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THE NEED FOR NATIONAL MORTGAGE SERVICING STANDARDS

HEARING

BEFORE THE

SUBCOMMITTEE ON
HOUSING, TRANSPORTATION, AND COMMUNITY DEVELOPMENT

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

ON

EXAMINING THE IMPORTANT NEED FOR NATIONAL MORTGAGE SERVICING STANDARDS

MAY 12, 2011

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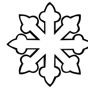

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THE NEED FOR NATIONAL MORTGAGE SERVICING STANDARDS

THURSDAY, MAY 12, 2011

U.S. SENATE,
SUBCOMMITTEE ON HOUSING, TRANSPORTATION, AND COMMUNITY DEVELOPMENT,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 2:12 p.m., in room SD–538, Dirksen Senate Office Building, Hon. Robert Menendez, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN ROBERT MENENDEZ

Chairman MENENDEZ. Good afternoon. This hearing will come to order, the hearing of the Banking Subcommittee on Housing, Transportation, and Community Development. This is the first Subcommittee hearing that I have called as Chairman in the 112th Congress, and for this hearing I have chosen to focus on the need for national mortgage servicing standards, which speaks to just how important I believe this subject is not only for homeowners and mortgage investors, but for the entire lending industry.

It is of particular concern to the countless New Jersey homeowners who have contacted my office, almost all with terrible stories about their experience going through foreclosure, and many with stories of being either mistreated or neglected by mortgage servicers. The typical problems they encounter are servicers losing their paperwork, not understanding what already happened the last time they called since they get a different person each time they call, asking them to reapply for modifications numerous times with new documentation each time, a lack of transparency as to whether their modification requests are being calculated properly, ineffective appeals, excessive delays in coming to decisions, and a general reluctance by servicers to modify loans in ways that would be sustainable in the long run. And we are going to hear from some witnesses as to why that might very well be the case. Overall, the current process is both emotionally draining and ineffective in keeping people in their homes.

Closely related to homeowner concerns are mortgage investor concerns about the conflicts of interest that many mortgage servicers face when deciding whether to foreclose or modify a loan. In response to all of these concerns, numerous commentators have suggested that national mortgage servicing standards may be a way to provide consistency, accountability, and better homeowner and mortgage investor protections.

There seems to be an increasing consensus that at least some kind of national mortgage servicing standards are warranted, and I believe that if they are done in the right way, they can actually make mortgage servicers' jobs easier as well.

This is also a timely topic because Federal banking regulators, including the OCC, the Federal Reserve, FDIC, and OTS, recently issued consent orders as enforcement actions against some of the largest banks to require changes in their mortgage servicing practices. These actions take a step in the direction of developing national mortgage servicing standards, but they are also too little and too late.

The independent Government Accountability Office, the GAO, has also released a report recently that speaks to the need for national servicing standards related to foreclosures. There have also been numerous bills introduced in Congress requiring various kinds of national mortgage servicing standards. So I have convened this hearing to solicit the views of various experts and market participants. I have asked them to comment on whether they believe national mortgage servicing standards are needed and what exactly should be in those standards, and I want to thank all of the witnesses in advance for their testimony here today.

I want to apologize. We were a few minutes late in starting because we have a vote that is taking place on the floor. I know Senator Merkley, who is very involved in these issues, has voted and is on his way here, and so if he wishes to, when he gets here I will recognize him. But in the interest of moving our process ahead here, let me start off with our first witness on this first panel, Nicole Clowers. She is the Acting Director of Financial Markets and Community Investment, Government Accountability Office. She has testified here before, and she is the lead author of a GAO study that Senator Franken and I requested and that just came out last week on the Federal banking regulators' response to the so-called robo-signing, which is the illegal rubber-stamping of foreclosures by mortgage servicers in court documents.

So, Ms. Clowers, thank you for your work. Thank you for being here for testimony. I would ask you to summarize your testimony in about 5 minutes or so. We are going to include your full testimony in the record, and with that, I would like to recognize you to start off.

STATEMENT OF A. NICOLE CLOWERS, ACTING DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, GOVERNMENT ACCOUNTABILITY OFFICE

Ms. CLOWERS. Thank you, Chairman. Thank you for having me here today to talk about our recent work on mortgage servicing issues.

As you know, last fall a number of servicers announced that they were halting or reviewing their foreclosure practices after allegations that foreclosure documents may have been improperly signed or notarized. While the servicers resumed their foreclosure activities after completing their reviews, concerns about servicing practices and the impact of reported problems remain. In light of these concerns, you and several others asked us to review Federal oversight of the servicing industry.

We issued our report last week and concluded that the documentation problems revealed the need for ongoing oversight of servicers. Although Federal regulators have taken steps in recent months to increase their focus on servicing issues, the resulting delays in completing foreclosures and increased exposure to litigation highlight how the failure to oversee whether institutions follow sound practices can heighten the risk these entities present to the financial system and create problems for the communities in which foreclosures occur.

As a result, we recommended that the banking regulators take various actions, including: one, developing and coordinating plans for ongoing oversight of the servicing industry; two, ensuring that foreclosure practices are included as part of any national servicing standards that are developed. In my comments today, I will discuss each of these recommendations in more detail.

First, we recommended that the banking regulators and the new Bureau of Consumer Financial Protection work together to develop and coordinate oversight plans. Until the problems regarding foreclosure documentation came to light, Federal oversight of the servicing industry had been limited, in part because regulators viewed such activities as low risk to safety and soundness. Furthermore, past Federal oversight was fragmented and not all servicers were overseen by Federal banking regulators.

In response to reported foreclosure documentation problems, banking regulators conducted a review of foreclosure processes at 14 servicers. This review found that servicers had generally failed to properly prepare documentation and lacked effective supervision and controls over their foreclosure processes. Examiners also identified a limited number of cases in which foreclosures should not have proceeded, even though the homeowner was seriously delinquent, including cases where foreclosures proceeded against military servicemembers on active duty in violation of the Servicemembers Civil Relief Act.

Banking regulators plan to follow up with servicers to better ensure that they implement agreed-upon corrective actions, and the new Bureau also plans to conduct oversight of servicing activities. However, the extent to which the regulators will conduct ongoing supervision of servicing activities in the future as well as the goals for the supervision and the roles that each regulator will play have not been fully determined. Until these plans are developed, the potential for continuing fragmentation and gaps in oversight remain.

Second, we recommended that the banking regulators and the Bureau of Consumer Financial Protection take steps to include foreclosure practices in any national servicing standards that are developed. To help address the identified problems and concerns with servicing activities, various market participants, as you noted, Chairman, have begun calling for the creation of national servicing standards, and most of the regulators have stated that national servicing standards could be beneficial. Regulators and others cite a number of potential benefits of implementing standards, including creating clear expectations for all servicers, establishing consistency across the servicing industry, increasing transparency of servicing practices, and promoting accountability in dealing with

consumers. Regulators have established an interagency process to consider these issues in developing national servicing standards.

While servicing standards could cover a wide range of activities, it is unclear the extent to which they would address the identified weaknesses and lack of consistency among servicer foreclosure practices and how the standards would be implemented. If national servicing standards are developed, ensuring that they provide clear expectations for servicers to follow as part of the foreclosure process could be a way to improve consistency in the servicing industry. Consistent expectations for the foreclosure process could also help address the limited oversight of the servicing industry that we have seen in the past.

In conclusion, regulators have recently increased their oversight of the servicing industry, but additional actions are warranted. We made several recommendations to the regulators to help strengthen the oversight of this industry. The regulators generally agreed with our recommendations, and some are taking steps to implement them. We look forward to working with the regulators and this Subcommittee to ensure these recommendations are fully implemented.

Mr. Chairman, this concludes my prepared statement. I would be happy to answer any questions you may have.

Chairman MENENDEZ. Well, thank you very much, and you are so effective. You had 5 seconds left.

[Laughter.]

Chairman MENENDEZ. Let me ask you just a couple of questions. One is you reported that past Federal oversight was limited and fragmented. So if we were to have national servicing standards, would that help address this problem?

Ms. CLOWERS. It could help address the limited and fragmented oversight that we saw. In terms of addressing the fragmentation, the servicing standards could help increase consistency in both the treatment of the borrower as well as increase consistency in regulator oversight of the servicers. It could also increase the attention that the regulators give to the servicing process and the servicing industry and, therefore, help address the limited oversight that we saw.

Chairman MENENDEZ. And if we were to have national servicing standards, what should be included in them?

Ms. CLOWERS. The servicing standards could cover a wide range of activities, from loss mitigation to the compensation model for servicers. We did not evaluate all the potential elements. Rather we found that if servicing standards were developed, the foreclosure process should be included. OCC has developed a set of potential standards that I think could be used as a starting point in considering what type of foreclosure processes to include. The enforcement orders that were recently issued by the regulators also contained elements such as a single point of contract that could be another starting point as the stakeholders work to develop the standards.

I would also note that in 2009 we issued a report outlining principles for financial regulatory reform, and I think these principles could be useful in the context of developing servicing standards as they relate to the foreclosure process, including making sure that

the goals that we set are clear and not conflicting, making sure that all parties are treated consistently, considering the regulatory burden placed on the industry versus increasing oversight, as well as ensuring that they are flexible and forward looking so that we are not necessarily fighting the last fight.

Chairman MENENDEZ. Finally, the banking regulators just recently issued a report themselves with reference to their review of servicers' practices, and I wonder if you have had an opportunity to review that and some of their findings.

Ms. CLOWERS. I have. The regulators found significant weaknesses in the foreclosure practices of the 14 servicers they reviewed. The weaknesses fall into three general categories.

There were weaknesses with the documentation process, which would include such things as the person signing the affidavit not having the personal knowledge of the facts and circumstances of the loan as required by law.

There were also weaknesses with regard to vendor management in that the servicers were not providing sufficient oversight and due diligence in their oversight of the vendors that they use, such as the law firms.

And, finally, there were a number of weaknesses in what would be categorized as governance issues, and this ranged from a lack of documented written policies, lack of staffing capacity, lack of training, and a lack of controls and quality checks to make sure that documentation errors did not occur.

Chairman MENENDEZ. Good. Let me thank you for your work and your testimony. We may have colleagues who are going to ask questions in writing in the next couple days, so we appreciate your responses to those.

Ms. CLOWERS. Absolutely.

Chairman MENENDEZ. And thank you for coming before the Committee.

Ms. CLOWERS. Thank you.

Chairman MENENDEZ. Let me introduce the second panel as we excuse Ms. Clowers and ask them to come up and we will dictate the order here as we introduce them.

Diane Thompson is Of Counsel at the National Consumer Law Center and has represented low-income homeowners since 1994, and she has testified here before on foreclosure-related issues, so welcome back. Diane, please come on up.

Laurie Goodman is a senior managing director at Amherst Securities where she is responsible for research and business development. Before joining Amherst, she was the head of global fixed income research and manager of U.S. Securitized Products Research at UBS, and she is one of the most well respected mortgage investor analysts in the country, so we welcome her.

David Stevens is president and CEO of the Mortgage Bankers Association, and he just assumed that role. I think this may be his first hearing, so, David, welcome. Members of the Committee may recognize Mr. Stevens from his previous role only a few months ago as the head of the Federal Housing Administration at HUD. He has had a long and distinguished career in the public and private sectors.

Anthony Sanders is a professor of finance at George Mason University School of Management. He has written extensively about real estate finance and securitization. Thank you, Professor. And I am told he is from Rumson, New Jersey, so you can have all the time you want.

[Laughter.]

Chairman MENENDEZ. All politics is local. Welcome.

And Richard Harpootlian is a distinguished attorney who has tried cases in South Carolina for over three decades, and he currently represents thousands of military members, many of whom were illegally foreclosed on or overcharged in a class action lawsuit, and so we welcome you and your insights in that respect as well.

So thank you all for coming before the Committee. We would ask you to limit your oral testimony to about 5 minutes. Your entire written testimony will be included in the record, and this way we will have some opportunities for some Q&A with you.

With that, Ms. Thompson, would you begin?

STATEMENT OF DIANE E. THOMPSON, OF COUNSEL, NATIONAL CONSUMER LAW CENTER

Ms. THOMPSON. Thank you, Chairman Menendez.

Chairman MENENDEZ. You want to put your microphone on.

Ms. THOMPSON. Thank you.

Chairman MENENDEZ. We want to hear you.

Ms. THOMPSON. Thank you for inviting me to testify today. I am an attorney, currently of counsel to the National Consumer Law Center. In my work at NCLC, I provide training and support to hundreds of attorneys representing homeowners from all across the country. For nearly 13 years before that, I represented low-income homeowners East St. Louis, Illinois. I testify here today on behalf of the National Consumer Law Center's low-income clients and the National Association of Consumer Advocates.

The time for national mortgage servicing standards has come. We have tried reliance on servicers' good faith and competent execution. Servicers' good-faith efforts 4 years into this Nation's most devastating foreclosure crisis have failed to produce results. Serious delinquencies continue to outpace modifications by nearly five to one. Homeowners wait on average 14 months for approval of a permanent HAMP modification and often face wrongful foreclosure even after entering into a permanent modification. The loan modification process is dysfunctional in the extreme.

