

Questions for the Hearing on “Problems in Mortgage Servicing From Modification to Foreclosure”

November 16, 2010

Answers from Diane E. Thompson, National Consumer Law Center

Questions for Ms. Diane Thompson, on behalf of the National Consumer Law Center, from Ranking Member Shelby:

1. Ms. Thompson, you conclude your testimony by calling for legislation or regulations to “reform the servicing industry, to allow for loan modifications in bankruptcy, and to address the tax consequences of loan modifications...” These actions would, according to you, “aid in protecting homeowners from indifferent and predatory servicing practices and reducing the foreclosure surge.” When analyzing effects of alternative possible actions that would affect the mortgage and housing markets, you focus on protecting homeowners. Indeed, such a focus is welcome and warranted. There is also, of course, a need to consider effects of any action on securities holders, including retirement funds that help provide interest and other income to retirees who continue to struggle in the current zero-interest rate environment to live off of the assets they accumulated during their working years.

Ms. Thompson, could you discuss the economic, financial, and distributional analysis you have performed to arrive at the policy recommendations that you provide in your conclusion?

Answer:

You correctly note that my analysis focuses on the homeowners. The interests of homeowners have been, in my view, almost entirely overlooked during the foreclosure crisis. This is particularly unfortunate since it is the failure to pay attention to those interests and reduce the foreclosure rate that has caused the economic recession.¹ Preserving homeownership, where economically appropriate, has a net positive benefit for the society at large and the unnecessary destruction of homeownership hurts the rest of us from an economic and financial perspective.

¹ See, e.g., Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, Speech at the Federal Reserve System Conference on Housing and Mortgage Markets: Housing, Mortgage Markets, and Foreclosures (Dec. 4, 2008) [hereinafter Bernanke, Speech at Federal Reserve], available at <http://www.federalreserve.gov/newsevents/speech/bernanke20081204a.htm> (“Despite good-faith efforts by both the private and public sectors, the foreclosure rate remains too high, with adverse consequences for both those directly involved and for the broader economy.”).

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The impact of the foreclosure crisis has damaged the financial interests of many constituencies in this country, including securities holders. Aside from the indirect financial harm caused by the scale of the financial crisis—the weak economy, the slumping interest rates, the outright collapse of many securities—foreclosures hurt all homeowners in the communities in which they occur. Violent crime increases in neighborhoods with increased foreclosures—at twice the rate of the increase in the foreclosure rate.² Surrounding neighbors watch their housing values plummet and their insurance costs increase.³ The losses to communities in taxes are staggeringly high, amounting to millions to billions of dollars in lost taxes.⁴ For securities holders who own homes, or pay taxes, or live in neighborhoods with increasing crime, their interests are not distinct from those of homeowners subject to foreclosure.

² Dan Immergluck & Geoff Smith, *The Impact of Single-Family Mortgage Foreclosures on Neighborhood Crime*, 21 Housing Studies 851 (2006), available at www.prism.gatech.edu/~di17/housingstudies.doc (calculating that for every 1% increase in the foreclosure rate in a

census tract there is a corresponding 2% increase in the violent crime rate).

³ See, e.g., Ctr. for Responsible Lending, *Soaring Spillover: Accelerating Foreclosures to Cost Neighbors \$502 Billion in 2009 Alone; 69.5 Million Homes Lose \$7,200 on Average (2009)*, available at www.responsiblelending.org/mortgage-lending/research-analysis/soaring-spillover-acceleratingforeclosures-to-cost-neighbors-436-billion-in-2009-alone-73-4-million-homes-lose-5-900-onaverage.html (estimating losses to neighboring property values due to the foreclosure crisis at \$1.86 trillion dollars); John P. Harding, Eric Rosenblatt, Vincent W. Yao, *The Contagion Effect of Foreclosed Properties*, J. of Urban Econ. (forthcoming), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1160354 (finding a 1.2% drop in market value for each additional neighboring home in foreclosure; effect drops to 0.6% if property in foreclosure is one-eighth of a mile away); Dan Immergluck & Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, 17 Housing Pol’y Debate 57, 69, 75 (2006) (“for each additional conventional foreclosure within an eighth of a mile of a house, property value is expected to decrease by 1.136 percent”; estimating total impact in Chicago to be between \$598 million and \$1.39 billion).

⁴ See, e.g., Staff of the Joint Economic Comm., 110th Cong., 1st Sess., *The Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues, and How We Got Here (2007)*, available at http://jec.senate.gov/index.cfm?FuseAction=Reports.Reports&ContentRecord_id=c6627bb2-7e9c-9af9-7ac7-32b94d398d27&Region_id=&Issue_id= (projecting foreclosed home owners will lose \$71 billion due to foreclosure crisis, neighbors will lose \$32 billion, and state and local governments will lose \$917 million in property tax revenue); William Apgar & Mark Duda, *Collateral Damage: The Municipal Impact of Today’s Mortgage Foreclosure Boom*, at 4 (May 11, 2005), available at www.hpfonline.org/PDF/Apgar-Duda_Study_Final.pdf (estimating costs to the City of Chicago per foreclosure upwards of \$30,000 for some vacant properties).

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Retirees are themselves often homeowners,⁵ and all too often subject to abusive lending and foreclosure.⁶ For many retirees, their home is their largest asset—of far more importance to their financial (not to mention psychological and social) well-being than their pension funds invested in derivatives. The interests of retirees, as a class, are not substantially different from the interests of homeowners, as a class.

Retirees, like all securities holders, have watched servicers strip wealth from them by piling on unnecessary and excessive fees in foreclosure.⁷ The servicer can either collect these fees from the homeowner—reducing the likelihood of a successful modification—or collect them from monies otherwise payable to the trust upon the conclusion of a foreclosure. Either path leaves securities holders poorer. Servicing reform benefits all stakeholders in the system—except, of course, to the extent that servicing reform prevents servicers themselves from profiting at the expense of both homeowners and securities holders. Our specific proposals focus on providing a net benefit to investors as well as homeowners. You cite three proposals: reform of the servicing industry, allowing loan modifications in bankruptcy, and addressing tax consequences for homeowners. Our recommendations include requiring servicers to modify loans where doing so would provide a net benefit to the investor. There is considerable evidence that servicers fail to modify loans, even when the investor would benefit from a modification. Investors, including pension funds, lose dramatically when servicers fail to modify loans and foreclose instead. The foreclosure will in many cases cut off the flow of

⁵ U.S. Census Bureau, Housing Vacancies and Homeownership T 17 (2009), *available at* <http://www.census.gov/hhes/www/housing/hvs/annual09/ann09ind.html> (reporting that the 2009 homeownership rates for Americans 65 and over was 80.5%).

⁶ AARP Public Pol’y Inst., A First Look at Older Americans and the Mortgage Crisis 5 (2008), http://assets.aarp.org/rgcenter/econ/i9_mortgage.pdf. Cf. Ellen E. Schulz & Theo Francis, *High-Interest Lenders Tap Elderly, Disabled*, Wall St. J., Feb. 12, 2008 (reporting that payday lenders concentrate their outlets around subsidized elder housing).

⁷ See, e.g., Jody Shenn, *Mortgage Investors with \$500 Billion Urge End of Practices*, *Lawyer Says*, Bloomberg News, July 23, 2010, <http://www.bloomberg.com/news/2010-07-23/mortgage-investors-with-500-billion-urge-end-of-practices-lawyer-says.html> (reporting on letters sent to trustees of mortgage pools on behalf of a majority of the investors in the pool); Complaint, Carrington Asset Holding Co., L.L.C. v. American Home Mortgage Servicing, Inc., No. FST-CV 09-5012095-S (Conn. Super. Ct., Stamford Feb. 9, 2009) (complaint alleges that servicer’s practices regarding fees and post-foreclosure sales were costly to investors); Ass’n of Mortg. Investors Press Release, *AMI Supports Long Term, Effective, Sustainable Solutions to Avert Foreclosure*; Invites Bank Servicers to Join, Nov. 16, 2010 (citing servicers’ profit from fees and payments from affiliates as an impediment to loan modifications that would be in the interests of investors); Letter from Kathy D. Patrick to Countrywide Home Loans Servicing, Oct. 18, 2010 (notifying a trust and master servicer of breaches in the master servicer’s performance).

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payments to the ultimate beneficiaries of the trust, who are often, as you note, retirees, dependent on that income to maintain a comfortable standard of living. Available data suggests that those retirees and other investors are losing, on average, over \$145,000 per foreclosure.⁸ They would do much better if more loan modifications were made.

