

Foreclosure Fraud and Homeowner Abuse Prevention Act of 2011

Solutions for the Foreclosure Crisis

Aligning Incentives for Trustees, Servicers and Investors

- *Problem: Trustees are often non-responsive to investors needs.* The trustee of a pool of mortgage-backed securities is supposed to oversee the pool's operation, keep track of the note, and monitor the servicer, but trustees have little incentive to do so vigorously, and little potential recourse against servicers.¹ Many originators and servicers have arrangements with trustees that they use for most of their deals.² This has resulted in poor maintenance of trust documents and servicer abuse of investors and homeowners.

Solution: To improve trustee accountability to investors, this bill removes the exemption from the standards and requirements established by the Trust Indenture Act for trustees of pools of mortgage-backed securities.³ This bill also creates a fiduciary duty for servicers to act in investors' financial interest.

- *Problem: Barriers to collective actions by investors.* In a practice known as "tranche warfare," some investors push for immediate foreclosure and others push to extend the loan. Pooling and servicing agreements also include provisions that require a certain investor threshold before actions can be taken under the trust agreement.⁴

Solution: This bill aligns financial incentives of all investors and eliminates some of the barriers to that prevent investors from working together. It also provides for the lowest order of investors to pick the trustee, as is already provided in commercial mortgage-backed security (CMBS) agreements.⁵

- *Problem: Second liens interfere with the best interests of investors and homeowners.* The nation's four largest banks own nearly half of all outstanding second liens and also service nearly half of all first mortgages.⁶ For the past two years, investors in mortgage-backed securities have complained that the nation's largest banks too often consider how various modifications will affect their second liens when they service mortgages.

Solution: This bill prohibits servicers from owning any second lien on a property that secures a loan included in a pool of mortgages that they are servicing. It also requires the owners of second liens to appropriately write down those mortgages when a primary mortgage has been modified.

¹ See Gretchen Morgenson, *Foreclosures Hit a Snag for Lenders*, N.Y. TIMES, Nov. 15, 2007; see also Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. ON REGULATION 1, 60 (2011)

² See *id.*, at 61.

³ See Trust Indenture Act of 1939, 53 Stat. 1149, at §4(a)(2) (Exempting "any certificate of interest or participation in two or more securities having substantially different rights and privileges[.]").

⁴ See Levitin & Twomey, *supra*, at 62-63 ; see also Anna Gelpern & Adam J. Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions In Residential Mortgage-Backed Securities*, 82 SOUTHERN CAL. L. REV. 1075, 1091-93

⁵ See *id.*, at 1106.

⁶ See *Regulators: Time to Crack the Whip on Second Mortgages*, WALL ST. J., Dec. 1, 2010.

Providing Uniform and Effective Foreclosure Prevention Procedures

- *Problem: Servicers proceeding to foreclosure without considering modification.* Servicers proceeding with a foreclosure before considering a loan modification results in primarily benefits servicers at the expense of investors and homeowners.⁷ Servicers are able to recover full costs at foreclosure, giving them an incentive to avoid doing modifications in favor of foreclosure. Accounting rules encourage servicers to drag out temporary modifications to delay recognizing the costs associated with mortgage modifications.⁸
- *Solution:* This bill requires servicers to participate in sustainable loan modifications when it is in investors' best interest. It creates a defense to foreclosure when servicers fail to offer loan modifications, and gives servicers an incentive to work with homeowners by extending the protections of the *Fair Debt Collection Practices Act*.⁹ The bill also prohibits servicers from masking the non-performing loans by requiring them to mark to market loans that are more than 120 days delinquent and have not been granted a modification. Any homeowner denied a modification would be entitled to the documentation justifying their denial.
- *Problem: "Dual track."* Servicers have been known to file for, or continue, foreclosures against homeowners participating in the modification process. In a survey of consumer attorneys from 34 states, almost 99 percent said that they have represented homeowners placed in foreclosure while awaiting a loan modification.¹⁰ The dual track system results in "accidental" foreclosures, when one department of the servicer fails to communicate with another, or papers are lost, or instructions are not conveyed to the foreclosure attorney.¹¹

Solution: Consistent with guidance from the OCC, this bill bars "dual track," while a homeowner is participating in a modification.¹² Servicers are permitted to proceed with foreclosures only after working with borrowers on a modification.