For example, high-level Bank of America employees recently promised a California homeowner that they would honor a modification they had granted the homeowner and cancel a pending sale. And yet the foreclosure sale went forward.

Despite repeated orders from a New York State court judge tolling interest on the loan for over 14 months percentage Chase's participation in court-supervised mediation, Chase has still not complied with its undertakings in that process.

Litton denied a North Carolina homeowner for failure to provide documentation, after sending all requests for additional documentation to an address that corresponded to neither the homeowner's nor her attorney's.

Chase foreclosed on a Washington State homeowner who was making payments and, then when she called after receiving the eviction notice in connection with the foreclosure, denied that it had foreclosed. That woman and her family are now living in an apartment and are no longer homeowners.

Loan modifications make economic sense, but servicers nonetheless deny modifications because they, the servicers, can do better financially by foreclosing than providing permanent sustainable modifications and because there are no consequences to servicers for failing to provide the modifications.

The lack of restraint on servicer abuses has created a moral hazard juggernaut that at best prolongs and deepens the current foreclosure crisis and at worst threatens our global economic security. State regulators have attempted to rein in these abuses, but servicers have often sought protective shelter in the preemption rulings issued by the Office of the Comptroller of the Currency. Recent consent orders announced by the Federal banking agencies are of limited reach and threaten to undermine the combined and unprecedented efforts of the Department of Justice and the Attorneys General of all 50 States.

The GSEs—Fannie Mae and Freddie Mac—and their oversight agency, the Federal Housing Finance Authority—have failed to prioritize loan modifications over foreclosure. Even new guidance from the FHFA fails to end dual track—the practice of proceeding with a foreclosure and a loan modification at the same time.

The dual-track process must be ended. Key to any national servicing standards is the evaluation of a homeowner for a loan modification prior to the initiation of a foreclosure. Homeowners must be evaluated for and, when appropriate, offered a loan modification before a foreclosure. Once a foreclosure is started, it takes on a life of its own. Fees mount up and legal deadlines must be met. A modification becomes increasingly out of reach and accidents happen. Initiating foreclosure before completing the loan modification review guarantees wrongful foreclosures.

Failing to stop an existing foreclosure proceeding while a modification review is underway has the same costs, the same risks, and the same results—families turned out on the street while awaiting a review on their application or even while making payments on a modification.

In order to prevent wrongful foreclosures, reduce costs for both homeowners and investors, and encourage the timely evaluation of loan modification applications, the dual-track system must be stopped, and stopped absolutely. Recent bills introduced by Senator Reed, Senator Brown of Ohio, and today's bill introduced by Senator Merkley take this and other important steps.

To promote responsible servicing that serves the interests of both homeowners and investors, principal reductions must be mandated, fees limited, transparency provided throughout the modification process, including the calculation of the net present value. Servicers should be prevented from foreclosing if they have not complied with these baseline servicing standards.

We are at a watershed moment. To date, we have imposed no restraints on servicers' excesses. The existing proposals for servicing reform from the banking agencies and the FHFA would leave the

existing dysfunctional system intact. We can do better. In my written testimony, I detail the reforms needed. We must hold mortgage servicers accountable to the stakeholders, homeowners, investors, and the American public.

I thank you for the opportunity to testify today, and I am happy to answer any questions you may have.

Chairman MENENDEZ. Thank you, Ms. Thompson.

I want to interrupt the panel for a moment and ask my colleague—I know he is under time constraints—whether he wishes to make any statement or let the rest of the witnesses go, and I would be happy to yield to you first for questioning. It depends on your time constraints.

Senator MERKLEY. I simply deeply appreciate the folks who have come to testify on such an important issue to the health of our families and the health of our economy, and I would like to have them continue. Thank you.

Chairman MENENDEZ. Thank you.

Ms. Goodman.

STATEMENT OF LAURIE F. GOODMAN, SENIOR MANAGING DIRECTOR, AMHERST SECURITIES

Ms. GOODMAN. Mr. Chairman and Members of the Subcommittee, I am honored to testify today. My name is Laurie Goodman, and I am a senior managing director at Amherst Securities Group, a leading broker/dealer specializing in the trading of residential mortgage-backed securities. I am in charge of the strategy and business development efforts for the firm.

The purpose of my testimony is to discuss conflicts of interest facing mortgage servicers that may stop them from acting in the best interests of mortgage investors and homeowners. Let me begin by pointing out that the interests of mortgage investors and homeowners are largely aligned for two reasons.

First, the mortgage market is reliant on investors to continue to extend credit, allowing borrowers to achieve competitive mortgage rates.

Second, foreclosure is, without question, the worst outcome for both investors and borrowers. It is a long and drawn-out process in which a borrower is forced from his home, and an investor typically suffers a loss on his investment of between 50 and 80 percent of the loan amount.

Here are the five inherent conflicts that we see.

Conflict number one, large first-lien servicers have significant ownership interests in second liens and often have no ownership interest in the corresponding first lien. The four largest banks—Bank of America, Wells Fargo, JPMorgan Chase, and Citigroup—collectively service 54 percent of the 1–4 family servicing in the United States. They own approximately 40 percent of the second liens and home equity lines of credit outstanding. This is a conflict because the servicer has a financial incentive to service the first lien to the benefit of the second lien holder. Some examples:

Short sales and deeds in lieu are less likely to be approved. If the servicer accepts a short sale offer, the second lien, which is held on the balance sheet of the financial institution, must be written off immediately. As a result, the servicer may be more inclined

to reject the short sale offer, even if the offer makes sense for the investor and borrower. In addition, loan modification efforts are suboptimal. Principal reduction is used far less often than it should be. National servicing standards should require servicers to perform the modification to maximize the net present value of the loss mitigation options.

Conflict two, the servicer often owns a share in companies that provide ancillary services during the foreclosure process and charges above market rates. These services included force-placed insurance and property preservation. Even when a servicer is not affiliated with the company providing the service, they often mark up the fees considerably. These fees are added to the delinquent amount of the loan, making it much harder for a borrower to become current. Moreover, when a loan is liquidated, the severity on the loan will be much higher, to the detriment of investors.

National servicing standards can be used to require servicers to keep existing homeowners insurance policies in place as long as possible. There should be a prohibition on marking up third-party fees. Moreover, following the lead of the proposed Attorney General settlement, national servicing standards should prohibit a servicer from owning an interest in an entity that provides foreclosure-related services.

Conflict three, conflicts of interest in the enforcement of representations and warranties are becoming an increasing issue for the market, as indicated by recent litigation. Once a "rep and warrant" violation is discovered, the trustee is charged with the enforcement. However, the trustee does not have the information to detect the violations as they do not have direct access to the loan files. Servicers who do have the information to identify "rep and warrant" violations often have a financial disincentive to do so as they would be putting the loan back to an affiliated entity.

It is critical to have an independent third party that is incented to enforce reps and warrants and has both access to the information and enforcement authority. This must be achieved through the deal documents. National servicing standards should, however, direct servicers to make sure that there is an adequate enforcement mechanism for reps and warrants.

Conflict four, the servicing fee structure is unsuitable to this environment. There are many situations in which transferring the servicing of a loan on which the borrower is delinquent to a servicer that specializes in loss mitigation would be the best outcome for both borrowers and investors. A number of special servicers have had considerable experience tailoring modifications to the needs of individual borrowers and tend to provide more hand holding to the borrower post modification than what a major servicer can offer. Servicing transfer issues are made very difficult as servicers are compensated too highly for servicing current loans, not highly enough for servicing delinquent loans. If fees for servicing current loans were lowered while fees for servicing delinquent loans were raised, it would allow the special servicer to be adequately compensated for his high-touch efforts. This, in turn, would make it much easier to transfer delinquent loans to servicers who would do a better job of loss mitigation.

Conflict number five, transparency for investors is woefully inadequate. In a private label securitization, there is often a large difference between the monthly cash payment the investor expected to receive and what is actually received. Moreover, an investor is unable to delve into the cash-flow information further as transparency on the action of the servicer that would be necessary to reconcile the cash-flows is not available. When I receive the statement from my bank each month, I balance my checkbook, reconciling the differences. Investors want to be able to do exactly this with the cash-flows from the securitizations in which they have an interest. They are unable to. We believe the remittance reports for future securitizations should contain loan-by-loan information, and that loan-by-loan information should be rolled up into a plain English reconciliation. National servicing standards should encourage this transparency.

In conclusion, national servicing standards can go a long way toward dealing with the conflicts of interest between servicers on the one hand and borrowers and investors on the other.

We appreciate the opportunity to testify on this important set of issues. Thank you.

Chairman MENENDEZ. Thank you.

Mr. Stevens.

STATEMENT OF DAVID H. STEVENS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, MORTGAGE BANKERS ASSOCIATION

Mr. STEVENS. Thank you, Mr. Chairman, for the opportunity to testify here on the need for national mortgage servicing standards. On May 1st, I began my tenure as president and CEO of the Mortgage Bankers Association, and most recently I served as Assistant Secretary for Housing and the Federal Housing Commissioner. I have also been actively involved in this industry for three decades.

In 2008, we faced the perfect storm. As the global economy collapsed, the subprime market imploded. Many Americans lost their jobs. Millions of Americans defaulted on their mortgages, putting extraordinary strains on the existing servicing system. It is clear that our industry was unprepared to handle these unprecedented events and that we made mistakes. Acknowledging our mistakes is the first step to rebuild trust in industry and our actions. Without trust, the industry is nothing, and by trust, I mean the ability of policy makers, thought leaders, borrowers, and the industry at large to have faith in the products and services that we provide, and we absolutely have to do better moving forward.

I can assure you that the mortgage finance industry and servicers in particular have not stood still in addressing the mistakes. Many have put in place training, internal controls, independent third-party auditors, adding thousands of people and improved technology needed to move forward. Presently, servicers face a growing number of checks and balances ranging from Federal laws and regulations, RESPA and TILA, to 50 State laws, regulations that vary, local ordinances, as well as court rulings, FHA, VA, Rural Housing Service requirements, *et cetera.* These requirements are in addition to Fannie Mae standards, Freddie Mac standards, and other contractual obligations. In short, servicers are

faced with complex, often contradictory rules and regulations, many of which are emergent.

So what is the answer? A consolidated servicing standard could drive these reforms. Creating a servicing standard would streamline and eliminate many of the overlapping requirements, provide clarity and certainty for borrowers, lenders, and investors alike. It is critical that all of the Federal regulators involved act in a coordinated manner to establish one national consolidated servicing standard that applies to the entire industry rather than piling on requirement after requirement. A national standard should start with a complete analysis of existing servicer requirements and State laws governing foreclosures. Developments should include an open dialog with stakeholders in the servicing arena, all of whom must ultimately implement and comply with the national standard.

The MBA has initiated this process by convening a blue ribbon Council on Residential Mortgage Servicing. The council examined the entire servicing model and is forming recommendations to improve the system for all stakeholders.

I am pleased to announce that today we actually rolled out a white paper, which I believe is the first white paper on the subject, and ask that it be included as part of my testimony.

In the white paper, the council aims to examine the current servicing model, address public misconceptions relating to servicing practices and incentives, and educate the public on the role and compensation of servicers. I believe this white paper will provide useful information to you and other policy makers that are currently debating the national servicing standards, and I encourage the Subcommittee to use the MBA and its Council on Residential Mortgage Servicing as a resource going forward.

In conclusion, as we develop servicing standards, I will urge you to pay careful attention to the interdependence of servicing and the impact that change to the servicing system will have on the economics of mortgage servicing, tax and accounting rules and regulations, and effects of the new requirements on Basel capital requirements and on the TBA market. Servicing does not exist in a vacuum. Instead, it is part of a broader ecosystem which involves all the varied elements of the mortgage industry. The housing market remains very fragile and, therefore, when considering changes to the current model, policy makers we ask be mindful of unforeseen and unintended consequences that could ultimately result in higher housing costs for consumers and reduced access to credit.

As I mentioned at the beginning of my remarks, I have spent more than three decades in this industry. Despite what we have just lived through and the challenges we continue to face, I am optimistic we can successfully address the challenges of the mortgage servicing system going forward. And, Mr. Chairman, MBA supports reasonable, rational national servicing standards that apply best practices to the process to better serve the needs of borrowers, servicers, and investors alike. We want to be part of the solution and look forward to working with you and other policy makers toward that end.

Thank you.

Chairman MENENDEZ. Well, thank you, Mr. Stevens. Thank you for the spirit in which the association comes here.

I want to accommodate Senator Merkley, who has been very involved in these issues, so to our final two witnesses, if you would just forbear with us a moment or a few minutes and recognize Senator Merkley, who has some questions of the panel at this time.

Senator MERKLEY. Thank you very much, Mr. Chair, and thank you for holding this hearing, because I think this issue of the complexity of the mortgage markets and the role servicers play within the set of parties is an extremely important one to figure out.

And, Mr. Stevens, thank you for your work at the FHA. I appreciate the spirit that you bring to trying to address some of these key complexities.

Ms. Goodman, I wanted to ask you one question about the conflicts of interest, and that is you put forward—one of your concepts was to increase the fees for dysfunctional mortgages and decrease the fees for servicing current mortgages, and one concern I have had about that is it creates perhaps—well, let me explain that I have had many Oregonians tell me that the first time they missed a payment was after they had talked to their servicer about the change in their financial circumstances and the servicer said to them, well, what you do is you are eligible for a mortgage modification, and so—but first, you have to—you cannot be current, so you need to miss three payments or make half-payments for 3 months.

