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Modify This! — Policymakers Are Wrong to Push for Loan Modifications to Help Defaulted Borrowers

Introduction

Loan modifications for defaulted sub-prime mortgage loans have become a hot topic over the past several months. Policymakers have called for lenders to make greater use of loan modifications in order to help defaulted borrowers keep their homes. We think that this is wrong. The only proper purpose of loan modifications is for lenders to mitigate losses that they would otherwise suffer from defaulted loans. The fact that a loan modification allows a defaulted borrower to keep his home is irrelevant – it should not be a consideration. The only consideration should be the lender's/investor's economic interest.

Discussion

On May 2, Senator Chris Dodd convened a "homeownership preservation summit" and invited a selection of key mortgage industry players. The senator proposed a *Statement of Principles* that urges lenders to use loan modifications to help defaulted borrowers. It states as follows:

Modify to Create Longterm Affordability: If the borrower cannot afford the reset payment (as described above), servicers should seek to modify loans prior to the reset. ***The objective of the modification should be to create a permanent solution for the borrower to ensure that the loan is sustainable for the life of the loan rather than, for example, deferring the rate reset period.*** Such modification options should include, as appropriate, one or more of the following:

- **Change of terms.** Switching from an adjustable to a fixed rate loan at an affordable rate by, for example, making the introductory rate permanent.
- **Reduce the interest rate.** Reducing the interest rate is one way to assist a borrower to afford the mortgage. Ability to repay should take into account the borrower's total debt-to-income ratio, including factoring in the costs of taxes and insurance.
- **Reduce principal.** Reducing the principal in order to ensure affordability and a continued revenue stream on the loan.
- **Reamortize the loan.** Reamortizing the loan to account for any changed loan terms or to make the payments more affordable.
- **Escrows.** If possible, servicers should begin to escrow for taxes and insurance as part of the modification process to ensure the home loan will remain sustainable for the life of the loan.¹

¹ U.S. Senate Committee on Banking, Housing, and Urban Affairs, Homeownership Preservation Summit, *Statement of Principles* (2 May 2007) (emphasis added), http://banking.senate.gov/files/050207_summitprinciples.pdf.

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Senator Dodd pushed the summit participants to agree to the *Statement of Principles*. On May 4, just two days after the summit, the senator's website announced that "[a]ll of the organizations that participated in the Summit have now endorsed the principles."² Those organizations included the following:

- Bear Stearns
- Citigroup
- Countrywide Financial Corp.
- Fannie Mae
- Freddie Mac
- HSBC
- JPMorgan Chase
- Litton Loan Servicing
- Mortgage Bankers Association
- Wells Fargo

By pushing the organizations to endorse the *Statement of Principles*, Senator Dodd arguably was asking some of them to violate (i) their fiduciary duties to their shareholders and (ii) their contractual duties to third-party investors for whom they service loans. When a corporation services loans for itself, its duty to shareholders arguably means that it should seek the best economic recovery on loans that default. A borrower's desire to keep his home would be a consideration only if the servicer believed that it could affect future business opportunities (either with the borrower or with others by virtue of positive publicity).

When a company services mortgage loans for third parties, its servicing duties are governed by a contract. Such contracts typically specify that a loan servicer shall service the subject mortgage loans "in the same manner in which it services and administers similar mortgage loans for its own portfolio, giving due consideration to customary and usual standards of practice of mortgage lenders and loan servicers administering similar mortgage loans..."³ Thus, same servicing practices should apply to loans serviced for third parties as for loans that a company services for itself.

The organizations represented at Senator Dodd's summit surely understand their obligations to their shareholders and investors. Nonetheless, the fact that the organizations endorsed the *Statement of Principles* is not very surprising. Pressure from a U.S. senator is hard to resist. One can only hope that the organizations were not sincere in endorsements; that they plan instead to fulfill their duty to shareholders and investors.

Unfortunately, even if the organizations service loans in a manner fully consistent with their duties to shareholders and investors, the fact that they expressly endorsed the *Statement of Principles*, may drag them into litigation. Litigious shareholders or investors, who suffer losses from defaulted loans, may try to use the a company's endorsement as an "admission" or a "statement against interest" in a lawsuit.

The fact that a mortgage servicer does not (and should not) help a borrower to keep his home does not make the company wicked or mean. The lender-borrower relationship is a commercial relationship. It has nothing to do with either "meanness" or "niceness." The problem with Senator Dodd's *Statement of Principles* is that he is attempting to introduce the notion of niceness into purely commercial relationships. Neither meanness nor niceness has any place in such relationships.

Unfortunately, Senator Dodd is not the only policymaker pushing for niceness. FDIC Chairman Sheila Bair is doing the same thing. For example, in her keynote address at the June 6 meeting of the American Securitization Forum, Chairman Bair stated as follows:

² *Senator Dodd Commends Wells Fargo's Agreement to Principles*, press release (4 May 2007), <http://dodd.senate.gov/index.php?q=node/3868>. See also <http://dodd.senate.gov/index.php?q=node/3870/print> (indicating that the American Financial Services Association and Option One Mortgage Corp. also had endorsed the *Statement of Principles*).

³ See e.g., Option One Mortgage Loan Trust 2006-2, Pooling & Servicing Agreement § 3.01 (1 Jun 2006).

I also want to highlight the principle that specifically encourages servicers to conduct modifications that are in the best interest of the borrower. This principle alone should ensure that the borrower's needs are not subordinate to the interests of everyone else.⁴

More than 200 years ago, James Madison, who later became the fourth President of the U.S., characterized the "abolition of debts" as an "improper or wicked project." He argued that New Yorkers should ratify the Constitution because the Union would safeguard Americans from improper laws that might be passed by a particular faction. He stated:

A rage for paper money, **for an abolition of debts**, for an equal division of property, or for any other improper or wicked project, will be less apt to pervade the whole body of the Union than a particular member of it...⁵

Policymakers today should heed Madison's words. Aside from the Bankruptcy system, Government should not interfere with lawful commercial relationships. We think that pushing lenders to transfer wealth to borrowers through loan modifications is improper. Any law requiring that result arguably would violate the contracts clause of the Constitution (Art. I, Sec. 10). Moreover, such a law might broadly undermine confidence in the durability of all sorts of commercial relationships.

The bottom line is this: Loan modifications should be just for mitigating losses – nothing else. Remember, it's not personal, it's just business.

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⁴ Remarks of FDIC Chairman Sheila C. Bair, American Securitization Forum (ASF) Annual Meeting (6 Jun 2007) <http://www.fdic.gov/news/news/speeches/chairman/spjun0607.html>.

⁵ James Madison, Federalist No. 10 (23 Nov 1787) (emphasis added). Interestingly, property rights and the protection of wealth figured heavily into Madison's rhetoric:

The diversity in the faculties of men, from which the rights of property originate, is not less an insuperable obstacle to a uniformity of interests. The protection of these faculties is the first object of government. From the protection of different and unequal faculties of acquiring property, the possession of different degrees and kinds of property immediately results; and from the influence of these on the sentiments and views of the respective proprietors, ensues a division of the society into different interests and parties.

* * *

But the most common and durable source of factions has been the various and unequal distribution of property. Those who hold and those who are without property have ever formed distinct interests in society. Those who are creditors, and those who are debtors, fall under a like discrimination. A landed interest, a manufacturing interest, a mercantile interest, a moneyed interest, with many lesser interests, grow up of necessity in civilized nations, and divide them into different classes, actuated by different sentiments and views.

Id.

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