- *Problem: "Underwater" homeowners.* Homeowners who could normally refinance their way out of a lost job or sell their home in the face of foreclosure are denied both options when they owe more on their home than it is worth.¹³ At the end of the fourth quarter of 2010, 11.1 million, or 23.1 percent, of all residential properties were in negative equity.¹⁴ Amherst Mortgage Insight recently found that principal reductions are the most effective type of modification.¹⁵ A recent IMF report found that U.S. banks have enough capital to absorb a 30 percent writedown on seriously delinquent and foreclosed loans through 2015.¹⁶

⁷ See Thompson, *supra*, at 25-27.

⁸ See *id.*, at 12.

⁹ See Levitin & Twomey, *supra*, at 53.

¹⁰ See National Association of Consumer Advocates & National Consumer Law Center, *Servicers Continue to Wrongfully Initiate Foreclosures*, Dec. 15, 2010.

¹¹ See Thompson, *supra*, at 32.

¹² See Alan Zibel, *Banks Told To Stop Foreclosures During Mortgage Modification*, Wall St. J., Dec. 1, 2010.

¹³ See Thompson, *supra*, at 33.

¹⁴ See "New CoreLogic® Data Shows 23 Percent Of Borrowers Underwater With \$750 Billion Dollars Of Negative Equity", CoreLogic, Mar. 8, 2011.

¹⁵ Amherst Mortgage Insight, *The Case for Principal Reductions*, March 24, 2011.

¹⁶ See International Monetary Fund, *Global Financial Stability Report: Durable Financial Stability: Getting There From Here* 43 (Apr. 2011).

Solution: This bill permits borrowers who are 90 or more days delinquent to earn principal reductions where it is economically beneficial to all investors.

Improving Disclosures and Protections for Homeowners

- *Problem: Misapplication of homeowner payments.* Levying outsize default fees is another tactic — the fees are diverted from the principal to the servicer, and they can still propel a property into foreclosure more quickly.¹⁷ Being short by as little as \$0.14 on a mortgage payment can trigger fees and drive some homeowners into default.¹⁸

Solution: The bill requires payments, including partial payments, to be applied to scheduled principal and interest before they are applied to fees.

- *Problem: Poor disclosure to homeowners.* Servicers' communication with borrowers has been so disorganized that one federal bankruptcy court opinion asked "Is it too much to ask a consumer mortgage lender to provide the debtor with a clear and unambiguous explanation of the debtor's default prior to foreclosing on the debtor's house?"¹⁹

Solution: This bill entitles borrowers to a monthly servicing statement describing the payment amount, the date, time, and location for payments to be received under the terms of the loan agreement. It also requires an explanation of all payments received by the servicer and their allocation.

- *Problem: Confusion stemming from mortgage transfers.* There have been reports of nightmare scenarios of homeowners having their loans transferred to new servicers without being notified. One Cleveland couple was never notified that their mortgage had been transferred, and continued to send payments to their old servicer.²⁰ The old servicer continued to cash their checks, but their new servicer promptly held them in default.

Solution: This bill would apply the *Truth in Lending Act's* transfer notification requirements to servicers, and create substantive protections and disclosure rules for homeowners whose mortgages are transferred, including a 2-month safe harbor for homeowners who mistakenly send payments to the wrong servicer.

Reforming Mortgage Servicer Fees and Compensation

- *Problem: Servicer fee income favors foreclosure over modifications.* Servicers make income off defaulted loans by tacking on fees, advancing payments to the trusts, and then recovering the costs at foreclosures.²¹ Servicers are also able to direct fee income for services to affiliates. This gives servicers incentives to maximize fee income over value to

¹⁷ See Gretchen Morgenson, *Opening the Bag of Mortgage Tricks*, N.Y. TIMES, Dec. 18, 2010.

¹⁸ See Teresa Dixon Murray, *Mortgage Foreclosure Uproar Sweeps Up Northeast Ohio*, CLEVELAND PLAIN DEALER, Oct. 17, 2010.

¹⁹ Porter, *supra*, at 136.

²⁰ See Murray, *supra*.

²¹ See Levitin & Twomey, *supra*, at 71.

investors and homeowners. Thus, foreclosure claims in bankruptcy are usually full of junk fees tacked on by servicers.²² And servicers recover their fees before any payments are made to investors, effectively making them the senior-most creditor in a foreclosure claim.²³

Solution: The bill restricts the amount that servicers can advance to the trust. It also requires all fees to be reasonably related to the cost of providing the service and prohibits self-dealing through servicers insourcing work to their affiliates.

- *Problem: Forced placed insurance.* Recent industry reports have homeowners being abuse by forced placed insurance, and servicers benefitting from kickback agreements.²⁴

Solution: This legislation Builds off of forced placed insurance reforms in the Dodd-Frank Act, and protects borrowers from being forced into high-cost policies by requiring servicers to continue borrowers' existing forced placed insurance policy or reestablish such policy if there is a lapse in payment.