One of the issues that has come up as to whether there was kind of a perverse incentive in the servicer structure in which they were getting paid more for loans that were not current versus loans that were current, and to put salt into the wound, the same families then report that after they missed those payments, they were often told, because you are not current, you are not a good credit risk for a mortgage modification. This is kind of a hellish nightmare position to be in, and your recommendation about accentuating the difference between those fees, could that make this problem worse?

Ms. GOODMAN. I would be very careful about how I would do it. I agree that that is definitely a moral hazard issue, and what I actually suggested in my written testimony is there is a very simple solution to this. Give the GSEs or private label investors the ability to move the servicing when the higher fees are scheduled to take effect.

So what that does is I am servicing a current loan. That loan goes delinquent. If I do not make that proactive phone call to keep that loan from going delinquent, I stand a chance of losing that servicing when the higher fee takes effect. You have to have something like that in there in order to eliminate the moral hazard.

Senator MERKLEY. Yes, eliminate that conflict of interest. Thank you. That is helpful.

And, Mr. Stevens, one of the ideas that Ms. Goodman put forward was to try to reduce or eliminate the conflict of interest, where the servicer who may have originated the loan still holds the second mortgage, but no longer the first because the first has been sold. It creates distinctions between operating on behalf of the trust that holds the first mortgage and the interest of the second mortgage. Do you have any particular insights on the concepts that she put forward to address that?

Mr. STEVENS. These are all subjects I would love to engage in a longer discussion with you, Senator, as we have in the past on

these issues. We have struggled as we work through these foreclosure processes over the past several years with incentives in the process, incentives on first mortgage modifications or principal write-down or foreclosure resolution, incentives on seconds, loans held, loans sold.

The one thing I am challenged by is does the mere act of having someone else service the second in any way change the outcome as to what could ultimately be write-down on the second, and just to articulate that, whether the first lien gets modified or protected in any way—in some form, whether that second is held on the first lien holder's—on the same servicer's balance sheet or another servicer's balance sheet, both of those can cause challenges ultimately to having anything happen to the second lien. It will ultimately depend on how that second lien is valued.

I think, fundamentally, the thing that is absolutely clear is when the loan goes to foreclosure, the second lien gets wiped out in its entirety and the bank loses. So fundamentally, there should be an incentive to have that loan perform and to engage in some sort of modification.

I think we have communication challenges. Seconds are often held on bank balance sheets. First mortgages are held on the mortgage side balance sheet. But I am not certain that having two sets of servicers in any way resolves the complexity around the incentive structure and the ultimate resolution of that foreclosure.

Senator MERKLEY. And to add to this dilemma, the servicer of the second, even if the servicer is separate, may find the second is fully performing when the first is not, in part because there is a line of credit. The family may have chosen to say, I need to keep this line of credit valid because it is the only way to rescue myself from difficult financial bumps I might encounter.

Mr. STEVENS. That is right.

Senator MERKLEY. So then you are asking the servicer of the second to essentially engage in a process in which the loan that is current is—yes, it is messy and difficult——

Mr. STEVENS. Well, and——

Senator MERKLEY. ——and I am glad to have you all working on it.

Mr. STEVENS. And, Senator, the only thing I would just add as a follow-up to that, it needs to be a consideration, is many of these second loans were set up as home equity lines of credit, as you know. You know this very well. And many small businesses in America basically use that as their funding resource to operate a small business in this country. That is just one example.

So these are solutions that, as I said in the outset, we fully realize the mistakes and lack of preparedness that our industry did not have at the time and the mistakes we made, but working through these resolutions is critically important, as well, because we need to make certain that we are not disrupting, again, small business access or the kind of incentive misalignment that you just referred to in terms of the performing versus the nonperforming first.

Senator MERKLEY. Well, thank you all. I am sorry I have to leave, but I think just this short conversation shows how important this set of issues is in order to taking and restoring a healthy mort-

gage market, which is essential to working families being successful in home ownership and rebuilding their wealth. Thank you.

Chairman MENENDEZ. Thank you, Senator.

Dr. Sanders.

STATEMENT OF ANTHONY B. SANDERS, PROFESSOR OF FINANCE, GEORGE MASON UNIVERSITY SCHOOL OF MANAGEMENT

Mr. SANDERS. Chairman Menendez, Ranking Member DeMint, and distinguished Members of the Subcommittee, thank you for inviting me to testify today. I have been asked to opine on the need for national mortgage servicing standards.

The recent crash of the housing market and the rise of unemployment led to a historic surge in serious delinquencies and requests for loan modifications, short sales, and related transactions. As a result, the residential mortgage servicing industry was overwhelmed. Going forward, it is helpful to recommend changes to both servicing and securitization industries so they can avoid problems going forward as we attempt to revive the securitization market.

In December, Christopher Whalen, Nouriel Roubini, Josh Rosner, and others, including myself, wrote a letter to the U.S. financial regulators regarding national loan servicing standards. Again, I am one of the signors of the letter, but not because I wanted to have necessarily a national loan servicing standard created by the Government. Rather, I wanted to facilitate consideration for servicing companies on how to proceed forward.

Many of the items that were discussed in our letter were plausible recommendations, with a few exceptions. And one thing I want to point out is that Fannie Mae and Freddie Mac have their own servicing standards, which are, again, quite good and have been the industry standard for a long time. Since Fannie and Freddie can actually mandate servicing standards, that is a good place to begin.

You have just heard Dave Stevens for the Mortgage Bankers Association talking about the Blue Ribbon Committee to modify the standards that Freddie and Fannie use for the private label market and general mortgage servicing in general, and while it is very tempting to have the Federal Government regulate loan servicing, I would argue that, in fact, since Fannie, Freddie, and the FHA basically occupy 95 percent of the space now, they are, in fact, regulating the market for national loan servicing anyway.

But one recommendation that the Whalen letter had that I disagree with was risk retention by securitizers, where Dodd-Frank requires that securitizers retain at least 5 percent of the risk of the loans or they do not qualify as QRMs, or qualified residential mortgages sold in the securitization market. In theory, that retention would lead securitizers to be more careful in loan origination, underwriting, and even servicing process since many of the services are actually captured by the banks. To be sure, 5 percent risk retention would be the simplest approach to implement to improve all these things. However, risk retention also appears to be the least useful approach.

Once again, housing prices in Las Vegas fell 56 percent from peak to trough. Five percent risk retention would have been knocked out of the box within months. Therefore, that also complicates and exaggerates, or exasperates—makes it worse.

[Laughter.]

Mr. SANDERS. Sorry. My coffee machine broke this morning.

Fannie Mae and Freddie Mac along with the FHA do control a large segment of the market, but even they have had to file repurchase claims on some of the loans sold to them in regards to servicing. Therefore, one thing I recommend that bypasses both the 5 percent risk retention and also addresses what Ms. Goodman talks about is transparency to investors and regulators. Greater transparency would permit more accurate pricing, better loan servicing, and reduce the asymmetric information between securitizers, investors, regulators, and homeowners.

There has already been a movement, as witnessed by what the Mortgage Bankers Association is doing. But again, we have relied heavily on the reps and warranties which served very well to kind of back up the claims on securitized issues. But again, just that simple tsunami of requests of loan buy-backs and defaults, *et cetera,* by consumers has made that market a little bit tough to deal with.

Therefore, I recommend in addition to greater transparency such as loan level files and also whatever the servicing standards are, and I think some of Ms. Goodman's ideas are very good, I would also like to propose a securitization certificate, which is a little change to the model, but what that does is the certificate at origination which follows the loan from hand to hand, including all of the relevant information, chain of title, but would also include the servicing guidelines so everyone is clear that purchases the loan exactly what those guidelines are. And again, following Freddie and Fannie, I think this would actually be a very simple thing to do.

Thank you very much.

Chairman MENENDEZ. Thank you, Doctor.

Mr. Harpootlian.

STATEMENT OF RICHARD A. HARPOOTLIAN, ATTORNEY, RICHARD A. HARPOOTLIAN P.A.

Mr. HARPOOTLIAN. Mr. Chairman, thank you for allowing me to be here today. I want to tell you, it is my honor to represent over 6,000 service men and women who were wrongfully overcharged or foreclosed on by Chase Bank. We resolved this case by settlement last week and they are going to receive payment of about $56. And Chase has stepped up to the plate and is going to do a number of things that are going to benefit these 6,000 service men and women and other service men and women.

But what I think is important for this body to know is that prior to being caught, if you will, there was no effort on the part of Chase—and we can find seeing other financial institutions—to monitor the accounts of these service men and women.

Now, the Servicemen's Civil Relief Act goes back to the 1940s. The concept is fairly simple. If you are deployed and fighting in a foxhole in Afghanistan, you should not have to worry about the bank taking your house because you cannot keep up with the fi-

nancial affairs at home. Likewise, the Act requires that the mortgage interest rate be no more than 6 percent during that period of time to alleviate some of the financial burden on these men and women in uniform.

What we find is, again, a dysfunctional system. There is no way, no method by which the Pentagon or any of the Department of Defense informs banks when someone is deployed. There is no method other than going to a Web site for the bank to know before they foreclose that someone is deployed. Everything is put on that servicemember to send their orders to the bank, and we found in most instances those got lost somewhere.

The most important thing to understand is this process affects the quality of defense, the quality of effort we get from our men and women in the field. I talked to hundreds of service men and women, some of whom had SCRA protection, many of whom did not, that are worried about the financial welfare of their family while they ought to be worrying about bullets coming in and shells coming in. And this is a national disgrace. It is a national disgrace because these men and women are putting their lives on the line for us. Even the ones that are not deployed are performing a valuable defense effort and function.

So in my prepared remarks, I have outlined a couple of things I think that are important that ought to be enacted. A much more streamlined way of financial institutions knowing who is deployed, who is not deployed. But more importantly, the military itself ought to have resources available. JAG officers do a great job, but they are not tasked, if you will, with ensuring that the men and women in uniform understand what their rights are under the SCRA and they are protected against harassment and, I mean, the main plaintiff in this case got 100—his wife and he got 140 collection phone calls from the bank while he was deployed while she was 8 months pregnant and while he is flying an airplane in combat. That is wrong and we need to stop that.

The last thing I would say, which may have applicability to what the other speakers said here, is things have gotten so bad in South Carolina that our Chief Justice has enjoined mortgage foreclosures—all mortgage foreclosures—and I put in my remarks, unless and until a financial institution certifies certain things, and all of those things are—I will briefly summarize them. One, that the mortgagor has been served with notice of the mortgagor's right to foreclosure intervention by means of loan modification or other means of loss mitigation; that the mortgagor has been given an opportunity to do that; that they have had a full and fair opportunity to submit information or data to the mortgagee; that after completion of foreclosure intervention process, the mortgagor does not qualify and why; and that the notice of the denial of loan modification or other means of loss mitigation has been served on the mortgagor by mailing and there has been a 30-day period after that mailing before they can begin foreclosure.

This is not a model, but it certainly shows that, at least on a State level, our Chief Justice has said this thing is a mess and too many people are not being given the opportunity to try to modify their loans.

Most of the people I talk to in uniform could work some sort of modification out if the financial institutions allowed them to do so. What we have heard here today about beginning this process, being told, well, you should miss—you know, we cannot help you unless you miss two or three payments, I heard that over and over again.

Thank you for the opportunity to be here today.

Senator MERKLEY. Thank you. Thank you all.

Mr. Stevens, without objection, your white paper is included in the record as part of your testimony.

Let me ask all of you, do all the witnesses here agree that some national mortgage servicing standards would be helpful?

Ms. THOMPSON. Yes.

Ms. GOODMAN. Yes.

Mr. SANDERS. Yes.

Mr. STEVENS. Yes.

Chairman MENENDEZ. OK. Now, in that respect, I want to ask you, if you had to name just three specific national mortgage servicing standards that you believe would be most helpful in your area of expertise, what would those be and exactly how would they be helpful? Ms. Thompson?

Ms. THOMPSON. End dual track, both for loans that are in foreclosure and for loans that are not yet in foreclosure. Dual track must be ended, absolutely.

The other large recommendation that has many sort of subparts is that you have got to create transparency in the entire process, so that includes dealing with tracking systems. It includes making available publicly the net present value test and holding servicers to account to actually make the net present value test.

And the third critical point is that you have to have enforceability of all these—of everything you do, there has to be enforceability, and one of the things that that means is that homeowners have got to be able to raise violations of the servicing standards as a defense to foreclosure, because if homeowners cannot raise violations as a defense to foreclosure, there is really, in the end, not much to stop servicers from conducting business as usual.

Chairman MENENDEZ. Ms. Goodman.

Ms. GOODMAN. My number one is that national servicing standards should require servicers to perform the modification to maximize the net present value of the lost mitigation options, and regardless of the conflicts of interest that entails for the servicers.

Second would be addressing the fact that the servicer also provides ancillary services during the foreclosure period and prohibiting a servicer from owning an interest in an entity that provides foreclosure-related services.