Servicers’ fee-gouging hurts securities holders. Fees come off the top in a foreclosure: servicers get paid before the investors do.⁹ When times are good, and equity in homes is increasing, securities holders can afford to ignore fees. Indeed, until recently, the impact of servicers’ fee-skimming was largely invisible to investors.¹⁰ But with one in four homes underwater,¹¹ and foreclosures at an all time high, the cost of those fees is reducing investors’ profits.¹²

⁸ See Alan M. White, Sept. 26, 2010 Columbia Collateral File Summary Statistics, http://www.valpo.edu/law/faculty/awhite/data/sep10_summary.pdf.

⁹ See, e.g., Prospectus Supplement, Chase Funding Loan Acquisition Trust, Mortgage Loan Asset-Backed Certificates, Series 2004-AQ1, at 34, (June 24, 2004), available at <http://www.sec.gov/Archives/edgar/data/825309/000095011604003012/four24b5.txt> (“[T]he Servicer will be entitled to deduct from related liquidation proceeds all expenses reasonably incurred in attempting to recover amounts due on defaulted loans and not yet repaid, including payments to senior lienholders, legal fees and costs of legal action, real estate taxes and maintenance and preservation expenses.”); Prospectus, CWALT, INC., Depositor, Countrywide Home Loans, Seller, Countrywide Home Loans Servicing L.P., Master Servicer, Alternative Loan Trust 2005-J12, Issuer 56 (Oct. 25, 2005) (“In addition, generally the master servicer or a sub-servicer will retain all prepayment charges, assumption fees and late payment charges, to the extent collected from mortgagors”); Prospectus Supplement, IndyMac, MBS, Depositor, IndyMac INDX Mortgage Loan Trust 2007-FLX5, at S-73 (June 27, 2007):

Default Management Services

In connection with the servicing of defaulted Mortgage Loans, the Servicer may perform certain default management and other similar services (including, but not limited to, appraisal services) and may act as a broker in the sale of mortgaged properties related to those Mortgage Loans. The Servicer will be entitled to reasonable compensation for providing those services, in addition to the servicing compensation described in this prospectus supplement.

Letter from Kathy D. Patrick to Countrywide Home Loans Servicing, Oct. 18, 2010 (notifying a trust and master servicer of breaches in the master servicer’s performance).

¹⁰ E.g., Peter S. Goodman, *Lucrative Fees May Deter Efforts to Alter Troubled Loans*, N.Y. Times, July 30, 2009.

¹¹ First American Core Logic Negative Equity Report Q22010, available at http://www.corelogic.com/uploadedFiles/Pages/About_Us/ResearchTrends/CL_Q2_2010_Negative_Equity_FINAL.pdf.

¹² See, e.g., Jody Shenn, *Mortgage Investors with \$500 Billion Urge End of Practices*, Lawyer Says, Bloomberg News, July 23, 2010, <http://www.bloomberg.com/news/2010-07-23/mortgage-investors-with-500-billion-urge-end-of-practices-lawyer-says.html> (reporting on letters sent to trustees of mortgage pools on behalf of a majority of the investors in the pool); Complaint, Carrington Asset Holding Co., L.L.C. v. American Home Mortgage Servicing, Inc., No. FST-CV 09-5012095-S (Conn. Super. Ct., Stamford Feb. 9, 2009) (complaint alleges that servicer’s practices regarding fees and post-foreclosure sales were costly

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The reforms we propose are either directly beneficial or neutral for securities holders, in addition to the important positive impacts these reforms would have in stabilizing the housing market and the larger economy.

Comprehensive servicing reform has two primary components: requiring servicers to offer homeowners a modification where the modification would provide a net benefit to the securities holders and limiting fees to those both reasonable and necessary. Securities holders, as much as homeowners, stand to benefit from both those reforms.

Currently, there is only one type of lien that bankruptcy judges can never modify in any way: first liens on single-family principal residences. Loans on vacation homes, boats, cars, and corporate collateral can be modified. Even junior liens on single-family principal residences can be modified if they are wholly underwater, as many are today. By contrast, first liens on principal residences cannot be reduced to the value of the security interest and the interest rate cannot be changed. Securities holders, however, have not suffered larger losses from the modification of these other secured loans than they have from the foreclosure of home loans: it is the large losses on home loans that have driven the current economic crisis.

Judicial modification of secured liens often provides creditors (and any ultimate securities holders) with a better return than foreclosure. Creditors do not have to absorb the same losses in bankruptcy as they do with a forced foreclosure sale, with its below market price and out-of-pocket expenses. If bankruptcy courts were permitted to modify first-lien loans on primary residences by reducing the secured balance to the value of the property, securities holders would not be saddled with losses as a result of below market prices and mortgage servicers' foreclosure costs. Instead, securities holders, who are suffering catastrophic losses now, would receive a stable flow of income from borrowers able to make ongoing payments on the reduced principal balance. Significantly, judicial modification in bankruptcy is limited to reducing the loan to the actual current value of the home; moreover, bankruptcy judges also have long experience balancing the claims of competing creditors to maximize returns to creditors. Losses to security holders, borrowers, and communities

to investors); Ass'n of Mortg. Investors Press Release, AMI Supports Long Term, Effective, Sustainable Solutions to Avert Foreclosure; Invites Bank Servicers to Join, Nov. 16, 2010 (citing servicers' profit from fees and payments from affiliates as an impediment to loan modifications that would be in the interests of investors); Letter from Kathy D. Patrick to Countrywide Home Loans Servicing, Oct. 18, 2010 (notifying a trust and master servicer of breaches in the master servicer's performance).

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would likely be lower if bankruptcy judges had the power to modify residential home loans.

Addressing the tax consequences of loan modifications is unlikely to have any significant impact on securities holders or on the fisc. Few lay people believe that a reduction in the value of a loan to its fair market value is taxable income; indeed, existing exceptions to the general rule that any reduction in the value of a loan is taxable income mean that homeowners who have access to a competent tax attorney or CPA are likely to be able to exclude that imputed value from income, but these exceptions, and the reporting forms are sufficiently complicated that unrepresented homeowners are unlikely to be able to avail themselves of the exception. The National Taxpayer Advocate has repeatedly identified the treatment of cancellation of debt income as a serious problem.¹³

The proposals outlined in my November testimony are designed to align the interests of the servicers with those of investors and society at large, so that modifications will be made when doing so provides a net benefit. In this distributional analysis, it is only the servicers who lose. Servicers have made more money per loan in the recent times, precisely while securities holders are suffering steep losses from foreclosures.¹⁴ The servicers, when loan modifications that produce a net benefit to the investor are required before foreclosure, when servicing reform limits their ability to strip equity by piling on fees, and when bankruptcy judges have the power to force modifications that leave securities holders better off, will have to find a different business model. Instead of using default fees to cushion the cost of default, they will have to learn to make modifications and save money for both investors and homeowners. This is not an impossible goal: indeed, specialty servicers have long proclaimed their ability to make money by doing modifications.¹⁵ Servicers should not be allowed to strip wealth from both securities holders and homeowners but should be required to provide service to both groups in exchange for their substantial fees.

2. Given the varying state laws that govern foreclosure, there must be the opportunity to observe both best and worst practices. While foreclosures are not the preferred option for any party at the onset of a loan, sometimes it is the path forward that presents the least harm to borrowers, lenders and the economy. In those instances, it is essential that our foreclosure process be effective.

¹³ See, e.g., 2007 Nat'l Taxpayer Advocate Report to Congress 13-33, *available at* http://www.irs.gov/pub/irs-utl/arc_2007_vol_1_cover_msps.pdf.

¹⁴ *Servicers Earn More Per Loan*, MortgageDailyNews.com, June 29, 2010.

¹⁵ See, e.g., Press Release, Paul A. Koches, Ocwen Fin. Corp. 2 (Feb. 25, 2010).

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Which states do each of you feel provide the most efficient path forward in foreclosures, while providing borrowers proper legal channels in the event that there is a dispute? What is the average length of time between original delinquency and foreclosure sale in these states?

Which states do each of you feel have the most problems in effectively executing foreclosures? What is the average length of time between original delinquency and foreclosure sale in these states?

Answer:

The answer to this question depends a great deal on how one defines the appropriate goal for an effective foreclosure law. Speed is one goal; reducing losses to investors is another. A third is providing a fair and transparent process, to ensure that homeowners are not wrongfully deprived of their home. Speed by itself, as you suggest in the question, cannot be the ultimate measure of the effectiveness and efficiency of the foreclosure process in any state. Rather, the focus in most cases should be on providing a fair process for homeowners and reducing losses to investors.

