretion, or by a congressional amendment to the National Housing Act. Al HUD properties should comply with local laws related to the conditions of the property.

7. <u>Ownership of Foreclosed Properties</u>. In strong real estate markets there are market incentives to record foreclosure deeds promptly after a foreclosure sale. In weak real estate markets the reverse is true and many jurisdictions lack any statutory requirement for the recording of foreclosure sale deeds, or deeds in lieu of foreclosure,

---

[10] 12 U.S.C. § 1714.

[11] 12 U.S.C. § 1710(g).

[12] U.S. DEP'T OF HOUSING & URBAN DEV., 4310.5, PROP. DISPOSITION HANDBOOK – ONE TO FOUR FAMILY, ch. 10, sec. 3, pt 10-11.

[13] http://portal.hud.gov/portal/page/portal/HUD/about/mission (Full text of the mission statement: "HUD's mission is to increase homeownership, support community development and increase access to affordable housing free from discrimination. To fulfill this mission, HUD will embrace high standards of ethics, management and accountability and forge new partnerships--particularly with faith-based and community organizations--that leverage resources and improve HUD's ability to be effective on the community level.").

within any specific period of time. This has two negative consequences. The first is that there is no public record (at least in nonjudicial foreclosure states) of whether a foreclosure sale actually occurred, and we are now seeing increased instances of foreclosures that are commenced but not completed as a lender decides at the last minute that it is not in its interest to complete the foreclosure. The second is that when the sale does occur the lender that now holds the "REO" is able to avoid public scrutiny – and public liability – for the post-foreclosure conditions of the property. The lesson to learn is that involuntary transfers of property as a result of foreclosures must be filed in the local real property records immediately after the sale.

8. Foreclosure Assessments. Foreclosures impose costs not just on owners, tenants, and lenders, but also on neighbors, neighborhoods, and communities. The costs to the public at large, and to local governments in particular, are dramatic. Local government expenditures for police and fire protection and code enforcement activities increase sharply precisely when tax revenues decline. The lesson to learn is that our current system significantly understates the costs of foreclosures imposed on others. The simplest and most direct solution is to impose a specific dollar assessment on the filing of each and every foreclosure sale deed, payable to the local government as revenue dedicated to covering the costs it incurs.

9. Vacant Property Registration Ordinances. The significant cost of vacant and abandoned properties post-foreclosure is a challenge that most jurisdictions have not faced in our lifetimes. Neighborhoods and local governments need a mechanism which permits them to know immediately the owner, or at least the identity of the entity with management control, of the property. The lesson to learn is that in weak market conditions owners will neglect their responsibilities and impose the costs on the rest of the community. A state statute, or local ordinance, that requires notification to public officials of properties that remain vacant and unoccupied for more than short period of time will allow access to those who are responsible for the property, and opportunity to levy fines and assessments for harmful conditions.

10. Property Taxes. The untold story of the current mortgage foreclosure crisis is its relationship to property taxes, which are the largest single source of general revenues for most local governments. We are now learning that many residential mortgages were originated without a requirement for monthly escrows of property taxes, partially to qualify the borrowers at lower monthly payments, and as a result property tax delinquencies are rising. We are also learning that the failure to record promptly foreclosure deeds results in homestead exemptions remaining on properties when the property is no longer legally eligible for the exemption. Finally, we are realizing that most state property tax foreclosure laws remain grounded in 19th Century traditions and fail to comply with 20th Century constitutional requirements of due process. These lessons prompt the need for (i) mandatory escrows for real property taxes in all residential mortgages, (ii) notice to be given immediately following a foreclosure sale by

the foreclosing lender to local tax assessors of each completed foreclosures, and (iii) property tax foreclosure reform.

III. Avoiding Reoccurrence in the Future

11. Prohibit Inherently Dangerous Products. The backdrop of the current mortgage foreclosure crisis is a generation of a completely deregulated and unregulated market in residential mortgages. No other aspect of American life which is at the core of our daily lives is left so entirely to the vicissitudes of the market. It is now evident that, as in most every aspect of commerce, there are certain products that are inherently dangerous. Very few residential borrowers understand the ramifications of negative amortization, prepayment penalties, balloon payments, teaser rates of interest and the host of related exotic mortgage attributes. Very few residential borrowers can project debt coverage ratios or know when a mortgage is essentially asset based rather than income justified. The lesson to learn is that, at least as to a certain range of residential borrowers, only a small narrow range of standard mortgage products should be permitted. Teaser rates, negative amortization, prepayment penalties, and balloon payments should be simply and explicitly prohibited as a matter of law.