And my third would be better disclosure. That is, better transparency in terms of what is happening on the modification side, what the cash-flows are on these loans. Again, those are my three.

Chairman MENENDEZ. Mr. Stevens, if you have some. I do not want to force people to have some. If you have some.

Mr. STEVENS. I think, generally speaking, getting uniform foreclosure time lines, uniform time lines for modification, uniform foreclosure requirements nationally versus all the State variations would help. I think there is an opportunity, Senator, to have some discussions about both dual track and single point of contact, which

I think are the two most commonly vetted items to support better foreclosure processes by servicers.

And I would also suggest that there is an opportunity to have a further dialog around minimum servicing compensation, as I think all of these things have potential unintended consequences that we should talk through. I would love to talk through and engage with you or your staff as you work through these processes. But clearly, aside from what the two previous comments were is that the difficulty of all the various rules and regulations State by State, I think, add a level of confusion that is unnecessary to the overall process.

Chairman MENENDEZ. Doctor, do you have any?

Mr. SANDERS. Chairman, first of all, I would recommend that the industry move toward more standardization of pooling and servicing agreements. Those are the PSAs. Whether it is regulated or the industry moves toward it, I am sure as Mr. Stevens's MBA is working on, that would be very helpful in reducing problems in the future.

Second, transparency. Not only transparency of the process to the consumer, but again, and I want to say this, had we had loan-level details about the private label market in the first place, we might not have seen the problems that we saw, and therefore we might not be sitting here today. But again, whether it is loan-level transparency or servicer transparency, I think that is an excellent idea.

And in addition, the one thing that has been left off the table, and there is nothing we can do about it, is that, in part, the huge housing bubble that blew up and collapsed so many consumers and caused us grief and heartache was attributable to the Federal Reserve keeping interest rates so low for so long and creating a huge asset bubble. There is nothing we can do about that, but I just wish we could throw that into a servicing standard. Please stop printing money. But thank you very much.

Mr. HARPOOTLIAN. I have nothing really to add. Thank you.

Chairman MENENDEZ. Ms. Thompson, what are the views of homeowner advocates on the draft consent orders that were recently promulgated by several of the banking regulators, such as OCC, the Fed, and FDIC? And let us try to split this, if I can, your answer into three parts. What did they get right about mortgaging service standards? What did they get wrong, from your perspective? And what do they not address that they should have addressed?

Ms. THOMPSON. Thank you, Chairman. I will start with what did they get right. What they got right was that there are problems that are endemic throughout the servicing industry, that the servicing industry has failed to document virtually everything and has gross inadequacies in its foreclosure process. That is part of the review, I think, that supports the allegations that have been widespread for many years about servicer abuses and loss mitigation.

Beyond that, the orders are not very helpful and are potentially harmful in some ways. The orders are vague. They do not set out clear standards. They lack any meaningful enforcement action. At best, they suggest that the agencies may come back and do some enforcement action. These are agencies that, unfortunately, do not have a good track record of enforcement actions.

They only look at loans for a very limited timeframe. It is 2009 and 2010. So we provide no protection for loans going forward, no remedies for homeowners who were wrongfully foreclosed on before then, even if remedies to homeowners are provided. I think we could safely say that we are disappointed.

Chairman MENENDEZ. Any other comments from any other members of the panel on those consent orders?

Ms. GOODMAN. They are relatively teethless. I agree with Diane 100 percent.

Chairman MENENDEZ. All right. Let me ask, Ms. Goodman, you outlined a series of the conflicts. What do you think is the most important of those conflicts of interest from a mortgage investor's perspective?

Ms. GOODMAN. I actually think the first lien–second lien issue, and more broadly the fact that first lien servicers oftentimes do not own the first lien. In a GSEs loan, the GSEs have the first loss position in the first lien. Servicers do, however, own the second lien. In addition, they also own credit card debt and auto debt of the borrower.

You will notice that in a modification, the only thing that is really affected is mortgage debt. There is no restructuring of the borrower's entire debt. There are two reasons why modifications fail. The first is that the borrower has substantial negative equity. The second is that he has a back-end debt-to-income ratio, that is, a total debt burden that is unsustainable. And for more successful modifications, you really have to address the borrower's overall debt situation. There has been an extreme reluctance to do that. And even in terms of more successful modifications, respecting lien priority and writing off the second completely, or at least a greater than proportionate write-down on the second lien versus the first lien would help a great deal in eliminating negative equity.

So my first order of business would be looking at the conflicts of interest between the servicers who own the second lien and other borrower debts and do not own the first lien.

Chairman MENENDEZ. Mm-hmm. And I just want to just stay with this conflict of interest question. Flesh out for me a little bit more how, number 1, how it is a conflict of interest for the mortgage servicer for the primary mortgage on a property to also own the secondary mortgage, and how do we best address that conflict of interest, from your perspective?

Ms. GOODMAN. There are a couple of different ways to address that. The reason it is a conflict of interest is because you own the second lien, you can make decisions, or there is an incentive to make decisions that basically help the second lien holder at the expense of the first lien holder. So, for example, if a borrower gets a short sale opportunity, the servicer may reject that even though it is in the best interest of both the investor and the borrower because it essentially requires them to wipe out the second lien.

How do you address it? I think, as Dave mentioned, it is an extraordinarily difficult, difficult problem. You can—one way is basically to say——

Chairman MENENDEZ. That is why we get paid the big bucks here.

Ms. GOODMAN. One way—basically, the easiest way to address it is to say if you own the second lien, you cannot also service that first lien, or alternatively saying if you service that first lien, you cannot own the second lien.

Let me also mention that in the modification process, the first and second liens are oftentimes treated *pari passu*. So if I am making a first lien mortgage going forward, the costs of that may well be higher if this becomes institutionalized. So you really have to consider how to make it clear to investors that lien priority is, in fact, lien priority. I think that is just a critical point.

There are a variety of ways to do that. We seem to be unwilling to address the second lien situation on any level. We have gone to great lengths to put out QRM standards, which I have some real issues with, but basically, there is nothing that prohibits that borrower from going out, taking out a second lien tomorrow and essentially negating the whole purpose of those standards. So I think you have to basically put some up-front restrictions on second liens, as well, in order to have better mortgages going forward. But certainly, you have to respect lien priority.

Chairman MENENDEZ. Mr. Stevens, do you have any views of that? I sort of like heard——

Mr. STEVENS. I do, and actually——

Chairman MENENDEZ. I thought you might, so——

[Laughter.]

Mr. STEVENS. Ninety-nine percent of the time, I agree with everything Laurie says. I think the challenge here is that I am not at all certain that by having someone else service the second lien, it is going to change the outcome. I think——

Chairman MENENDEZ. I heard that in response to a separate question.

Mr. STEVENS. And I think, actually, one of the things we ought to test for and we ought to think about—"test" sounds a little too clinical—is whether, if it is two different servicers, is there perhaps even less incentive? Again, as I said earlier, when the first lien ultimately goes to foreclosure, if the investor owns a second, as well, they are completely wiped out on the second.

So I am not sure that is necessarily the case when—and I will just take this to an extreme—many of the loans originated during this boom period in this low-interest rate market when stated income loans were created, *et cetera,* so were not very sustainable loans on the first lien basis. So a stated income, negatively amortizing ARM on the first lien that some PLS investor was ready and willing and able to buy, you know, that fundamentally could be part of the challenge of why the borrower ultimately went into default. So I understand why the investors would like the second liens expunged and have the first lien written down, because they hold the—their whole interest is in that first lien, just as in the second lien holder, their objective is to keep whole on their second lien.

I spent a couple of years in my last position talking to everybody who would come in and talk about their interests, and it clearly reflected the businesses they were in. You know, in the end of the day, it is a very complicated subject——

Chairman MENENDEZ. Let me ask you two questions.

Mr. STEVENS. Yes.

Chairman MENENDEZ. First of all, the mere fact that you are a second lien holder basically says, yes, you have certain legal rights, but you have inferior rights to the first lien holder.

Mr. STEVENS. Absolutely.

Chairman MENENDEZ. So as such, you know that you are taking another level of risk, right?

Mr. STEVENS. Correct.

Chairman MENENDEZ. Second, I understand your view that maybe not having different servicers is the answer, but by the same token, if I am the servicer and owner of the second lien and not the owner of the first, I truly have a, if not an actual conflict, a potential conflict in ensuring that, somehow, my legal interests and my economic interests are preserved. And so I am more reticent to find a way to either do a mortgage adjustment or, you know, some principal pay-down or reduction because I will be wiped out. I mean, that is, to me, pretty obvious. Now——

Mr. STEVENS. Yes, and Senator, I am going to tell you, I do not have the answer to this as some others may feel they do. My view on this is I do not think it ultimately ends up being that simple, because the one thing for certain, having been a banker for most of my career, is if I do not keep that first performing, I am going to get wiped out completely if I hold both. And I am not so certain if you separate those interests that second lien holder is going to have any additional incentive whatsoever to write down the second when they have absolutely no interest in the performing of the first due to an obligation as the servicer.

So, again, I am not arguing necessarily that one solution is better than the other. I just think we ought to be very thoughtful to make sure that is really the answer to this thing, because I can see challenges with the outcomes if we said we separate them. That can even make it more dysfunctional.

Chairman MENENDEZ. Ms. Goodman, let me hear your response.

Ms. GOODMAN. My response is twofold. First, the fact that you have got the same guy servicing the first and owning the second actually does produce some distortions in terms of the type of loan modifications you get. You end up with a lot of sub-optimal loan modifications.

So, for example, if you do a first lien proprietary modification, you do not have to touch the second. That may not be necessarily the best modification for the borrower, but it is sure as hell the best modification for the servicer, and it is certainly not the best modification for the investor, either, because the borrower and investor are fairly well aligned there.

Another instance is the reluctance to approve a short sale because you wipe out the second. It may well be the best interests of the borrower and the investor, but it is not the best interest of the servicer. So I think you get sub-optimal loss mitigation because of the conflicts of interest in terms of the liens.

Chairman MENENDEZ. Doctor, did you have an opinion on this? I saw you raise your hand.

Mr. SANDERS. Yes. What I wanted to comment on is the commercial mortgage, or CMBS market, went through these gyrations years before we had the big housing bubble burst, and I actually

have a study on adverse selection and mortgage servicing in the commercial sector, and what we found is that the difference between what we call same servicer and different servicer was negligible. So I would agree that it is a very complicated problem, and in defense of Ms. Goodman, it could be a little different for the residential market, but I agree with Mr. Stevens that this is going to be such a—you know, there are so many competing problems in this industry, I would just say that would not be the focal point. I would go to, again, examining or total debt as something we really had to consider. And bear in mind that many of the PSAs, the servicing agreements, were all written back in the day when we were not thinking about second mortgages or the big HELOC problem, and I think those definitely should be amended going forward.

Chairman MENENDEZ. Let me ask you just one or two more questions and then I will let you go. Principal deductions—they are not typically offered very often today to borrowers, even though we know the borrowers are more likely to simply walk away from their homes and decide it is not worth it to stay if they are deeply underwater. Why are servicers not doing more about principal reductions? Ms. Thompson?

Ms. THOMPSON. Principal reductions are the one kind of modification that servicers will unequivocally absolutely lose money on by doing. Servicers' largest source of income is the monthly servicing fee, which is based on the outstanding principal. So if they reduce the principal, they are guaranteeing themselves a loss of future income.

Ms. GOODMAN. Let me also mention that while banks are—while servicers are not doing principal reductions for others, they are doing it for their own portfolio loans. According to the OCC OTS Mortgage Metrics Report from the fourth quarter of 2010, overall, principal reduction was done on 2.7 percent of modifications. Seventeen-point-eight percent of portfolio loans, however, received principal reduction as part of the modification package, 1.8 percent for private investors, and 0 percent for Fannie, Freddie, and Government-guaranteed loans. I realize there are some institutional constraints on Fannie, Freddie, and Government-guaranteed loans, but there are basically no—there are very few institutional constraints in terms of why private investor loans do not receive principal reduction in the same proportion as banks' own portfolio loans.

Chairman MENENDEZ. Mm-hmm.

Mr. STEVENS. I would just add, having been the architect for the FHA Short Refi program, which was designed around principal write-down, one of the big resistance points is that the—for Freddie Mac and Fannie Mae, FHFA put out a letter that they will not participate in the principal write-down. That is why, I think, one of the reasons why the percentage is point-zero-one, or whatever it is——

Ms. GOODMAN. Yes. Yes.

Mr. STEVENS. ——and it is such a large part of the market. It is also, unfortunately, and I hate to make it all sound like—I think there are solutions if we work deliberately at it, but in the PLS market with trustees in the middle of the ultimate investor, getting ultimate authority to do the principal write-down with no real safe

harbor that would likely stand up in the courts becomes a problem for the servicers.

But without question, as Laurie points out, and I was going to say the same, you do see a lot of principal write-down mostly where it is occurring on whole loans held by the servicers on their own balance sheet, the banks, where clearly there are no impediments to them doing the write-down because they own the asset themselves. You could also say it is in their best interest to do so, potentially, but there are clearly restrictions from the secondary market to be able to allow the servicer to simply do a principal write-down.