We should remember that it is not so much the state laws that make the foreclosure process efficient or effective as servicers' compliance with those laws. Frequently, servicers are guilty of failing to process a foreclosure efficiently. When servicers fail to comply with long standing requirements for affidavit execution or notice to borrowers, their procedures are neither effective nor efficient, as they call into jeopardy the successful completion of a foreclosure and often result in unnecessary and costly litigation. As discussed in my testimony, and in response to Senator Brown's questions, servicers have significant incentives to process foreclosures inefficiently and often do so. That is not the fault of the laws (although it may reflect weak enforcement); it is the fault of the servicers. The effectiveness or lack thereof cannot be judged by the complications created by servicers' willful noncompliance.

NCLC is generally supportive of strengthening weak and ineffective state foreclosure laws; we do not believe that a federal foreclosure process would be appropriate. The foreclosure process has historically been part of state real property law and should remain so. Necessary servicing reform can be conducted at the federal level without undermining states' rights in this area traditionally regulated by the states.

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Greater detail on these questions can be found in a recent study co-authored by my NCLC colleagues John Rao and Geoff Walsh.¹⁶

Protections for Homeowners: The foreclosure process in the United States falls into roughly two categories: the traditional, judicial foreclosure process, which has required courts since colonial times to supervise foreclosure proceedings and prevent unjust results and a comparatively recent “non-judicial” process, which allows lenders to foreclose without court involvement. Slightly less than one-half of the states mandate court supervision over residential mortgage foreclosures.¹⁷ In the remaining states, foreclosure sales may proceed without any oversight by a court or neutral third party. In non-judicial foreclosures, homeowners with valid complaints about their treatment by a lender or mortgage servicer must hire an attorney to prepare a cumbersome and expensive lawsuit in order to stop an imminent foreclosure. In some states, they may even be required to post bond in the amount of the mortgage loan before the homeowner’s challenge to the foreclosure can be heard in court. The direct and inexpensive access to the courts, as occurs now in the many states requiring judicial foreclosure, is essential to an effective foreclosure system—one that protects the rights and interests of all parties.

State laws work best to prevent avoidable foreclosures when they include concrete options for the homeowner to terminate a foreclosure proceeding prior to a sale. For example, several state laws provide for a borrower’s right to “cure” a mortgage default before the mortgage holder may accelerate the loan and begin foreclosure proceedings. Before taking any action to foreclose, the mortgage holder must give the borrower a clear notice of the amount due and time within which to pay. This legal requirement promotes resolution of potential foreclosures before either party incurs any costs. Approximately fifteen states now provide for this type of pre-acceleration notice of right to cure, with Massachusetts, New Jersey, New York, and Maryland having recently added clear statutory notice of right to cure provisions to their foreclosure laws.¹⁸

¹⁶ John Rao & Geoff Walsh, Nat’l Consumer L. Ctr., *Foreclosing a Dream: State Laws Deprive Homeowners of Basic Protections* (2009), http://www.nclc.org/images/pdf/foreclosure_mortgage/state_laws/foreclosing-dream-report.pdf.

¹⁷ See National Consumer Law Center, *Foreclosing a Dream: State Laws Deprive Homeowners of Basic protections* February 2009, available at http://www.nclc.org/images/pdf/foreclosure_mortgage/state_laws/foreclosing-dream-report.pdf. This report contains state by state summaries of the states’ foreclosure laws, highlighting features related to court access and oversight of loss mitigation actions.

¹⁸ National Consumer Law Center, *Foreclosing a Dream: State Laws Deprive Homeowners of Basic protections* February 2009, *supra*.

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Twenty-two states provide for a right to cure an arrearage, pay costs and fees incurred, and reinstate the loan after commencement of foreclosure proceedings and up until the time of a foreclosure sale.¹⁹ When borrowers have clear notice of a right to reinstate, it is more likely that they will avail themselves of this opportunity. They will avoid foreclosure by restoring the loan to its original contract terms. In these post-acceleration reinstatements the mortgage holder ultimately suffers no loss because the borrower must reimburse foreclosure costs.

In approximately half the states borrowers have some form of post-sale redemption right that allows them to pay the sale price plus costs and set the foreclosure sale aside.²⁰ The post-sale redemption periods range from 60 days (North Dakota) to one year (Iowa, Kansas, Kentucky, Alabama, and Montana). In some states redemption rights and time frames vary according to factors such as extent of the borrower’s equity in the property or whether a third party purchased at the sale.

Reducing Losses to Investors: Investors lose enormous sums of money in foreclosure, \$2.7 billion from foreclosure sales in the month of September 2010 alone.²¹ For that month the average loss per foreclosed property was \$145,636, representing a loss of over 58% of the original principal per loan.²² Loan modifications substantially reduce these losses. For example, when mortgages were modified to forgive a portion of loan principal during September 2010, the recognized loss per loan averaged about 20% of the typical loan balance.²³ Loans modified under the HAMP program, for example, show low redefault rates, less than half those of other loan modifications made at the same time, even though the HAMP modifications typically do not provide for principal reductions and only a temporary below-market interest rate reduction.²⁴ These and similar modifications targeting borrower affordability provide investors with a steady stream of payments on the original loan principal. A foreclosure law that best facilitates sustainable loan modifications instead of foreclosures should be considered most “effective” in minimizing investor losses.

¹⁹ *Id.*

²⁰ *Id.*

²¹ Alan M. White, September 26, 2010 Columbia Collateral File Summary Statistics, Valparaiso University School of Law, available at http://www.valpo.edu/law/faculty/awhite/data/sep10_summary.pdf.

²² *Id.*

²³ *Id.*

²⁴ Congressional Oversight Panel December 2010 Oversight Report, A Review of Treasury’s Foreclosure Prevention Programs 34.; OCC/OTS Mortgage Metrics Report, Third Quarter 2010 at 37 (reporting a redefault rate on HAMP modifications after 6 months of 10.6%).

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State laws can set a requirement that mortgage holders consider loss mitigation options, including a loan modification, before a foreclosure sale will be allowed. For example, the South Carolina Supreme Court issued an administrative order in May 2009 requiring that all foreclosure complaints filed in the state describe how a servicer complied with any obligation it had to modify a loan under the HAMP program.²⁵ The Connecticut courts approved a similar order that went into effect in September 2010.²⁶ In several judicial foreclosure states, including New York, Maine, Vermont, and Connecticut, legislatures have recently enacted statutes requiring mediation or supervised conferences in foreclosure cases.²⁷ The goal of these sessions is to bring representatives of mortgage servicers and the borrowers together to consider loss mitigation options that mutually benefit all parties. Court-initiated programs in Ohio, Florida, Pennsylvania, Kentucky, New Mexico, New Jersey, Indiana, and Delaware are now offering similar mediation and conference programs.²⁸ Particularly where these programs involve use of net present value tests to examine the relative benefit to investors of an affordable loan modification as opposed to foreclosure, the sessions can provide a quick and effective means to determine whether foreclosures make economic sense for investors under accepted industry standards.²⁹

Recently, several state legislatures have incorporated mediation and conference requirements into non-judicial foreclosure procedures. For example, in Nevada, a traditionally non judicial foreclosure state, the courts now supervise a statewide mediation program. In Maryland, homeowners may request hearings before a state agency to review the servicer’s loss mitigation activities. Parties to a foreclosure in Maryland may also appeal conference decisions to the courts. The District of Columbia, another non- judicial foreclosure jurisdiction, recently enacted a foreclosure mediation law that will go into effect in early 2011.

Time Frames: Both Fannie Mae and HUD (on behalf of FHA) publish guidelines for what they consider to be the reasonable time frames from the

²⁵ South Carolina Supreme Court Administrative Order 2009-05-22-01 (May 22, 2009) at <http://www.judicial.state.sc.us/courtOrders/displayOrder.cfm?orderNo=2009-05-22-01>.

²⁶ State of Connecticut Superior Court *Mortgage Foreclosure Standing Order Federal Loss Mitigation Programs*, JD-CV-117 Rev 8/10 (August 18, 2010) available at <http://vww.jud2.ct.gov/webforms/forms/CV117.pdf>

²⁷ Links to the texts of these statutes can be found at the National Consumer Law Center web site: <http://www.nclc.org/issues/foreclosure-mediation-programs-by-state.html>.

²⁸ Links to the court web sites describing these programs are available on the same NCLC web page, <http://www.nclc.org/issues/foreclosure-mediation-programs-by-state.html>.