Improving Mortgage Servicer Staffing and Procedures

- *Problem: Inadequate staffing and resources.* Servicers lack the necessary staffing and resources to tackle the record rates of mortgage defaults and foreclosures. One commentator estimates that servicers would need to increase staffing 1000 percent in order to modify as few as 10 percent of the loans in default.²⁵ And loan modifications require a higher skill level than collections work.²⁶ In their rush to process foreclosures, banks hired inexperienced workers (“Burger King kids” as they have been referred to) who barely knew what a mortgage was.²⁷

Solution: This bill would require servicers required to provide appropriate staffing and training. Servicers of delinquent loans would impose a reasonable limit on the number of cases handled by each employee. To improve oversight and accountability, executive compensation could be clawed back if a servicer violates federal securities laws.

- *Problem: Lost and missing paperwork.* Loan modifications typically take between 120 and 240 days, and process errors— such as multiple requests for paperwork, incorrect evaluation, lack of communication between departments, etc.—are common among servicers.²⁸

²² See Katherine M. Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims*, 87 TEXAS L. REV. 121, 152-153 (2009).

²³ Levitin & Twomey, *supra*, at 43.

²⁴ See Jeff Horwitz, *Ties to Insurers Could Land Mortgage Servicers in More Trouble*, Am. Banker, Nov. 10, 2010.

²⁵ See Diane E. Thompson, *Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior*, National Consumer Law Center (2009) at 28.

²⁶ See *id.*

²⁷ See Eric Dash and Nelson D. Schwartz, *Bankers Ignored Signs of Trouble on Foreclosures*, N.Y. TIMES, Oct. 13, 2010.

²⁸ See Francisca Richter, Lisa Nelson, and Youngme Seo, *Mortgage Delinquencies in Ohio: Are Loan Modifications Stemming the Tide?*, Federal Reserve Bank of Cleveland (Oct. 19, 2010) at 3; see also Congressional Oversight

Solution: This bill requires servicers to create a single electronic record for each borrower, designate a single contact for each stage of the mortgage process, from loan servicing to loan modification to bankruptcy, and provide one team leader to coordinate between mortgage servicer departments. It also requires transferring servicers to update successor servicers on the status of the mortgage modification process, and requires successor servicers to continue the modification process or honor modification agreements.

- *Problem: Servicing defaulted mortgages is time intensive and unprofitable.* Currently, servicers are not incentivized to maximize a loan's value to investors, but are instead incentivized to drag out defaults in order to continue collecting fees.²⁹ Loan modifications require time-intensive work with borrowers.³⁰

Solution: In addition to servicer fee reforms, this bill would require loans that are imminent default or more than 60 days delinquent to be transferred to a special servicer for delinquent or defaulted loans. This would make residential mortgage-backed securities consistent with commercial mortgage-backed securities (CMBS), which usually feature a similar special default servicer arrangement.³¹ It also provides for such special servicers to receive an interest in the loans that they are servicing, similar to CMBS special servicers that receive an annual percentage of the principal for all loans being serviced.³²

Ensuring the Safety and Soundness of Mortgage Servicing

- *Problem: Bank examiners do not conduct risk-based examinations of mortgage servicers.* Shoddy mortgage servicing practices can increase banks' liabilities to homeowners and investors. Because the risks from mortgage servicing generally did not indicate the need to conduct more detailed reviews of these operations, federal banking regulators had not regularly examined servicers' foreclosure practices.³³ For example, OCC officials' examinations of servicing activities are generally limited to reviews of income that banks earn from servicing loans for others and do not generally include reviewing foreclosure practices.³⁴
- *Solution:* This legislation requires the appropriate federal banking regulators to establish independent capital reserve standards for mortgage servicer affiliates of federally regulated financial institutions.

Panel, December Oversight Report, Dec. 12, 2010 at 29 (Finding that the most common reason for denial of a HAMP modification is missing or lost paperwork).

²⁹ See Levitin & Twomey, *supra*, at 70.

³⁰ See Thompson, *supra*.

³¹ See Gelpert & Levitin, *supra*, at 1103; see also Levitin & Twomey, *supra*, at 85-89.

³² See Gelpert & Levitin, *supra*, at 1104; see also Levitin & Twomey, *supra*.

³³ See Government Accountability Office, *Additional Mortgage Servicer Actions Could Help Reduce the Frequency and Impact of Abandoned Foreclosures*, GAO-11-93, Nov. 2010.

³⁴ See *id.*