Ms. GOODMAN. Can I just say one other thing, and that is I would argue that there actually is a safe harbor for doing principal reductions on private investor loans and that safe harbor comes through the principal reduction alternative of the HAMP program. I would like to see that become mandatory if it is the highest NPV.

Ms. THOMPSON. Senator——

Chairman MENENDEZ. Net present value.

Ms. GOODMAN. Net present value, yes, thank you.

Chairman MENENDEZ. Just for the record for everybody who does not have the acronyms down, so yes?

Ms. THOMPSON. Yes. Indeed, I think the HAMP principal reduction alternative should be mandatory. It should be encouraged. It has been radically underused. There is no reason not to use it. That produces modifications that are more sustainable, better return for everybody, really.

On the FHFA point, that underscores the need for national servicing standards. The fact that Fannie and Freddie have stood in the way of principal reductions, there is no need to allow that to continue. They are in a conservatorship. It should be possible for Congress to indicate strongly to them that they should step out of the way and allow principal reductions to happen. Their failure to allow principal reductions to happen, I believe, is ultimately costing the American taxpayers money.

Chairman MENENDEZ. That is a concern that I have of my own.

Mr. SANDERS. Well, again——

Chairman MENENDEZ. I will let you go in a minute, Doctor. The largest owner is the Federal Government. At the end of the day, it seems to me that there are two interests of the Federal Government, and therefore the Federal taxpayer, which is, one, whatever we can do to have property values rise, and two, whatever we can do to mitigate that loss. But when we fail to do principal reduction when it is fitting and appropriate, we are not mitigating the loss. We are taking, in my view, a much larger loss. And we have the displacement of individual families from their homes and we have the consequential fact of property values being diminished, which ultimately means that ratable bases are diminished, and when ratable bases are diminished, mayors have just one of two choices. Either they cut services or they raise taxes. It is all a bad scenario. Doctor?

Mr. SANDERS. Yes. Let us not take this one too lightly, because I gave a presentation at Treasury when the Obama administration first came in and I said that, really, the only solution to this, the negative equity states, will be massive principal reductions. Otherwise, we probably are not going to have any resolution.

On the flip side, the moral hazard problem of putting up the sign saying, we will do principal reductions or short sales, could cause a kind of a massive entrance into doing loan modifications with everybody. I would like to have a principal write-down, but again, you do not apply for it. Again, it is just one of those touchy issues that—I think Mr. Stevens probably has looked into this, I think, quite intensively, but that is——

Chairman MENENDEZ. I think there are a lot of moral hazards that crossed when we gave out mortgages to individuals who should never have been enticed into a mortgage for which they did not have the wherewithal to live up to, and there was a lot of moral hazard crossed there. There was a lot of moral hazard when, because of systemic risk to this entire country's economy, we had to go in and resolve for every American taxpayer the consequences of institutions that would have collapsed but would have created a consequence to every American.

So I agree with you. There is a lot of moral hazard here. At some point, though, my concern at this point in time, having seen many of those moral hazards already crossed, is the question of how do we mitigate the consequences to the Federal taxpayer at this point for that which has already been determined. And we have, by virtue of Fannie and Freddie, the largest single portfolio of that, and that means that the Federal taxpayer has the largest single risk. And so in my mind is how do we mitigate that so that we walk out as best as we can under the circumstances.

Mr. Harpootlian, I want to close on a note. I appreciate the service that you rendered to the men and women in uniform. You know, it is pretty incredible that we find ourselves at a time in which we have two wars raging abroad, largely unpaid for but nevertheless raging abroad, that the men and women in uniform would have to worry about their homes being lost where their wives or husbands and children are. It is not how a grateful Nation says thank you, and it is not how institutions who are benefiting from the investments of those individuals in their companies should act.

So I read your greater testimony with interest. I know you recommended greater legal support for servicemembers to understand and enforce their rights and more cooperation with the Department of Defense and financial institutions, and I wholeheartedly agree. With reference to your recommendation that we should incentivize mortgage modifications and discourage foreclosures when it comes to service people, that is what some of our current mortgage modification programs are trying to do more broadly, not as successful as we would like. Do you have any ideas of how that would be tailored to service people?

Mr. HARPOOTLIAN. Well, I think that, again, our men and women in uniform are sacrificing—I mean, I have heard story after story of folks that were in the Reserves that were making a pretty good salary ending up in Afghanistan or Iraq. Salaries come down dramatically. They cannot make their house payments anymore. It just seems to me that at the front end, before—when they are deployed, somebody in the military ought to sit down and do some sort of financial analysis of what their situation is.

There is a Lieutenant Colonel from California who was a Reservist in military intelligence. Her husband was making about a half-a-million dollars a year and she was making about $125,000 a year. She got deployed. His business, RV business, shut down. She went from making $125,000 to about $30,000 or $40,000. And all that—nobody there to help them, nobody to talk to the financial institutions, and they foreclosed on her and she is one of our class members.

But that is an extreme case. I think the Department of Defense ought to work something out with the financial institutions so when folks, both deployed and not deployed, have issues, that there is somebody advocating for them, because they are distracted. They are distracted in some instances by incoming. In other instances, if they are maintaining a jet at Shaw Air Force Base in South Carolina, I want them focused on maintaining that jet, not worrying about their financial issues. And I think, again, the pay is not good, the life is pretty hard, and we ought to do something in addition to all this that you are talking about in terms of servicing standards, we ought to do something in addition for our men and women in uniform.

Chairman MENENDEZ. All right. Thank you very much.

Well, I do know this much, and you all have been very helpful in beginning, and I underline "beginning," to help us understand some of the challenges here. The present system as it is is not acceptable and not working, so there has to be change. And those who are involved, I hope, will come forth in the spirit of embracing the change and helping us structure it in a way that both meets the desire to have people obviously live up to their obligations, but also be able to stay in their homes.

In the absence of having those who are in the industry come forth and embrace the necessary changes, then I think that there will be changes forthcoming that they might not very well appreciate when they have an opportunity to engage. So I hope this hearing starts the highlighting of what some of these critical issues are and we have to think through as to how we best resolve them and have the pendulum strike in the right balance. But just the belief that we can tough it out is the wrong belief.

With that, I want to thank all the witnesses for sharing their expertise today. I hope, as I said, that we can come together to try to improve this process pretty dramatically.

The record will remain open for 7 days to give everybody an opportunity to answer questions in writing. I still have some, but I did not want to keep you here longer. And we would appreciate your answers as expeditiously as possible.

So with the thanks of the Committee and with no other Senator present, this hearing is adjourned.

[Whereupon, at 3:33 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF A. NICOLE CLOWERS

ACTING DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, GOVERNMENT ACCOUNTABILITY OFFICE

MAY 12, 2011

United States Government Accountability Office

GAO

Testimony

Before the Subcommittee on Housing, Transportation and Community Development, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

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MORTGAGE FORECLOSURES

Documentation Problems Reveal Need for Ongoing Regulatory Oversight

Statement of A. Nicole Clowers, Acting Director
Financial Markets and Community Investment

GAO-11-649T

Chairman Menendez, Ranking Member DeMint, and Members of the Subcommittee:

Thank you for the opportunity to discuss our work on mortgage servicing issues. With record numbers of borrowers in default and delinquent on their loans, mortgage servicers—entities that manage home mortgage loans—are initiating large numbers of foreclosures throughout the country. As of December 2010, an estimated 4.6 percent of the about 50 million first-lien mortgages outstanding were in foreclosure—an increase of more than 370 percent since the first quarter of 2006, when 1 percent were in foreclosure.[1] Beginning in September 2010, several servicers announced that they were halting or reviewing their foreclosure proceedings throughout the country after allegations that the documents accompanying judicial foreclosures may have been inappropriately signed or notarized.[2] The servicers subsequently resumed some foreclosure actions after reviewing their processes and procedures. However, following these allegations, some homeowners challenged the validity of foreclosure proceedings against them. Questions about whether documents for loans that were sold and packaged into mortgage-backed securities were properly handled prompted additional challenges.[3]

My statement today focuses on (1) the extent to which federal laws address mortgage servicers' foreclosure procedures and federal agencies' authority to oversee servicers' activities and the extent of past oversight; (2) federal agencies' current oversight activities and future oversight plans; and (3) the potential impact of foreclosure documentation issues on homeowners, servicers, regulators, and investors in mortgage-backed securities. It is based on the report we issued on May 2, 2011, on foreclosure documentation problems that Chairman Menendez, Senator

[1]A home mortgage is an instrument by which the borrower (mortgagor) gives the lender (mortgagee) a lien on residential property as security for the repayment of a loan. A first-lien mortgage creates a primary lien against real property and has priority over subsequent mortgages, which generally are known as junior, or second, mortgages. That is, first liens are the first to be paid when the property is sold.

[2]State laws primarily govern the foreclosure process and treat foreclosures differently, with some states requiring court action—that is, judicial foreclosure.

[3]These challenges have centered on whether the paperwork documenting transfers of loans into securities pools adequately proves that the trust (the entity formed to hold the securitized loans) seeking to foreclose on a property was the actual mortgage holder with the authority to foreclose.

Franken, and Ranking Members Conyers, Gutierrez, and Capuano requested.[4]

To conduct the work for our report, we reviewed relevant federal laws, regulations, examination guidance, and other agency documents. We also reviewed relevant literature, examples of reported court cases involving these issues, congressional testimonies, and other relevant publicly available documentation. In addition, we examined agency documentation on current oversight activities, such as an examination worksheet, checklists, and supervisory letters summarizing examination findings. We conducted interviews with representatives of federal agencies, including the Bureau of Consumer Financial Protection (CFPB), Federal Deposit Insurance Corporation (FDIC), Board of Governors of the Federal Reserve System (Federal Reserve), Office of the Comptroller of the Currency (OCC), and Office of Thrift Supervision (OTS). We also interviewed legal experts and representatives of the mortgage industry, investor groups, and consumer advocacy groups. We conducted the work for the report from October 2010 through April 2011 in accordance with generally accepted government auditing standards.

In summary, until the problems with foreclosure documentation came to light, federal regulatory oversight of mortgage servicers had been limited, because regulators regarded servicers' activities as low risk for banking safety and soundness. However, regulators' recent examinations revealed that servicers generally failed to prepare required documentation properly and lacked effective supervision and controls over foreclosure processes. Moreover, the resulting delays in completing foreclosures and increased exposure to litigation highlight how the failure to oversee whether institutions follow sound practices can heighten the risks these entities present to the financial system and create problems for the communities in which foreclosures occur. As a result, we recommended in our report that the financial regulators take various actions, including

- developing and coordinating plans for ongoing oversight of servicers,
- including foreclosure practices as part of any national servicing standards that are created, and

[4]GAO, *Mortgage Foreclosures: Documentation Problems Reveal Need for Ongoing Regulatory Oversight*, GAO-11-433 (Washington, D.C.: May 2, 2011).

- assessing the risks of improper documentation for mortgage loan transfers.

The regulators generally agreed with or did not comment on our recommendations, and some are taking actions to address them.

Background

The origination, securitization, and servicing of mortgage loans involve multiple entities. In recent years, originating lenders generally have sold or assigned their interest in loans to other financial institutions to securitize the mortgages. Through securitization, the purchasers of these mortgages then package them into pools and issue securities for which the mortgages serve as collateral. These mortgage-backed securities (MBS) pay interest and principal to their investors, such as other financial institutions, pension funds, or mutual funds. After an originator sells its loans, another entity is usually appointed as the servicer. Servicing duties can involve sending borrowers monthly account statements, answering customer service inquiries, collecting mortgage payments, maintaining escrow accounts for taxes and insurance, and forwarding payments to the mortgage owners. If a borrower becomes delinquent on loan payments, servicers also initiate and conduct a foreclosure in order to obtain the proceeds from the sale of the property on behalf of the owner of the loan. Any legal action such as foreclosure that a servicer takes generally may be brought in the name and on behalf of the securitization trust, which is the legal owner of record of the mortgage loans.

Several federal agencies share responsibility for regulating activities of the banking industry that relate to the originating and servicing of mortgage loans (see table 1). Upon assumption of its full authorities on July 21, 2011, CFPB also will have authority to regulate mortgage servicers with respect to federal consumer financial law.[5] Other agencies also oversee certain

[5]The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), enacted on July 21, 2010, establishes the Bureau of Consumer Financial Protection (known as the Consumer Financial Protection Bureau or CFPB) as an independent bureau within the Federal Reserve System. Section 1066 of the Dodd-Frank Act authorized the Secretary of the Treasury to provide administrative services necessary to support the CFPB before the transfer date and to exercise certain of its powers until the appointment of a CFPB Director. 12 U.S.C. § 5586. "Federal consumer financial law" is a defined term in the Dodd-Frank Act that includes more than a dozen existing federal consumer protection laws, including the Truth in Lending Act, the Real Estate Settlement Procedures Act, and the Equal Credit Opportunity Act, as well as title X of the Dodd-Frank Act itself. 12 U.S.C. § 5481(12), (14).

aspects of U.S. mortgage markets but do not have supervisory authority over mortgage servicers.