²⁹ The foreclosure mediation programs in effect in Maine and Vermont require use of these net present value tests.

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initiation of a foreclosure to a sale in each of the fifty states.³⁰ The expected time to foreclosure varies depending on state law and court procedures. Fannie Mae and HUD use these guidelines to assess performance of attorneys who are paid to conduct foreclosures of FHA insured and Fannie Mae owned and guaranteed loans. The guidelines show wide variations in foreclosure time frames from state to state. For example, HUD lists three non-judicial foreclosure states (Missouri, Rhode Island, and Texas) with time frames of three months from the commencement of foreclosure to sale. Nine non-judicial states have four-month time frames.³¹ On the other hand, HUD’s permissible time frames in judicial foreclosure states typically run ten months and longer.³² Actual times to foreclosure can vary wildly, depending on how aggressive and competently a servicer handles a foreclosure, ranging in the same state from 30 days to years to complete a foreclosure.

Vagaries in the reporting of these time frames exaggerates the discrepancy between non-judicial and judicial foreclosure states. The clock starts to run at a different point in time for judicial and non-judicial foreclosures. In non-judicial foreclosures the initial action is typically the publication of a notice of sale or the recording of a notice of default. In judicial foreclosures it is usually the filing of a foreclosure complaint in a court. But neither point in time measures how long it has been from default to the initiation of foreclosure. In many cases, the servicers will wait at least three months after the initial default before commencing a foreclosure, either because of contract limitations in the mortgage, or because of loss mitigation requirements imposed on government-insured loans and some loans insured with private mortgage insurance, or because of custom.³³ Post-sale redemption periods in some non-judicial foreclosure states (Michigan, Alabama, Minnesota Missouri and Wyoming) can extend the process beyond the Fannie Mae numbers in periods lasting from three months to one year. The time to completed foreclosures in these non-judicial foreclosure states is actually more in line with those of judicial foreclosure states.

Debates over changes to state foreclosure laws often focus on the relative speed of different foreclosure procedures. Some industry representatives suggest that

³⁰ Fannie Mae Servicing Guide (2010 version) Part VIII, sec. 104.05, Allowable Time Frames for Completing Foreclosure,

<https://www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2010/svc1012.pdf> and HUD Mortgagee Letter 2005-30 (July 12, 2005) with attachments,

<http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/2005ml.cfm>

³¹ Alabama, Arizona, Georgia, Mississippi, New Hampshire, Tennessee, and Virginia.

³² e.g. 17 months (Iowa), 14 months (New Jersey, Vermont), 13 months (New York), 12 months (Illinois, Maine, Ohio, Wisconsin), 10 months (Indiana, Pennsylvania, South Dakota).

³³ 24 C.F.R. 203.355(a).

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longer foreclosure time frames harm consumers because lenders must raise the cost of credit on a state by state basis in response to lengthening of foreclosure time frames. There is little empirical evidence indicating that this actually happens.³⁴

On the other hand, we now have analytical tools that allow us to see how the costs of foreclosure compare to the costs of various alternatives to foreclosure. We can easily quantify the cost to investors in interest lost during the five months additional time that a judicial foreclosure may take in comparison to a non-judicial foreclosure. However this short term incremental cost pales in relation to the overall loss of \$145,000 that investors incur in the typical foreclosure today. Foreclosure laws that allow for full consideration of loss mitigation can drastically reduce that loss. In today’s housing crisis, an analysis of state foreclosure laws that focuses on length of foreclosure time is dangerously outdated. An effective foreclosure system must provide a framework within which an evaluation of the true costs of foreclosure takes place in a timely and transparent manner.

States with Relatively Effective and Efficient Foreclosure Laws: The foreclosure laws in New York and Maine include: (1) judicial supervision over entry of judgments and sales; (2) clear pre-foreclosure notices to borrowers advising them of their rights in a potential foreclosure, including a right to cure before commencement of proceedings and during proceedings; (3) timely referrals to counseling resources; and (4) an opportunity for conferences or mediations supervised by neutral third parties who can enforce good faith participation by the borrower, mortgage holder, and servicer. The laws in Connecticut and Vermont similarly encourage efficient review of loss mitigation options.

Because the state laws in New York, Maine, Connecticut, and Vermont require court orders to schedule and approve sales, and allow time periods to negotiate and cure defaults, the foreclosure timelines from initiation of foreclosure to sale

³⁴ One study by a Federal Reserve Board economist offered some limited data on this subject. Karen M. Pence, *Foreclosing on Opportunity: State Laws and Mortgage Credit*, 88 Review of Economics and Statistics 177 (February 2006). The author looked for variances in home mortgage credit terms in states with judicial and non judicial foreclosure laws. The study concluded that borrowers in judicial foreclosure states tended to receive marginally smaller loan amounts than those in non-judicial foreclosure states, but found no significant disparities in loan terms such as interest rates. The report could not conclude that borrowers in judicial states were necessarily worse off than borrowers in non judicial states. According to the report, “homeownership might even increase if the judicial protections help borrowers remain in their homes.” The Report noted that further study was needed to assess the balance between any minor negative effects on credit terms and the benefits that heightened homeowner protections create for a housing market.

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in these states are longer than in most other states and run from 9 months to slightly over a year.³⁵

States with Relatively Ineffective and Inefficient Foreclosure Laws:

Several non judicial foreclosure states, including Georgia, Tennessee, Rhode Island, Virginia, and Missouri combine ineffective notice and cure rights, no judicial oversight, and a time frame that gives few homeowners a practical opportunity to participate actively in the foreclosure process.

The timelines in Georgia, Tennessee, Rhode Island, Virginia, and Missouri are shorter, running about four months.³⁶

3. To better gauge the level of violations surrounding the topic of this hearing it is necessary for us to understand who is being affected. Admittedly, this question is probably best suited for the regulators, and we hope to receive this information from them at some point.

In your research and investigations, how many individuals were discovered to have been fully current on their mortgage payments but foreclosed upon by their servicer? Please provide the data and evidence that you evaluated to arrive at your conclusions.

Answer:

Of course, I am not primarily a researcher, nor do I have access to the servicers' proprietary databases or an ability to conduct a comprehensive review of their loan files. While I did provide examples where the servicer wrongfully initiated foreclosure in my written testimony, including five homeowners who were foreclosed upon while negotiating a loan modification and making payments as instructed by the servicer, two homeowners who were placed into foreclosure solely because of the servicers' improper imposition of fees, three homeowners who were foreclosed upon although they were current in their required payments, and three cases where the servicer initiated foreclosure proceedings in the name of the wrong owner of the loan, these

³⁵ FHA's "reasonable diligence" timelines for these states are: Vermont (14 months); New York (13 months); Maine (12 months); Connecticut (9 months). Vermont, Maine, and Connecticut provide for a redemption period between entry of judgment and sale. These redemption periods are included in the timelines.

³⁶ FHA's "reasonable diligence" timelines for these states are: Georgia (4 months); Tennessee (4 months); Rhode island (3 months); Virginia (4 months); Missouri (3 months). In cases in which the mortgage holder purchases the property at the sale, Missouri permits a one-year redemption period for a borrower who makes an appropriate request within ten days of sale and posts a bond.

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examples were illustrative and not exhaustive. As you note, regulators with supervisory authority are better positioned to review the millions of foreclosure filings than I. As we recommend in our testimony, it is essential that the regulators begin random sampling of servicers’ files to determine the extent of the problem we are facing.

In an attempt to quantify the extent of the problem, absent the hard data only careful supervisory exams are likely to provide, the National Association of Consumer Advocates, in conjunction with NCLC, conducted a survey of attorneys representing homeowners in foreclosure. The ninety-six attorneys from thirty-four states reported representing over 1,200 homeowners who had been placed into foreclosure by a servicer when they were current on their payments. Those attorneys reported representing an additional 1,800 homeowners who had been placed into foreclosure by the servicer despite making payments as agreed under a plan.

More importantly, this is not a question easily answered. By the time homeowners seek legal counsel, they have usually spent several months attempting to resolve their dispute with the servicer on their own, and sorting out the payment history is cumbersome and often uncertain. There are frequently divergences between the servicer’s records and the homeowner’s, and reconciling those records can take months, in my experience. Several courts have noted that the gross inaccuracies pervading servicers’ records often make it impossible to determine whether a homeowner is in default and the extent of any default.³⁷

There is also the difference between the homeowner’s status at the time the servicer declares default and the time a foreclosure is formally filed. There is usually a lag of several months between the servicer’s declaring default and the filing of a foreclosure in a judicial foreclosure state; a homeowner who was current at the time of the declaration of default is unlikely to be current when the foreclosure is filed (the servicer will ordinarily refuse payments in that circumstance, or homeowners may give up making payments, assuming that they will lose the home).