12. A Federal Minimum Floor. The chaos that fueled the mortgage boom at the close of the twentieth century, and the bust of the last two years, is directly attributable to the absence of any regulation at either the state or the federal levels. Every attempt by local governments, or state governments, to impose constraints was met with swift federal preemption. Unlike other forms of federal displacement of state laws, federal preemption in real estate finance has been displacement of state laws without the substitution of federal laws. It has been preemption by a "null set". In the move towards creating a more rationale and stable mortgage market in the future, the lesson to learn is that the proper role for the federal government is to enact federal minimum standards for residential mortgages, but allow states the discretion to establish standards above that floor. There should be no federal preemption of state laws above the minimum federal floor.

13. Reinvigorate Mortgage Insurance. One of the most puzzling features of the current mortgage crisis is the silence of the mortgage insurance industry. For eighty years mortgage insurance – whether in the form of FHA, VA, or private mortgage insurance – provided the necessary assurance to capital markets of stability and risk allocation. The relative silence in the secondary mortgage market liquidity crisis of the past year suggests perhaps that the industry as a whole elected to cease requiring mortgage insurance on individual mortgages, preferring instead to rely upon hopes that credit default swaps and implicit federal guarantees would cover the risk. The lesson to learn is what happened to the historical requirement of mortgage insurance on residential loans.

If mortgage insurance (presumptively private mortgage insurance) were required on all residential mortgages in which the aggregate debt to value ratio exceeds eighty percent (80%), and was made applicable to all of the mortgages (first and second) that comprised the aggregate debt, there would be a return to stability in risk allocation. There would also emerge a new role for the mortgage insurance industry in becoming the primary voice for rating of mortgage backed securities. No industry would know or understand delinquencies, default, and foreclosures better than the industry that calculates premiums and covers losses. The lesson to learn is that relying on credit rating industries that have no stake in the outcome is hardly preferable to industries that are required to cover the losses when they occur.

14. The Federal "Conforming" Mortgage. For sixty years the standard form "conforming" mortgage instruments of Fannie Mae and Freddie Mac provided the base line for residential mortgages and facilitated the emergence of both the public and private secondary mortgage markets. The current mortgage crisis reveals that departure from the relatively safe harbors of the conforming loan documents places at risk not just Fannie Mae and Freddie Mac, but the entire mortgage industry. Regardless of the ultimate outcome of the current conservatorship of Fannie Mae and Freddie Mac, the lesson to learn is the important role of conservatively drafted, tightly underwritten, standard form approaches to residential finance. The public agencies should not displace the private mortgage industry, but should instead return to purchase and securitization of a narrow range of conforming mortgages. An additional lesson to learn from this crisis is that even the conforming loan documents need further revision. The ability of homeowners and private lenders to repeatedly withdraw all equity from homes by home equity lines of credit cries out for the inclusion of a "Due-on-Encumbrance" clause in the standard form document which would prohibit, or at least limit, the withdrawal of home equity at ATM machines.

15. Anti-Deficiency Legislation. Markets behave irrationally when parties can impose costs on others or ignore the future consequences of present behaviors. A mortgage loan should be based on the income of the borrower and the value of the security. In most jurisdictions, however, it is also based on a belief that in the event of a default the lender can sue the borrower personally if the value of the property is not sufficient to cover the debt. One of the lessons learned from the Great Depression is that by enacting "anti-deficiency" legislation, lenders realized that their only recourse would be to foreclose on the property. This, in turn, placed far greater emphasis on a lender's accurate estimation of the value of the property, and its determination of a reasonable loan to value ratio. The lesson to learn from the current "Great Recession" is that we completely lost sight of the importance of accurate appraisals of home values. If more states adopted the approach, currently found in some states, of prohibiting deficiency actions in residential mortgage transactions, rational calculations of home value would return to the market place in mortgage originations. If anti-deficiency legislation widely existed today at the state level we would see a much higher percentage of loan

modifications occurring for troubled loans, as net present value calculations under Pooling and Servicing Agreement would be capped at real property valuations.

Conclusion

Every crisis presents both a need for an immediate response, but also the opportunity to learn. If we do not see in each and every crisis the opportunity to realize our mistakes and to prepare for the future, then we will have failed in our response. Over the past twenty years we failed to remember the lessons of our parents that we should not "bet the house", or "mortgage our future". We have now done both. Let us respond to the immediacy of this current crisis, but in a way in which we can identify and claim the lessons to learn from it both for ourselves and our future generations.

I deeply appreciate the work of this Domestic Policy Subcommittee, the time you are taking to conduct these hearings across the country, and the actions you have taken and will be taking on behalf of the entire county. I thank you also for the privilege and honor of appearing before this Subcommittee to share these thoughts.

Frank S. Alexander
Professor of Law
Emory University School of Law
Frank.Alexander@Emory.edu
404.727.6982