Table 1: Federal Banking Regulators and Their Jurisdiction

Agency	Jurisdiction[a]
Office of the Comptroller of the Currency	Federally chartered banks.
Office of Thrift Supervision	Federally chartered savings associations (thrifts), including mortgage operating subsidiaries, as well as savings and loan holding companies and lenders owned by a savings and loan holding company. Shares oversight of state-chartered savings associations with the state regulatory authority that chartered them.
Board of Governors of the Federal Reserve System	State-chartered member banks and entities that may be owned by federally regulated holding companies but that are not federally insured depository institutions. Shares oversight with the state regulatory authority that chartered the bank.
Federal Deposit Insurance Corporation	State-chartered banks that are not members of the Federal Reserve System. Shares oversight with the state regulatory authority that chartered the bank.

Source: GAO.

Note: OCC will assume oversight responsibility of federal savings associations from OTS in July 2011. Concurrently, FDIC will assume oversight responsibility of state-chartered savings associations from OTS, and the Federal Reserve will assume oversight responsibility of savings and loan holding companies and lenders owned by a savings and loan holding company from OTS, according to OTS officials.

[a]12 U.S.C. § 1813(q).

Federal Laws Generally Do Not Address the Foreclosure Process, and Past Federal Oversight of Foreclosure Activities Has Been Limited and Fragmented

Because state laws primarily govern foreclosure, federal laws related to mortgage lending focus on protecting consumers at mortgage origination and during the life of a loan but not necessarily during foreclosure. Federal consumer protection laws, such as the Truth in Lending Act (TILA) and the Real Estate Settlement Procedures Act of 1974 (RESPA), address some aspects of servicers' interactions with borrowers.[6] For example, these laws require servicers to provide certain notifications and disclosures to borrowers or respond to certain written requests for information within specified times, but they do not include specific requirements for servicers to follow when executing a foreclosure. According to Federal Reserve officials, in addition to federal bankruptcy laws, federal laws that address foreclosure processing specifically are the Protecting Tenants at Foreclosure Act of 2009, which protects certain tenants from immediate eviction by new owners who acquire residential property through foreclosure, and the Servicemembers Civil Relief Act, which restricts foreclosure of properties owned by active duty members of the military.[7]

Banking regulators oversee most entities that conduct mortgage servicing, but their oversight of foreclosure activities generally has been limited. As part of their mission to ensure the safety and soundness of these institutions, the regulators have the authority to review any aspect of their activities, including mortgage servicing and compliance with applicable state laws. However, the extent to which regulators have reviewed the foreclosure activities of banks or banking subsidiaries that perform mortgage servicing has been limited because these practices generally were not considered as posing a high risk to safety and soundness. According to OCC and Federal Reserve staff, they conduct risk-based examinations that focus on areas of greatest risk to their institutions'

[6] Much of the Truth in Lending Act addresses disclosures for consumer credit transactions, and the Real Estate Settlement Procedures Act of 1974 focuses primarily on the regulation and disclosure of mortgage closing documents. Other relevant consumer protection laws include the Fair Housing and Equal Credit Opportunity Acts, which address granting credit and ensuring nondiscrimination in lending; the Fair Credit Reporting Act, which addresses consumer report information, including use of such information in connection with mortgage lending; and the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE Act), which requires licensing and/or registration of mortgage loan originators. Fair Housing Act, 42 U.S.C. §§ 3601–3619; Equal Credit Opportunity Act, 15 U.S.C. §§ 1691-1691f; Truth in Lending Act, 15 U.S.C. §§ 1601-1667f; Real Estate Settlement Procedures Act of 1974, 12 U.S.C. §§ 2601-2617; Fair Credit Reporting Act, 15 U.S.C. §§ 1681-1681x; SAFE Act, 12 U.S.C. §§ 5101-5116.

[7] 12 U.S.C. §§ 5201 note, 5220 note. The law expires December 31, 2014. 50 U.S.C. App. §§ 501–597b.

financial positions, as well as some other areas of potential concern, such as consumer complaints. Servicers generally manage loans that other entities own or hold, and are not exposed to significant losses if these loans become delinquent. Because regulators generally determined that the safety and soundness risks from mortgage servicing were low, they have not regularly examined servicers' foreclosure practices on a loan-level basis.

Oversight also has been fragmented, and not all servicers have been overseen by federal banking regulators. At the federal level, multiple agencies—including OCC, the Federal Reserve, OTS, and FDIC—have regulatory responsibility for most of the institutions that conduct mortgage servicing, but until recently, some nonbank institutions have not had a primary federal or state regulator. Many federally regulated bank holding companies that have insured depository subsidiaries, such as national or state-chartered banks, may have nonbank subsidiaries such as mortgage finance companies. Under the Bank Holding Company Act of 1956, as amended, the Federal Reserve has jurisdiction over such bank holding companies and their nonbank subsidiaries that are not regulated by another functional regulator.[8] Until recently the Federal Reserve generally had not included the nonbank subsidiaries in its examination activity because their activities were not considered to pose material risks to the bank holding companies. In some cases, nonbank entities that service mortgage loans are not affiliated with financial institutions at all, and therefore were not subject to oversight by one of the federal banking regulators. In our 2009 report on how the U.S. financial regulatory system had not kept pace with the major developments in recent decades, we noted that the varying levels or lack of oversight for nonbank institutions that originated mortgages created problems for consumers or posed risks to regulated institutions.[9]

[8]12 U.S.C. § 1844(c)(2). "Functional regulation" refers to the premise that risks within a diversified organization can be managed properly through supervision focused on the individual subsidiaries within the firm. That is, securities activities are supervised by securities regulators, banking activities by banking regulators, and insurance activities by insurance regulators.

[9]GAO, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, GAO-09-216 (Washington, D.C. Jan. 8, 2009).

While Federal Regulators Conducted Reviews in Response to Reported Problems, Future Oversight and Servicing Standards Have Yet to Be Determined

In response to disclosed problems with foreclosure documentation, banking regulators conducted coordinated on-site reviews of foreclosure processes at 14 mortgage servicers. Generally, these examinations revealed severe deficiencies in the preparation of foreclosure documentation and with the oversight of internal foreclosure processes and the activities of external third-party vendors. Examiners generally found in the files they reviewed that borrowers were seriously delinquent on the payments on their loans and that the servicers had the documents necessary to demonstrate their authority to foreclose. However, examiners or internal servicer reviews of foreclosure loan files identified a limited number of cases in which foreclosures should not have proceeded even though the borrower was seriously delinquent. These cases include foreclosure proceedings against a borrower who had received a loan modification or against military service members on active duty, in violation of the Servicemembers Civil Relief Act.

As a result of these reviews, the regulators issued enforcement actions requiring servicers to improve foreclosure practices. Regulators plan to assess compliance but have not fully developed plans for the extent of future oversight. According to the regulators' report on their coordinated review, they help ensure that servicers take corrective actions and fully implement enforcement orders.[10] While regulatory staff recognized that additional oversight of foreclosure activities would likely be necessary in the future, as of April 2011 they had not determined what changes would be made to guidance or to the extent and frequency of examinations. Moreover, regulators with whom we spoke expressed uncertainty about how their organizations would interact and share responsibility with the newly created CFPB regarding oversight of mortgage servicing activities. According to regulatory staff and the staff setting up CFPB, the agencies intend to coordinate oversight of mortgage servicing activities as CFPB assumes its authorities in the coming months. CFPB staff added that supervision of mortgage servicing will be a priority for the new agency. However, as of April 2011 CFPB's oversight plans had not been finalized. As we stated in our report, fragmentation among the various entities responsible for overseeing mortgage servicers heightens the importance of coordinating plans for future oversight. Until such plans are developed, the potential for continued fragmentation and gaps in oversight remains.

[10]Federal Reserve System, Office of the Comptroller of the Currency, and Office of Thrift Supervision, *Interagency Review of Foreclosure Policies and Practices*, (Washington, D.C.: April 2011).

In our report, we recommend that the regulators and CFPB develop and coordinate plans for ongoing oversight and establish clear goals, roles, and timelines for overseeing mortgage servicers under their respective jurisdiction. In written comments on the report, the agencies generally agreed with our recommendation and said that they would continue to oversee servicers' foreclosure processes. In addition, CFPB noted that it has already been engaged in discussions with various federal agencies to coordinate oversight responsibilities.

As part of addressing the problems associated with mortgage servicing, including those relating to customer service, loan modifications, and other issues, various market participants and federal agencies have begun calling for the creation of national servicing standards, but the extent to which any final standards would address foreclosure documentation and processing is unclear. A December 2010 letter from a group of academics, industry association representatives, and others to the financial regulators noted that such standards are needed to ensure appropriate servicing for all loans, including in MBS issuances and those held in portfolios of the originating institution or by other owners. This letter outlined various areas that such standards could address, including those requirements that servicers attest that foreclosure processes comply with applicable laws and pursue loan modifications whenever economically feasible.

Similarly, some regulators have stated their support of national servicing standards. For example, OCC has developed draft standards, and in his February 2011 testimony, the Acting Comptroller of the Currency expressed support for such standards, noting that they should provide the same safeguards for all consumers and should apply uniformly to all servicers.[11] He further stated that standards should require servicers to have strong foreclosure governance processes that ensure compliance with all legal standards and documentation requirements and establish effective oversight of third-party vendors. A member of the Board of Governors of the Federal Reserve System testified that consideration of national standards for mortgage servicers was warranted, and FDIC's Chairman urged servicers and federal and state regulators in a recent

[11]Testimony of John Walsh, Acting Comptroller of the Currency, Office of the Comptroller of the Currency, before the Committee on Banking, Housing, and Urban Affairs, United States Senate, Washington, D.C.: February 17, 2011.

speech to create national servicing standards.[12] Most of the regulators with whom we spoke indicated that national servicing standards could be beneficial. For example, staff from one of the regulators said that the standards would create clear expectations for all servicers, including nonbank entities not overseen by the banking regulators, and would help establish consistency across the servicing industry. The regulators' report on the coordinated review also states that such standards would help promote accountability and ways of appropriately dealing with consumers and strengthen the housing finance market.

Although various agencies have begun discussing the development of national servicing standards, the content of such standards and how they would be implemented is yet to be determined. According to CFPB staff, whatever the outcome of the interagency negotiations, CFPB will have substantial rulemaking authority over servicing and under the Dodd-Frank Act is required to issue certain rules on servicing by January 2013. We reported that problems involving financial institutions and consumers could increase when activities are not subject to consistent oversight and regulatory expectations.[13] Including specific expectations regarding foreclosure practices in any standards that are developed could help ensure more uniform practices and oversight in this area. To help ensure strong and robust oversight of all mortgage servicers, we recommended that the banking regulators and CFPB include standards for foreclosure practices if national servicing standards are created.

In written comments on our report, the agencies generally agreed with this recommendation, and most provided additional details about the ongoing interagency efforts to develop servicing standards. For example, OCC noted that ongoing efforts to develop national servicing standards are intended to include provisions covering both foreclosure abeyance and foreclosure governance. OCC added that the standards, although still a work in progress, will emphasize communication with the borrower and

[12]Statement by Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing and Urban Affairs, United States Senate, Washington, D.C.: December 1, 2010; and speech delivered by FDIC Chairman Sheila Bair at Mortgage Bankers Association's Summit on Residential Mortgage Servicing for the 21st Century, January 19, 2011. For example, Chairman Bair has suggested that servicers provide borrowers a single point of contact to assist them throughout the loss mitigation and foreclosure process. The contact would be able to put a hold on any foreclosure proceeding while loss mitigation efforts were ongoing.

[13]GAO-09-216.

compliance with legal requirements, documentation, vendor management, and other controls. The Federal Reserve commented that the intent of the interagency effort was to address the problems found in the servicing industry, including in foreclosure processing, and coordinate the efforts of the multiple regulatory agencies to ensure that consumers will be treated properly and consistently. FDIC noted that the agency successfully proposed the inclusion of loan servicing standards in the proposed rules to implement the securitization risk retention requirements of the Dodd-Frank Act. FDIC also noted that any servicing standards should align incentives between servicers and investors and ensure that appropriate loss mitigation activities are considered when borrowers experience financial difficulties. CFPB said it has effective authority to adopt national mortgage servicing rules for all mortgage servicers, including those for which CFPB does not have supervisory authority. Finally, Treasury said it has been closely engaged with the interagency group reviewing errors in mortgage servicing and that it supports national servicing standards that align incentives and provide clarity and consistency to borrowers and investors for their treatment by servicers.

While Documentation Problems Likely Will Result in Delays in the Foreclosure Process, the Impact on Financial Institutions and Others Is Less Clear

To date, a key impact of the problems relating to affidavits and notarization of mortgage foreclosure documents appears to be delays in the rate at which foreclosures proceed. Despite these initial delays, some regulatory officials, legal academics, and industry officials we interviewed indicated that foreclosure documentation issues were correctable. Once servicers have revised their processes and corrected documentation errors, most delayed foreclosures in states that require court action likely will proceed.