Moreover, whether homeowners are current on their payments or not may depend on whether the servicer accepted the homeowner’s payments, whether the servicer instructed the homeowner to stop making payments, whether the servicer properly applied the homeowner’s payments, whether the servicer

³⁷ See, e.g., *Schlosser v. Fairbanks Capital Corp.*, 323 F.3d 534 (7th Cir. 2003); *Maxwell v. Fairbanks Capital Corp.* (*In re Maxwell*), 281 B.R. 101 (Bankr. D. Mass. 2002); *Chu v. Green Point Sav. Bank*, 628 N.Y.S. 2d 527 (2nd App. Dist. 1995) (finding servicers’ conduct in foreclosing “frivolous” and imposing sanctions).

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charged improper fees or forceplaced insurance. An analysis that only looks to the servicers' records as to the homeowners' status at the time of foreclosure is likely to miss most if not all of these cases where the homeowner was, by any sensible measure, current in the payments at the time the servicer initiated foreclosure. In my experience representing homeowners, it is not uncommon for servicers to initiate foreclosure where the homeowner has a good faith basis to dispute the servicer's accounting. Furthermore, problems in servicing cannot easily be disentangled from problems in origination: borrowers may fail to make payments because they were told not to, told that the amount owed was a different amount, or borrowers may make payments to the wrong entity.³⁸ Fundamentally, if a loan modification would save the investors money, and the borrower qualifies for a loan modification, a servicer who initiates a foreclosure is acting wrongfully, in violation of their fiduciary obligations to the securities holders, in breach of the mortgage contract with the borrower, which requires good faith and fair dealing, and, often, in blatant disregard of regulatory guidance and HAMP Servicer Participation Agreements.

There continue to be press accounts—unrelated to either my testimony or the survey—documenting baseless foreclosures. Press reports from around the country have documented cases where servicers have initiated foreclosure, even though the homeowner was current in payments.³⁹ In some instances, servicers have foreclosed on mortgages that the homeowner had already paid off in full.⁴⁰ In other cases, servicers have foreclosed on the wrong home.⁴¹ A recent story in *The New York Times* reports on four separate cases where the servicer completed a foreclosure illegally.⁴² In one of those cases, the mortgage was paid off; in two of those cases, the homeowner was attempting to sort out the confusion following a loved one's death. Servicers will frequently refuse to accept payments from a spouse, partner, or child following a mortgagor's

³⁸ See, e.g., Karen Weise, ProPublica, *One “Nightmare” Mortgage: Problems from Origination through Foreclosure* Nov. 22, 2010, <http://www.propublica.org/article/one-nightmare-mortgage-problems-from-origination-through-foreclosure> (homeowner sent her payments to mortgage broker who failed to forward payments on).

³⁹ See, e.g., George Gombossy, *Bank of America's Christmas Present: Foreclose Even Though Not a Missed Payment*, ctwatchdog.com, Dec. 24, 2010, <http://ctwatchdog.com/2010/12/24/bank-of-americas-christmas-present-foreclose-even-though-not-a-payment-missed>; Jon Yates, *Processing Mistake Leads to Erroneous Foreclosure*, Chi. Trib. Nov. 23, 2010.

⁴⁰ See, e.g., Andrew Martin, *In Sign of Foreclosure Flaws, Suits Claim Break-Ins by Banks*, N.Y. Times, Dec. 22, 2010, at A1; Aldo Svaldi, *Foreclosure Paperwork Miscues Piling Up*, Denver Post, Nov. 14, 2010.

⁴¹ See, e.g., Harriet Johnson Brackey, *Lauderdale Man's Home Sold Out From Under Him in Foreclosure Mistake*, Sun Sentinel, Sept. 23, 2010; Tony Marrero, *Bank of America Forecloses on House that Couple Had Paid Cash For*, St. Petersburg Times, Feb. 12, 2010.

⁴² Andrew Martin, *In Sign of Foreclosure Flaws, Suits Claim Break-Ins by Banks*, N.Y. Times, Dec. 22, 2010, at A1.

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death, despite the fact that federal law forbids servicers from exercising their due-on-sale clauses in this context⁴³ and despite the fact that ordinary human feeling—or good business judgment—would suggest allowing the grieving survivor to continue making payments without hassle.

Servicer abuses are widespread and unquestionably result in wrongful foreclosure. Determining the true extent of the problem will require careful, independent scrutiny of both servicers’ and homeowners’ records.

Questions for Ms. Diane Thompson, on behalf of the National Consumer Law Center, from Senator Brown:

1. Please describe any barriers to mortgage modifications that servicers may encounter.

Answer:

In general, the barriers servicers face to mortgage modifications have been overstated. The barriers servicers face are usually surmountable or of their own making.

Servicers often complain about staffing shortages. Staffing is certainly expensive for servicers, particularly default staffing, although servicers continue to have enviable margins in their servicing of the majority of loans that are performing.⁴⁴ By any reasonable measure though, servicers have sufficient staff to perform modifications.⁴⁵ Training and supervision of staff

⁴³ 12 U.S.C. § 1701j-3.

⁴⁴ See, e.g., Mortg. Servicing News, *Servicers’ Collection Profits May Outweigh Cost of Defaults*, Dec. 28, 2010 (noting that while default servicing is expensive, servicing of performing loans is highly lucrative for large servicers, with the direct costs running perhaps \$60 a year and the principal based mortgage servicing income paid by the trust running \$450 a year on a mid-sized prime loan of \$180,000).

⁴⁵ For example, in April of this year, Bank of America reported that it had over 15,000 people working in customer outreach. Jennifer Harmon, Am Banker, *B of A Deploys More Resources from Origination to Servicing*, Apr. 12, 2010. By October, Bank of America had fewer than 80,000 HAMP permanent modifications in place. Making Home Affordable Program, *Servicer Performance Report Through Oct. 2010*. That suggests that it is taking Bank of America more than two full work days to process a homeowner for a HAMP modification—a highly standardized application that requires little individual underwriting. Jack Guttentag, *New Plan to Jump-Start Loan Mods: Web Portal Would Centralize Communication, Break Logjam*, Inman News, July 20, 2009, available at <http://www.inman.com/buyers-sellers/columnists/jackguttentag/new-plan-jump-start-loan-mods> (noting that it should take no more than an hour for a servicer to process a loan modification request; at that rate,

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may be an issue, as may the implementation of procedures to perform loan modifications correctly, but those are questions about servicers’ will to implement modifications, not their ability to do so.

Servicers often assert that investors prohibit modifications. As detailed in my written testimony, often those representations are entirely false. Most PSAs permit modifications of loans in default freely.⁴⁶ Where securitizations contain absolute bars to modifications, sponsors of those securitizations have successfully petitioned the trustee to amend the contract to allow modifications generally, so long as the loan is in default or at imminent risk of default.⁴⁷ Increasingly, groups representing investors call on servicers to perform more loan modifications, including principal reductions, and assert that servicers are failing to perform modifications, contrary to servicers’ wishes.⁴⁸

Chase’s 3500 loan modification counselors should be able to process at least 70,000 loan modifications a week—approximately the number of Making Home Affordable modifications that Chase has processed in the first five months of the HAMP program).

⁴⁶John P. Hunt, Berkeley Ctr. for Law, Business, and the Economy, *Loan Modification Restrictions in Subprime Securitization Pooling and Servicing Agreements from 2006: Final Results 2* (July 2010), *available at* http://www.law.berkeley.edu/files/bclbe/Subprime_Securitization_Paper_John_Hunt_7.2010.pdf (only 8% of subprime contracts reviewed barred modifications); John P. Hunt, Berkeley Ctr. for Law, Business, and the Economy, *What Do Subprime Securitization Contracts Actually Say About Loan Modification: Preliminary Results and Implications 7* (Mar. 25, 2009), *available at* http://www.law.berkeley.edu/files/bclbe/Subprime_Securitization_Contracts_3.25.09.pdf (discussing various limitations and quantifying the frequency of limitations); See Manuel Adelino, Kristopher Gerardi, and Paul S. Willen, Fed. Reserve Bank of Boston, *Why Don’t Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitizations 28* (Publicy Pol’y Paper No. 09-4, July 6, 2009), *available at* <http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf>. (summarizing several different studies finding no meaningful PSA restrictions in a majority of securitizations reviewed); Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang, & Eileen Mauskopf, Fed. Reserve Bd. Fin. & Econ. Discussion Series Div. Research & Statistical Affairs, *The Incentives of Mortgage Servicers: Myths and Realities 22* (Working Paper No. 2008-46) (reporting that of 500 different PSAs under which a large servicer operated, 48% had no limitations on modifications other than that they maximize investor return; only 7.5% of the PSAs had meaningful limits on the types of modifications a servicer could authorize); Credit Suisse, *The Day After Tomorrow: Payment Shock and Loan Modifications* (2007), *available at* <http://www.credit-suisse.com/researchandanalytics> (finding that 65% of survey PSAs contain no meaningful restrictions on ability to modify loans); American Securitization Forum, *Statement of Principles, Recommendations, and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans 2* (June 2007) (“Most subprime transactions authorize the servicer to modify loans that are either in default or for which default is either imminent or reasonably foreseeable.”).

⁴⁷ See, e.g., Morgan Stanley Omnibus Amendment (Aug. 23, 2007) (on file with author).

⁴⁸ Jody Shenn, *Mortgage Investors with \$500 Billion Urge End of Practices, Lawyer Says*, Bloomberg News, July 23, 2010, <http://www.bloomberg.com/news/2010-07-23/mortgage-investors-with-500-billion-urge-end-of-practices-lawyer-says.html> (reporting on letters sent to trustees of mortgage pools on behalf of a majority of the investors in the pool); Ass’n of Mortg.

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Servicers’ delayed recovery of expenses in modifications may create a barrier to performing modifications. Servicers have two main expenses when a loan is in default: advances of principal and interest to the trust and payments to third parties for default services, such as property inspections. The requirement for advances usually continues until a foreclosure is completed, a loan modification is reached, or the servicer determines that there is no realistic prospect of recovering the advances from either the borrower or the collateral.⁴⁹ Financing these costs is one of servicers’ biggest expenses.⁵⁰

Modifications in general do not allow servicers to recover their costs as quickly as foreclosures do.⁵¹ Servicers’ advances are taken off the top, in full, at the post-foreclosure sale, before investors receive anything.⁵² If advances of principal and interest payments remain beyond the sale value, servicers can usually collect them directly from the trust’s bank account (or withhold them from payments to the trust).⁵³ In contrast, when there is a modification,

Investors Press Release, AMI Supports Long Term, Effective, Sustainable Solutions to Avert Foreclosure; Invites Bank Servicers to Join, Nov. 16, 2010 (citing servicers’ profit from fees and payments from affiliates as an impediment to loan modifications that would be in the interests of investors); Letter from Kathy D. Patrick to Countrywide Home Loans Servicing, Oct. 18, 2010 (notifying a trust and master servicer of breaches in the master servicer’s performance).

⁴⁹Brendan J. Keane, Moody’s Investor Services, Structural Nuances in Residential MBS Transactions: Advances 3 (June 10, 1994)

⁵⁰Ocwen Fin. Corp., Annual Report (Form 10-K) 5 (Mar. 12, 2009).; Mary Kelsch, Stephanie Whited, Karen Eissner, Vincent Arscott, Fitch Ratings, Impact of Financial Condition on U.S. Residential Mortgage Servicer Ratings 2 (2007).

⁵¹Wen Hsu, Christine Yan, Roelof Slump, FitchRatings, U.S. Residential Mortgage Servicer Advance Receivables Securitization Rating Criteria 4 (Sept. 10, 2009) (finding that modifications do not appear to accelerate the rate of recovery of advances, in part because of high rates of redefault).

⁵²Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang, & Eileen Mauskopf, Fed. Reserve Bd. Fin. & Econ. Discussion Series Div. Research & Statistical Affairs, The Incentives of Mortgage Servicers: Myths and Realities 11 (Working Paper No. 2008-46); Ocwen Fin. Corp., Annual Report (Form 10-K) 4 (Mar. 17, 2008) (advances are “top of the waterfall” and get paid first); Wen Hsu, Christine Yan, Roelof Slump, FitchRatings, U.S. Residential Mortgage Servicer Advance Receivables Securitization Rating Criteria 1 (Sept. 10, 2009) (same); Prospectus Supplement, IndyMac, MBS, Depositor, IndyMac INDX Mortgage Loan Trust 2007-FLX5, at S-71 (June 27, 2007) (servicers repaid all advances when foreclosure is concluded).

⁵³ See, e.g., Ocwen Fin. Corp., Annual Report (Form 10-K) 11 (Mar. 12, 2009) (“[I]n the majority of cases, advances in excess of loan proceeds may be recovered from pool level proceeds.”); Prospectus Supplement, IndyMac, MBS, Depositor, IndyMac INDX Mortgage Loan Trust 2007-FLX5, at S-71 (June 27, 2007) (permitting principal and interest advances to be recovered from the trust’s bank account); Prospectus, CWALT, INC., Depositor, Countrywide Home Loans, Seller, Countrywide Home Loans Servicing L.P., Master Servicer, Alternative Loan Trust 2005-J12, Issuer 47 (Oct. 25, 2005) (limiting right of reimbursement from trust account “ to amounts received representing late recoveries of the payments for which the advances were made).

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servicers are usually limited to recovering their advances from the modified loan alone, after required payments to the trust, or, if the advances are deemed nonrecoverable, from only the principal payments on the other loans in the pool, not the interest payments.⁵⁴ As a result, servicers can face a delay of months to years in recouping their advances on a modification. Modifications involving principal reductions compound the problem: they lengthen the time to recover advances on any individual modified loan as well as on other modified loans, by reducing the amount of principal payments available for application to recovery of advances.⁵⁵ Limiting recovery of servicer expenses when a modification is performed to the proceeds on that loan rather than allowing the servicer to recover more generally from the income on the pool as a whole, as is done in foreclosure, clearly biases servicers against meaningful modifications, particularly modifications with principal reduction or forbearance.

Moreover, since the significant financing costs associated with making advances cannot be recovered,⁵⁶ servicers are likely to push through a foreclosure quickly when the cost of financing advances is climbing, even at the expense of investors who might prefer a modification.⁵⁷

⁵⁴Monica Perelmuter & Waqas Shaikh, Standard & Poor’s, Criteria: Revised Guidelines for U.S. RMBS Loan Modification and Capitalization Reimbursement Amounts 3 (Oct. 11, 2007).

⁵⁵ *But see* Rod Dubitsky, Larry Yang, Stevan Stevanovic, Thomas Suer, Credit Suisse, Subprime Loan Modifications Update (2008) (discussing how some servicers exploited then-existing imprecision in the accounting treatment of principal reduction modifications to use principal reduction modifications to halt interest advances).

⁵⁶Joseph R. Mason, Mortgage Loan Modification: Promises and Pitfalls 4 (Oct. 2007). A large subprime servicer noted in its 2007 annual report that although “the collectibility of advances generally is not an issue, we do incur significant costs to finance those advances. We utilize both securitization, (i.e., match funded liabilities) and revolving credit facilities to finance our advances. As a result, increased delinquencies result in increased interest expense.” Ocwen Fin. Corp., Annual Report (Form 10-K) 18 (Mar. 17, 2008); *see also* Wen Hsu, Christine Yan, Roelof Slump, FitchRatings, U.S. Residential Mortgage Servicer Advance Receivables Securitization Rating Criteria 1 (Sept. 10, 2009) (“Servicer advance receivables are typically paid at the top of the cash flow waterfall, and therefore, recovery is fairly certain. However, . . . there is risk in these transactions relating to the timing of the ultimate collection of recoveries.”).

⁵⁷ *See* Complaint at 11–15,); Carrington Asset Holding Co., L.L.C. v. American Home Mortgage Servicing, Inc., No. FST-CV 09-5012095-S (Conn. Super. Ct., Stamford Feb. 9, 2009) (alleging that servicer conducted “fire sales” of foreclosed properties in order to avoid future advances and recover previously made advances); Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 Housing Pol’y Debate 753, 757 (2004) (reporting that servicers sometimes rush through a foreclosure without pursuing a modification or improperly foreclose in order to collect advances); Peter S. Goodman, *Lucrative Fees May Deter Efforts to Alter Troubled Loans*, N.Y. Times, July 30, 2009.