The implications for borrowers could be mixed, but delays in the foreclosure process could exacerbate the impacts of vacant properties and affect recovery of housing prices. Borrowers whose mortgage loans are in default may benefit from the delays if the additional time allows them to obtain income that allows them to bring mortgage payments current, cure the default, or work out loan modifications. However, according to legal services attorneys we interviewed, these delays leave borrowers unsure about how long they could remain in their homes. And borrowers still might be subject to new foreclosure proceedings if banks assembled the necessary paperwork and resubmitted the cases. Communities could experience negative impacts from delayed foreclosures as more properties might become vacant. We reported that neighborhood and community problems stemming from vacancies include heightened crime, blight, and declining property values, and increased costs to local governments for

policing and securing properties.[14] Delays in the foreclosures process, although temporary, could exacerbate these problems. Various market observers and regulators indicated that the delays could negatively affect the recovery of U.S. housing prices in the long term. According to one rating agency's analysis, market recovery could be delayed as servicers work through the backlog of homes in foreclosure. Regulators also reported that delays could be an impediment for communities working to stabilize local neighborhoods and housing markets, and could lead to extended periods of depressed home prices.

Impacts on servicers, trusts, and investors because of loan transfer documentation problems were unclear. Some academics and others have argued that the way that mortgage loans were transferred in connection with some MBS issuances could affect servicers' ability to complete foreclosures and create financial liabilities for other entities, such as those involved in creating securities. According to these academics, a servicer may not be able to prove its right to foreclose on a property if the trust on whose behalf it is servicing the loan is not specifically named in the loan transfer documentation. In addition, we note in our report that stakeholders we interviewed said that investors in the MBS issuance may press legal claims against the creators of the trusts or force reimbursements, or repurchases. Conversely, other market participants argue that mortgages were pooled into securities using standard industry practices that were sufficient to create legal ownership on behalf of MBS trusts. According to these participants, the practices that were typically used to transfer loans into private label MBS trusts comply with the Uniform Commercial Code, which generally has been adopted in every state.[15] As a result, they argue that the transfers were legally sufficient to establish the trusts' ownership. Although some courts may have addressed transfer practices in certain contexts, the impact of the problems likely will remain uncertain until courts issue definitive, controlling decisions. In the near term, industry observers and regulators noted that these cases and other weaknesses in foreclosure processes could lead to increased litigation and servicing costs for servicers, more foreclosure delays, and investor claims.

[14]GAO-11-93.

[15]Loans that were sold into pools and then securities issued by entities other than the government-sponsored enterprises Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac), or Government National Mortgage Association (Ginnie Mae) are known as private label MBS.

Although tasked with overseeing the financial safety and soundness of institutions under their jurisdiction, the banking regulators have not fully assessed the extent to which MBS loan transfer problems could affect their institutions financially. According to staff at one of the regulators, as part of the coordinated review, examiners did not always verify that loan files included accurate documentation of all previous note and mortgage transfers—leaving open the possibility that transfer problems exist in the files they reviewed. The enforcement orders resulting from the coordinated review require servicers to retain an independent firm to assess these risks. Regulators will more frequently monitor these servicers until they have corrected the identified weaknesses; however, the regulators have not definitively determined how transfer problems might financially affect other institutions they regulate, including any of the institutions involved in the creation of private label MBS. With almost $1.3 trillion in private label securities outstanding as of the end of 2010, the institutions and the overall financial system could face significant risks.

To reduce the likelihood that problems with transfer documentation could pose a risk to the financial system, we recommended that the banking regulators assess the risks of potential litigation or repurchases due to improper mortgage loan transfer documentation on institutions under their jurisdiction and require that the institutions act to mitigate the risks, if warranted. Completing the risk assessments and fully ensuring that regulated institutions proactively address the risks could reduce the potential threat to the soundness of these institutions, the deposit insurance fund, and the overall financial system. In written comments on a draft of our report, the regulators generally agreed with or did not comment on this recommendation. For example, FDIC strongly supported this recommendation and noted its particular interest in protecting the deposit insurance fund. In addition, the Federal Reserve said that it has conducted a detailed evaluation of the risk of potential litigation or repurchases to the financial institutions it supervises and will continue to monitor these issues.

Chairman Menendez, Ranking Member DeMint, and members of the subcommittee, this completes my prepared statement. I would be happy to respond to any questions you may have at this time.

Contacts and Staff Acknowledgments

If you or your staff have any questions about matters discussed in this testimony, please contact A. Nicole Clowers at (202) 512-4010 or clowersa@gao.gov. Other key contributors to this testimony include Cody Goebel (Assistant Director), Beth Garcia, Jill Naamane, and Linda Rego.

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PREPARED STATEMENT OF DIANE E. THOMPSON

OF COUNSEL, NATIONAL CONSUMER LAW CENTER

MAY 12, 2011

The Need for National Mortgage Servicing Standards

Written Testimony

of

Diane E. Thompson
National Consumer Law Center

also on behalf of
National Association of Consumer Advocates

Before the United States Senate Subcommittee on
Housing, Transportation, and Community Development of the
United States Senate Committee on
Banking, Housing, & Urban Affairs

May 12, 2011

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I. Introduction

Chairman Menendez, Ranking Member DeMint, and members of the Subcommittee, thank you for inviting me to testify today regarding the need for national mortgage servicing standards.

I testify here today on behalf of the National Consumer Law Center's low-income clients. On a daily basis, NCLC[1] provides legal and technical assistance on consumer law issues to legal services, government and private attorneys representing low-income consumers across the country. I also testify here today on behalf of the National Association of Consumer Advocates.[2]

I am an attorney, currently of counsel to the National Consumer Law Center. In my work at NCLC, I provide training and support to hundreds of attorneys representing homeowners from all across the country. In that role, I hear many, many reports of the difficulties encountered by advocates and homeowners in working with loan servicers. For nearly 13 years prior to joining NCLC, I represented low-income homeowners at Land of Lincoln Legal Assistance Foundation in East St. Louis, Illinois. In that capacity, I became intimately familiar with the lack of regulation, restraint, or rules governing servicer behavior. Servicers have been and remain largely unaccountable to all stake holders for their actions.

Servicers do not believe that the rules that apply to everyone else apply to them. This lawless attitude, supported by financial incentives and too-often tolerated by regulators, is the root cause of the failure of HAMP and the wrongful foreclosure of countless American families. Whether servicers' errors are the result of intentional wrongdoing or mere incompetence, the result is the same: homeowners, investors, and the communities we all live in suffer, while servicers

continue to profit. Only national servicing standards, imposed uniformly on all servicers across the country, will rein the problem in.

Key to any national servicing standards is the evaluation of a homeowner for a loan modification prior to the initiation of a foreclosure proceeding. Homeowners must be evaluated for and, when appropriate, offered a loan modification before foreclosure. In order to prevent wrongful foreclosures while the homeowner is being evaluated for a loan modification, or even in a loan modification, the dual track system, of proceeding with a mortgage foreclosure and a loan modification at the same time, must be stopped and stopped absolutely.

Homeowners for decades have complained about servicer abuses that pushed them into foreclosure without cause, stripped equity, and resulted, all too often, in wrongful foreclosure. In recent months, investors have come to realize that servicers' abuses strip wealth from investors as well.[3] Unless and until servicers are held to account for their behavior, we will continue to see fundamental flaws in mortgage servicing, with cascading costs throughout our society. The lack of restraint on servicer abuses has created a moral hazard juggernaut that at best prolongs and deepens the current foreclosure crisis and at worst threatens our global economic security.

Servicers rely on extracting payments from borrowers as quickly and cheaply as possible; this model is at odds with notions of due process, judicial integrity, or transparent financial accounting. The current foreclosure crisis has exposed these inherent contradictions, but the failures and abuses are neither new nor isolated.

State regulators have attempted to rein in these abuses, but servicers have often thumbed their noses at state regulators and sought protective shelter in the preemption rulings issued by the Office of the Comptroller of the Currency. Recent consent orders announced by the federal

banking regulators are of limited reach and threaten to undermine the combined (and unprecedented) efforts of the Department of Justice and the Attorneys General of all fifty states. The GSEs, Fannie Mae and Freddie Mac, and their oversight agency, the Federal Housing Finance Authority, have failed to prioritize loan modifications over foreclosure. Even new guidance from the FHFA fails to end dual track.

In testimony before the Senate Banking committee in July 2009, I detailed widespread noncompliance with the Home Affordable Modification Program (HAMP). HAMP was a laudable attempt to overcome long standing reluctance by servicers to perform large numbers of sustainable loan modifications. While the permanent loan modifications offered under HAMP are performing well, with historically low redefault rates, only a very few of the potentially eligible borrowers have been able to obtain permanent modifications. Advocates continue to report that borrowers are denied improperly for HAMP, that servicers solicit opt-outs from HAMP, and that some servicers persistently disregard HAMP applications. HAMP sought to change the dynamic that leads servicers to refuse even loan modifications that would be in the investors' best interests by providing both servicers and investors with payments to support successful loan modifications. But, by failing to require that servicers perform modifications and by overlooking servicer accountability and transparency at every step of the process from application to evaluation to conversion, HAMP was set up to fail.

When servicers wrongfully foreclose, or fail to modify, or undermine the judicial process and imperil the legality of a foreclosure, homeowners, investors, and the American public at large all lose. The foreclosure rate is now more than three times what it was in 1933, at the height of the Great Depression.[4] The crisis has impacted every part of our country and most of the world. As

the chairman of the Federal Reserve Board has noted, the crisis threatens our national economy.[5] Losses to individual families foreclosed on are projected to exceed $2.6 trillion,[6] with spillover effects on neighbors and communities in the trillions of dollars.[7]

Servicers, however, can make money from foreclosures. Forceplaced insurance and other excessive fees that push homeowners into default provide servicers with revenue. Modifications cost money in staffing that foreclosures do not. Robosigning can save servicers even more money.[8]

We are facing a foreclosure tsunami, which has destabilized our economy, devastated entire communities, and destroyed millions of families. Yet we have failed to take aggressive action to restore stability. Neither the government nor the private sector has responded to scale in addressing the crisis. Public and private response to the crisis has been anemic at best, causing millions of families to lose their homes unnecessarily, at great cost to all of us. Foreclosures continue to outpace modifications.[9]

We must take immediate action to rein in servicer abuses and restore transparency to our mortgage markets. To restore rationality to our market we must take the following steps:

- Eliminate the two-track system. Homeowners should be evaluated for a loan modification before a foreclosure is initiated or continued, and that evaluation (and offer of a loan modification, if the homeowner qualifies for a loan modification) should be completed before any foreclosure fees are incurred. Such a requirement could be imposed by legislation or by regulation.
- The failure to offer loan modifications to homeowners, where doing so is predicted to save the investor money under the Net Present Value test, must be made a clear and absolute defense to foreclosure, in both judicial and non-judicial foreclosure states.
- Net Present Value tests for modifications should be standardized and made public.
- Loan modifications for qualified homeowners facing hardship, including those in bankruptcy, should be permanent, affordable, assumable, and available without any

waiver of a homeowner's legal rights. Where appropriate, principal reduction should be prioritized and available in a modification as well through bankruptcy.

- Homeowners denied a loan modification should receive a written servicer communication documenting the NPV inputs, any relevant investor restrictions and efforts to obtain an exception, and the appeal process. Appeals should be processed before a foreclosure commences or continues.

- Borrowers should be provided with access to full documentation of any investor restrictions, as well as all servicer attempts to procure a waiver, upon any denial based on investor guidelines.

- Servicers must be required to seek, and investors should be encouraged to grant, waivers of any restrictions prohibiting modifications.

- Homeowners must be provided the tools to focus servicer attention on resolving individual cases.

- Quality mediation programs should be funded in every community to provide an opportunity to resolve disputes outside of litigation.

- Funding for legal services lawyers representing homeowners facing foreclosure must be increased to allow our adversarial justice system to function as designed.

- Principal reductions should be mandated where they return a net benefit to the investor and permitted via judicial modification.

- Fees to servicers must be limited to those both reasonable and necessary for them to carry out their legitimate activities. Default-related fees should not remain an unconstrained profit center for servicers.

- Force-placed insurance should be replaced by a default reliance on replacing the existing coverage at a reasonable price.

- Transfer notices and periodic statements should be used to increase servicing transparency.

- Application of payments and use of suspense accounts should be fair and reasonable.

- Foreclosure documentation and notice standards should be established.

- A national system for assisting unemployed homeowners should be established. Unemployed homeowners should be provided with substantial forbearance options and the nascent Emergency Homeowner Loan Program (EHLP) must be made permanent and properly funded. In addition, the current funds for EHLP should be distributed to the states on a timeline that allows maximum distribution.

Unemployed homeowners were promised assistance over a year ago and most of them are still waiting for a program where they live to be finalized.

- National standards must be a floor, not a ceiling, so states can play the traditional role of legal laboratories to further protect homeowners, investors, and communities.

II. The Need for National Servicing Standards Is Acute

Servicing abuses are nothing new. Yet in this period of record foreclosure rates they can no longer be tolerated. The basic structure of the servicing industry has encouraged and facilitated the worst abuses; no market correction is available to restore rationality to the servicing industry. The interests of servicers are too distinct from those of homeowners, investors, and the national economy. While several states have taken action to limit the most egregious servicing abuses, the reach of state action is constrained by both the fears and reality of federal pre-emption. We are being buffeted because of our failure to curb predatory lending; we should not prolong our agony by permitting predatory servicing to flourish unchecked.

A. Servicing Abuses Are Endemic Throughout the Industry

At every stage of the process, from modification evaluation through foreclosure, servicers have failed to serve either the interests of investors or to treat homeowners fairly and honestly. The errors by servicers are systematic and widespread. In the aggregate, they cannot be explained as good faith mistakes.