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The two-track system also impedes servicers’ ability to perform modifications. Proceeding with a foreclosure before considering a loan modification results in high costs for both investors and homeowners. These costs—which accrue primarily to the benefit of the servicer—can make an affordable loan modification impossible. Moreover, the two track system, of proceeding simultaneously with foreclosures and loan modification negotiations, results in many “accidental” foreclosures, due to bureaucratic bungling by servicers,⁵⁸ as one department of the servicer fails to communicate with another, or papers are lost, or instructions are not conveyed to the foreclosure attorney. To some extent, the two-track system is still mandated by large investors and the FHFA. Ending the two-track system would facilitate servicers’ ability to complete loan modifications.

2. What systems should mortgage servicers implement to correct their mistakes and compensate the individual homeowners who have suffered through the actions of others?

Answer:

We believe that servicers must take steps to redress harm caused consumers, ensure fair and effective processing going forward, and begin complying with existing standards.

Compliance. Compliance with existing rules and policies must come first. Any redress to harmed borrowers is undercut if servicers do not stop violating existing standards. We continue to hear examples of outright misrepresentations by all of the major servicers. Bank of America, for example, has continued to require homeowners to sign waivers for its proprietary loan modification program, despite representations to the contrary. Chase has been sending out letters that implicitly discourage homeowners from applying for Pennsylvania’s HEMAP program. Servicers must comply with both the letter and the spirit of the law.

Improved Processing. In addition to taking steps to comply with existing standards, servicers could implement the following systems to ease the process for homeowners going forward.

⁵⁸For some descriptions of all too typical bureaucratic bungling by servicers, see Peter S. Goodman, *Paper Avalanche Buries Plan to Stem Foreclosures*, N.Y. Times, June 29, 2009, and Jack Guttentag, *New Plan to Jump-Start Loan Mods: Web Portal Would Centralize Communication, Break Logjam*, Inman News, July 20, 2009, available at <http://www.inman.com/buyers-sellers/columnists/jackguttentag/new-plan-jump-start-loan-mods>.

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- ❖ End dual track. Stop the foreclosure process during modification applications (and modifications), even for people already in foreclosure at the time of application.
- ❖ Create a single point of contact for each homeowner, one with real decision making authority and ability to follow through.
- ❖ Process modification applications in hours instead of months or years. Expedited review.
- ❖ Clear in-house escalations for homeowners who have been denied a modification or encountered difficulties in obtaining a modification.

Redress. Providing redress for homeowners harmed will not be easy and would require a significant commitment on the part of servicers. There are two basic categories of homeowners who have been harmed by servicers’ malfeasance: 1) those who have lost their homes and 2) those who are still in their homes, but have been denied a loan modification, pushed into default, or merely had improper fees tacked onto their account. Addressing the former category, homeowners who lost their homes, is more complex than providing relief to those who have not yet lost their homes at a foreclosure sale.

For homeowners who have not yet lost their home in a foreclosure sale, servicers should institute a supervised, full review of every file marked in default. This review must include a review of the payment history, including the timing and application of payments and the validity of fees charged.

- ❖ Homeowners found not to be in default should be removed from foreclosure, corrections of credit reporting status must be provided to the credit bureaus, and accounts should be fully corrected.
- ❖ All pending foreclosures should be halted while this review takes place, and dual track processing must be stopped on all loans so that the modification review can be completed.
- ❖ Fees should be rolled back and limited to reasonable and necessary ones.
- ❖ Recalculation of principal balances should be done to account for improperly assessed fees or overcharged interest.

The servicers should also be required to undertake a review of all completed foreclosures. There are two large categories of cases for which servicers should attempt to make redress: first, cases where the foreclosure was executed on the wrong home or where the homeowner was not in default; and second, cases where the foreclosure was completed without completing the loan modification review process, providing a written denial to the homeowner, or failing to offer a qualifying homeowner an appropriate modification.

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- ❖ If the home has not yet been sold to a bona fide third party, the servicer should offer to restore the mortgage, with a reduction of the principal balance to account for all assessed foreclosure fees, as well as any improper fees. If the borrower is in default, the servicer also should provide a reduction of the interest rate to the Freddie Mac Prime Weekly Rate, if that is lower. Such homeowners further should be evaluated for a deeper modification where the monthly payment would be greater than 31% of the homeowner’s income. As part of those NPV positive modifications, servicers should be required to reduce the principal balance on the loan to the assessed value of the property that the servicer relied on in evaluating the loan for foreclosure originally. Servicers must further provide corrected credit reporting to the credit bureaus to mitigate the negative credit reporting.
- ❖ If the home has already been sold to a third party or if the homeowner no longer wishes to retain the home, the servicer should be required to refund to the homeowner all foreclosure fees assessed against the homeowner’s account, plus the amount by which the valuation the servicer relied on exceeds the foreclosure sale price. Servicers must also take steps to repair the homeowner’s credit in these situations.

No waiver of the homeowner’s rights should be required.

If the homeowner who was subject to a wrongful foreclosure cannot be located, the servicer should be required to deposit the money that would otherwise be paid to the homeowner into a fund for legal services and housing counselors. Funding must be available to legal services lawyers to support foreclosure litigation, as well as counseling.

3. What are the financial incentives encouraging mortgage servicers to foreclose on homeowners?

Answer:

As detailed in my report, “Why Servicers Foreclose When They Should Modify,”⁵⁹ the balance of servicer incentives leans toward foreclosure over modification.

⁵⁹ Diane E. Thompson, *Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior: Servicer Compensation and its Consequences* (Oct. 2009), *available at* consumerlaw.org.

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Staffing costs: Servicers encounter increased staffing costs that are not reimbursed when they modify. In contrast, the staffing costs of foreclosures, which are often lower than those for modifications, may be outsourced and charged back to the trust. Many of those foreclosure staffing needs are provided by affiliates or other organizations that provide financial compensation to the servicers in exchange for repeat business.⁶⁰

Fees: Servicers get paid off the top in a foreclosure for any costs and expenses, before the investors get paid. But when a loan is modified, servicers can only collect their fees and expenses from the payments on that loan.

Servicers can charge homeowners and investors more fees in a foreclosure than in a modification. There are property preservation fees, REO sale costs, attorney fees, and title work, to name a few. For example, one servicer recently charged the account of a Maine homeowner \$600 for cutting the grass, once. The servicer charged this “property preservation fee” multiple times over the course of a few months. The servicer tacked these fees onto a petition for deficiency judgment against the homeowner; had the homeowner not been able to force those fees to be waived, the servicer would likely have collected any unpaid amount from the trust, before the investors got paid. Additionally, HAMP and other loan modification programs may require waiver of late fees, which servicers are otherwise entitled to retain.⁶¹

Pressure from credit rating agencies to expedite foreclosures: Credit rating agencies rate servicers’ performance on the speed to conduct a foreclosure.⁶² Since servicers are dependent on the credit rating agencies for approval to enter into new mortgage servicing contracts and affordable

⁶⁰See Complaint ¶ 15, Fed’l Trade Comm’n v. Countrywide Home Loans, Inc., No. CV-10-4193 (C.D. Cal. Jun. 7, 2010), available at <http://www.ftc.gov/os/caselist/0823205/100607countrywidemcpt.pdf>; (alleging that Countrywide’s “countercyclical diversification strategy” was built on its subsidiaries funneling the profits from marked-up default fees back to Countrywide); Peter S. Goodman, *Homeowners and Investors May Lose, But the Bank Wins*, N.Y. Times, July 30, 2009 (describing Bank of America’s refusal to entertain three separate short sale offers during two years of non-payment while its affiliate continues to assess property inspection fees); Peter S. Goodman, *Lucrative Fees May Deter Efforts to Alter Troubled Loans*, N.Y. Times, July 30, 2009.

⁶¹See Home Affordable Modification Program, Supplemental Directive 09-01 (Apr. 6, 2009).

⁶²Diane Pendley & Thomas Crowe, FitchRatings, U.S. RMBS Servicers’ Loss Mitigation and Modification Efforts 11, 15 (May 26, 2009).; see also Michael Guttierrez, Michael S. Merriam, Richard Koch, Mark I. Goldberg, Standard & Poors, *Structured Finance: Servicer Evaluations* 15–16 (2004). The rating agencies do not set benchmarks for any of these, but expect servicers to develop timelines and standardized loss mitigation options for each loan product, with reference to the industry standards as developed by Fannie Mae and Freddie Mac.

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financing, servicers have a strong financial incentive to push forward a foreclosure rather than allowing for the possibility of a loan modification.

Troubled debt restructuring rules: The troubled debt restructuring rules discourage servicers from performing permanent modifications, as well as more generally discouraging those modifications most likely to be successful—modifications that provide deep payment reductions and modifications before default. While the TDR accounting rules only apply to loans held in portfolio,⁶³ preserving the assets of the trust from the originators’ creditors has required that servicers generally categorize modifications using the TDR rules.⁶⁴

FAS 15 generally requires all permanent modifications occasioned by the “borrower’s financial difficulties” to be treated as “troubled debt restructurings.”⁶⁵ A TDR usually results in immediate loss recognition and, for loans held in portfolio, a cessation of interest payments.⁶⁶ The FAS 15 rules apply whether the loan is current or delinquent when modified. A servicer who modifies a loan pre-default—say an adjustable rate mortgage in advance of a rate reset—will have to report that loan as a TDR. Many servicers prefer to postpone that paper loss, thus converting the paper loss into a real loss, at least for the homeowner and investors.⁶⁷

Junior liens: Servicers who own junior liens will be reluctant to modify those loans. Homeowners often continue to pay on junior liens after they have defaulted on first mortgages, because the smaller payment associated with the junior lien feels more manageable. As long as that mortgage is performing,

⁶³Fin. Accounting Standards Bd., Accounting by Creditors for Impairment of Loans, An Amendment of FASB Statement No. 5 and 15, Statement of Fin. Accounting Standards No. 114 (1993).

⁶⁴FASB has recently altered the rules protecting the bankruptcy-remote status of the trust. Instead of qualifying as a Special Purpose Entity, all “variable interest entities” now must be reviewed to determine the extent to which the transferring entity maintains control and appropriate disclosures provided. This is unlikely to impact the weight of the TDR rules directly, but it does change the formal mechanism by which bankruptcy-remote status is achieved and evaluated. See Transfers of Financial Assets, An Amendment to FASB Statement No. 140, Statement of Fin. Accounting Standards No. 166 (2009).

⁶⁵Fin. Accounting Standards Bd., Accounting by Debtors and Creditors for Troubled Debt Restructurings, Statement of Fin. Accounting Standards No. 15 at §2 (1977).

⁶⁶Manuel Adelino, Kristopher Gerardi, and Paul S. Willen, Fed. Reserve Bank of Boston, Why Don’t Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitizations 23-24 (Publicy Pol’y Paper No. 09-4, July 6, 2009), available at <http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf>.

⁶⁷Manuel Adelino, Kristopher Gerardi, and Paul S. Willen, Fed. Reserve Bank of Boston, Why Don’t Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitizations 23-24 (Publicy Pol’y Paper No. 09-4, July 6, 2009), available at <http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf>.

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servicers will be reluctant to recognize a loss, even if doing so would enable a greater return on the first mortgage.

Advances: Servicers’ requirement to advance the principal and interest payments on loans that are in default favors foreclosures. Servicers have two main expenses when a loan is in default: advances of principal and interest to the trust and payments to third parties for default services, such as property inspections. Servicers, under their agreements with investors, typically are required to continue to advance interest on loans that are delinquent until a foreclosure is completed.⁶⁸ Financing these costs is one of servicers’ biggest expenses.⁶⁹ Recovery of these fees (but not the financing costs) is more certain and often swifter via a foreclosure than a modification.

Servicers’ advances are taken off the top, in full, at the post-foreclosure sale, before investors receive anything.⁷⁰ If advances of principal and interest payments remain beyond the sale value, servicers can usually collect them directly from the trust’s bank account (or withhold them from payments to the trust).⁷¹ In contrast, when there is a modification, servicers are usually limited to recovering their advances from the modified loan alone, after required payments to the trust, or, if the advances are deemed nonrecoverable, from only the principal payments on the other loans in the pool, not the interest payments.⁷² As a result, servicers can face a delay of months to years in

⁶⁸Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang, & Eileen Mauskopf, Fed. Reserve Bd. Fin. & Econ. Discussion Series Div. Research & Statistical Affairs, *The Incentives of Mortgage Servicers: Myths and Realities* 16 (Working Paper No. 2008-46).

⁶⁹Ocwen Fin. Corp., Annual Report (Form 10-K) 5 (Mar. 12, 2009).; Mary Kelsch, Stephanie Whited, Karen Eissner, Vincent Arscott, Fitch Ratings, *Impact of Financial Condition on U.S. Residential Mortgage Servicer Ratings* 2 (2007).

⁷⁰Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang, & Eileen Mauskopf, Fed. Reserve Bd. Fin. & Econ. Discussion Series Div. Research & Statistical Affairs, *The Incentives of Mortgage Servicers: Myths and Realities* 11 (Working Paper No. 2008-46); Ocwen Fin. Corp., Annual Report (Form 10-K) 4 (Mar. 17, 2008) (advances are “top of the waterfall” and get paid first); Wen Hsu, Christine Yan, Roelof Slump, FitchRatings, *U.S. Residential Mortgage Servicer Advance Receivables Securitization Rating Criteria* 1 (Sept. 10, 2009) (same); Prospectus Supplement, IndyMac, MBS, Depositor, IndyMac INDX Mortgage Loan Trust 2007-FLX5, at 71 (June 27, 2007) (servicers repaid all advances when foreclosure is concluded).

⁷¹ See, e.g., Ocwen Fin. Corp., Annual Report (Form 10-K) 11 (Mar. 12, 2009) (“[I]n the majority of cases, advances in excess of loan proceeds may be recovered from pool level proceeds.”); Prospectus Supplement, IndyMac, MBS, Depositor, IndyMac INDX Mortgage Loan Trust 2007-FLX5, at 71 (June 27, 2007) (permitting principal and interest advances to be recovered from the trust’s bank account); Prospectus, CWALT, INC., Depositor, Countrywide Home Loans, Seller, Countrywide Home Loans Servicing L.P., Master Servicer, Alternative Loan Trust 2005-J12, Issuer 47 (Oct. 25, 2005) (limiting right of reimbursement from trust account “to amounts received representing late recoveries of the payments for which the advances were made).

⁷²Monica Perelmuter & Waqas Shaikh, Standard & Poor’s, *Criteria: Revised Guidelines for U.S. RMBS Loan Modification and Capitalization Reimbursement Amounts* 3 (Oct. 11, 2007).

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recouping their advances on a modification. Modifications involving principal reductions compound the problem: they lengthen the time to recover advances on any individual modified loan as well as on other modified loans, by reducing the amount of principal payments available for application to recovery of advances.⁷³

Although the cost of the advances themselves may be recovered, the significant financing costs associated with making advances cannot be.⁷⁴ Thus, servicers are encouraged to reach a resolution of default as quickly and completely as possible, even at the expense of investors who might prefer a modification.⁷⁵

⁷³ *But see* Rod Dubitsky, Larry Yang, Stevan Stevanovic, Thomas Suer, Credit Suisse, Subprime Loan Modifications Update 8 (2008) (discussing how some servicers exploited then-existing imprecision in the accounting treatment of principal reduction modifications to use principal reduction modifications to halt interest advances).

⁷⁴ Joseph R. Mason, Mortgage Loan Modification: Promises and Pitfalls 4 (Oct. 2007). A large subprime servicer noted in its 2007 annual report that although “the collectibility of advances generally is not an issue, we do incur significant costs to finance those advances. We utilize both securitization, (i.e., match funded liabilities) and revolving credit facilities to finance our advances. As a result, increased delinquencies result in increased interest expense.” Ocwen Fin. Corp., Annual Report (Form 10-K) 18 (Mar. 17, 2008); *see also* Wen Hsu, Christine Yan, Roelof Slump, FitchRatings, U.S. Residential Mortgage Servicer Advance Receivables Securitization Rating Criteria 1 (Sept. 10, 2009) (same) (“Servicer advance receivables are typically paid at the top of the cash flow waterfall, and therefore, recovery is fairly certain. However, . . . there is risk in these transactions relating to the timing of the ultimate collection of recoveries.”).

⁷⁵ *See* Complaint at 11–15, Carrington Asset Holding Co., L.L.C. v. American Home Mortgage Servicing, Inc., No. FST-CV 09-5012095-S (Conn. Super. Ct., Stamford Feb. 9, 2009) (alleging that servicer conducted “fire sales” of foreclosed properties in order to avoid future advances and recover previously made advances); Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 Housing Pol’y Debate 753, 757 (2004) (reporting that servicers sometimes rush through a foreclosure without pursuing a modification or improperly foreclose in order to collect advances); Peter S. Goodman, *Lucrative Fees May Deter Efforts to Alter Troubled Loans*, N.Y. Times, July 30, 2009.