1. Servicers Deny and Delay Loan Modification Requests Improperly

Servicers routinely delay processing loan modification applications long past any reasonable time frames. For example, the average length of time homeowners spend seeking a HAMP loan

modification is 14 months.[10] Documents are lost; additional grounds for denial are advanced; prior agreements are disclaimed. Getting to a final modification remains difficult and, even once achieved, is no panacea. A recent informal survey conducted by Connecticut Fair Housing Center of thirteen legal services or nonprofit organizations and one private attorney representing homeowners found, in preliminary results, that nearly 20% of all permanent modifications (over 400, in this survey) run into some servicer-created problem, including additional post-modification fees, refusing to recognize the agreement, and, most devastatingly of all, new foreclosures.

Delay and deny remains many servicers' standard response to loan modification requests, as recent examples from advocates around the country illustrate:[11]

- ❖ One California family was only converted to a permanent modification (on their third modification agreement, despite having made all required payments) in April 2011, four months after the completion of the temporary modification, despite hundreds of phone calls by their attorney.
- ❖ One West Virginia family has been waiting two years for a permanent modification, after having made six months of payments on their first trial modification, and subsequently approved and denied multiple times for additional trial modifications.
- ❖ Chase put a New York family in foreclosure after they had successfully completed two separate trial modifications (Chase, in violation of HAMP guidelines, required them to re-apply for a modification after the first one because their income documentation was "stale," and required them to re-start the second modification because the family overpaid by $62 over three months' time) and made several months of additional payments in accordance with the modification terms.
- ❖ One Minnesota family has spent over a year and a half in multiple trial modifications with Chase, without being converted to a permanent modification. After the family completed their payments under the first modification agreement, Chase first requested that the family resubmit all income documentation and then informed the family that it intended to foreclose, and sent the family two separate letters denying them (for different, and apparently erroneous, reasons). This family is now on their fifth HAMP application with Chase, in response to repeated solicitations from Chase to apply for HAMP.

- A New York family who fell behind on their mortgage payments in 2008 has still not received a permanent modification despite numerous mediation conferences and twelve months of consecutive trial modification payments.

- One Wisconsin family made 18 payments under their trial modification before the servicer, Bank of America, initiated foreclosure, even though the servicer had previously confirmed in writing that she had qualified for a permanent modification and the documents were "on the way." One California family was denied a modification agreement because the servicer claimed the mortgage was in the name of the father only—despite the fact that the father was long dead, and only the mother's name was on the deed and mortgage.

- Another California family was denied because the servicer, based on a credit report, had determined that the homeowner was dead. When the attorney called his client, she confirmed that she was alive and well. The notice of denial stated that the denial was on "investor guidelines," but provided no further notice that would have enabled the homeowner to know that her vitality was in question.

- A North Carolina family has been trying to get a loan modification from Litton for over a year. Litton has denied the family multiple times for failing to provide documentation. Since neither the attorney nor her client had received any requests for additional documentation (although both had received other communications from Litton, including the denial notices), the attorney contacted HAMP escalations. HAMP escalations were able to determine that Litton was mailing the requests for additional documents to an address that corresponded to neither the homeowner's nor the attorney's—an address Litton apparently made-up.

- Last summer a Connecticut homeowner tried to obtain a modification of her Fannie Mae loan from CitiMortgage. She submitted all the requested paperwork, but learned that Citi planned to move forward with a foreclosure sale—because the pay stubs she had submitted in August were from June. The homeowner explained that she was a school bus driver and was off during the summer months. Citi nevertheless went forward with the sale.

- A Michigan homeowner, after making all the payments required by the terms of her HAMP modification with AHMSI for a year, was informed early this year that her modification date is incorrect, and she will need to execute entirely new documents, with a new, higher interest rate, and a new higher payment. AHMSI refuses to honor the terms of the original modification, and has been returning the homeowner's payments to her.

- One New York homeowner accepted a proprietary permanent modification with Bank of America in January 2010, and has been making payments on it ever since. For the last year, since April 2010, Bank of America has repeatedly threatened foreclosure and disputed the existence of the permanent modification.

- An Illinois homeowner who entered into a trial modification with Chase in October 2010 had his third trial period payment rejected. Instead, Chase demanded and received payments nearly twice what the homeowner was required to pay under the modification agreement. When he went to a local Chase Homeownership Preservation office, he was told that he needed to reapply for a modification.

- Bank of America misapplied a California homeowner's payments under a repayment agreement and required her to capitalize the arrears to catch up on the repayment agreement (which she had, in fact, already completed). After the woman began sending payments that included her regular monthly payment and the improperly capitalized amounts, Bank of America rescinded the offer of a modification and initiated foreclosure proceedings, despite representations from high level bank employees to the homeowner's attorney that they would honor the modification.

- In early 2010, CitiMortgage offered a New York family a permanent modification, which they signed and sent back. Two months after the bank counter-signed the modification, Citi sent the family a new modification with payments that were nearly $700 higher. The family called Citi, and Citi instructed them to ignore the new modification and continue making the lower payment, because the discrepancy was a result of a problem with Citi's computers, which hadn't been updated to reflect the July 2010 modification. Even though the family made all payments under the modification, which Citi had signed, Citi told the family in March that it was disregarding the modification agreement and filing a foreclosure action.

- After finally being converted from a temporary modification to a permanent modification in September 2010, more than a year after their initial application, a Staten Island, New York, family thought they were home free. However, Chase has started placing their regular payments in a suspense account and reporting them as delinquent to the credit bureaus. Chase also ceased sending the family monthly servicing statements. Because of the delinquency on their credit report, the family has been denied a car loan. When the homeowners call the number given them by Chase to resolve this situation, it goes to a voicemail inbox and their messages are unreturned.

- A Wisconsin family, after making payments under an oral trial modification for over a year, was placed into foreclosure when servicing was transferred.

As discussed more in II.B below, delay serves servicers' interests. During delay, fees and interest accrue. These fees and interest can quickly mount up. One New York family, upon finally receiving an offer for a permanent modification, found themselves faced with a bill for over $9000 in foreclosure related fees and costs.

These fees will ultimately be paid to the servicer, either by the homeowner or from the proceeds of a foreclosure sale. If, ultimately, the loan is modified, and the fees are capitalized, the servicer's monthly servicing fee will increase since it is calculated as a percentage of the outstanding principal.

Of course, the servicer must also advance the borrower's principal and interest payments to the investors every month, and delay increases the servicer's overall costs to borrow funds to make these advances. But only when the costs of financing advances outstrip the additional accumulating fees do servicers have a meaningful incentive to end delay. At that point, the scales will often tilt toward a foreclosure rather than a modification—in part because investor restrictions on how long a loan can be in default before modification may have been exceeded, in part because the accumulated arrearages may make any modification unsustainable, and in part because the time to recover those fees and any legitimate advances will be much shorter in a foreclosure proceeding than in a modification.

Requiring homeowners to enter into multiple temporary modifications—and accepting their payments—offers all the advantages of delay, plus payments to offset the cost of advances. These serial temporary modifications keep income flowing in to the servicers; they keep the loan in the pool, so that the servicer can continue to draw down the monthly principal-based servicing fee; they generate late fees and other-default related-fees for the servicers. These serial temporary modifications also skew the HAMP statistics, making it look as if more homeowners are offered modifications than actually are and concealing servicers' failure to convert temporary modifications to permanent modifications. But they do not serve homeowners or investors well. Homeowners face accruing costs on their loan, which can place them in jeopardy of foreclosure or make the

conversion to a permanent modification impossible. Investors suffer, often, a loss of equity in the collateral as time passes and housing values decline, [12] fees are stripped from any ultimate foreclosure, and the reporting of temporary modifications instead of permanent modifications may upend the order of payments in the securitization pool, resulting in payments to lower-level tranches at the expense of senior tranches.[13]

2. The Loan Modification Process Is Dysfunctional

The process seems designed to result in loan modification denials, in its Byzantine communications or lack thereof. Advocates report making hundreds of phone calls per each individual loan modification, and receiving multiple denials on most files. Who has authority to speak for the servicer to what extent is never clear. When a Wisconsin advocated finally reached a Bank of America case negotiator, after many attempts and over a month, the case negotiator stated that she could not negotiate any terms of a modification, but could only provide status updates. A California attorney was told by the SunTrust representative that not only could the attorney not speak directly to the case negotiator, but that the representative was also forbidden from having any direct contact with the negotiator—the best she could do to communicate to the case negotiator that the borrower had presented new information was to post a note in the closed file. In another California case, high-level Bank of America representatives agreed that no foreclosure sale would happen while a loan modification review was pending, yet one did. One Washington state woman was reduced to tears by the insistence of Chase employees that her house had not, in fact, been foreclosed on, even though the homeowner had received an eviction notice.

Few attorneys and even fewer housing counselors have the persistence to negotiate such a system. Getting a loan modification should not be a trial by ordeal, with success predicated on a

miraculous intervention. Yet obtaining a permanent modification remains a matter of skill and luck and persistence, without much regard to the underlying cold, hard economic calculations. Relatively few of the reported HAMP denials are based on Treasury's Net Present Value test, which measures the economic return to an investor from a modification.[14] Far more often, the economic calculus of a loan modification is not considered in the denial.

3. Servicers' Errors Result in Wrongful Foreclosure

We do not know—and cannot know—how many homeowners have been improperly foreclosed on. Poor documentation by servicers is not merely a "technical" error. Reported cases abound where servicers are unable to establish the amount of default[15] or where a servicer misapplication of payments leads to default.[16] Servicer errors can and do lead to foreclosure.

In an attempt to quantify the extent of the problem, 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.

Surprisingly often, servicers return or ignore homeowners' catch-up payments and institute foreclosure. Two examples from New York are illustrative:

- One New York homeowner fell behind in her payments in December 2010. When she tried to resume making payments in February, the servicer, Wells Fargo, returned her payments and referred her case to foreclosure. When the homeowner called Wells Fargo to ask how she could bring the account current, she was told that a payment in the amount of $5,729.03, if made by the end of March, would cure her default and prevent foreclosure. Wells Fargo accepted the payment, placed it in a

suspense account, and instituted foreclosure proceedings against the homeowner the following week (Wells Fargo's counsel is seeking an additional amount in foreclosure related fees).

- Another New York family overnighted the funds—over $8000—that their servicer represented was required to bring the account current. Yet the servicer, without explanation, returned the funds and instituted foreclosure. Only after more than a year of litigation and the intervention of Staten Island Legal Services was a permanent modification offered, but at the cost of over $9000 in foreclosure related fees and costs.

Even more commonplace, as the following recent examples illustrate, is the institution of foreclosure on homeowners who are making payments under a plan:

- Bank of America foreclosed on a California homeowner who was making payments on a modification agreement that required the capitalization of arrears she did not, in act owe, despite representations from high level bank employees to the homeowner's attorney that they would honor the modification and not foreclose.

- In early 2010, CitiMortgage offered a New York family a permanent modification, which they signed and sent back. Two months after the bank counter-signed the modification, Citi sent the family a new modification with payments that were nearly $700 higher. The family called Citi, and Citi instructed them to ignore the new modification and continue making the lower payment, because the discrepancy was a result of a problem with Citi's computers, which hadn't been updated to reflect the July 2010 modification. Even though the family made all payments under the modification, which Citi had signed, Citi told the family in March that it was disregarding the modification agreement and filing a foreclosure action.

- A Wisconsin family, after making payments under an oral trial modification for over a year, was placed into foreclosure when servicing was transferred.

- Chase put a New York family in foreclosure after they had successfully completed two separate trial modifications (Chase, in violation of HAMP guidelines, required them to re-apply for a modification after the first one because their income documentation was "stale," and required them to re-start the modification because the family overpaid by $62 over three months' time) and made several months of additional payments in accordance with the modification terms.

- Bank of America initiated foreclosure proceedings on an Illinois family after over a year of payments under their modification agreement. When the family's housing counselor called Bank of America, she was told that Bank of America had failed to process the final modification agreement.

- One Wisconsin family made 18 payments under their trial modification before the servicer, Bank of America, initiated foreclosure, even though the servicer had previously confirmed in writing that she had qualified for a permanent modification and the documents were "on the way."
- A California family learned that, because of "a computer error," Chase sold their home at a foreclosure sale, despite the fact that they were making regular payments under a modification agreement. This was a Freddie Mac loan.
- A Washington state family lost nearly $200,000 in equity when the servicer proceeded to foreclosure while the family was making regular payments under a temporary modification agreement. The purchaser of the property succeeded in evicting the family, who are now living in an apartment.

As discussed II.B.2, servicers have substantial incentives to impose significant fees on homeowners because they are usually permitted under the pooling and servicing agreements to retain all of those fees. Forceplaced insurance in particular is often a locus of abuse,[17] with examples of forceplaced insurance leading to foreclosure reported around the country.[18] One New York homeowner was tipped into foreclosure by Chase's improper and unnecessary placement of an escrow account on his second mortgage. Despite the intervention of the New York State Banking Department, Chase, nearly three years later has still not credited the homeowner for fees imposed wrongfully by Chase in connection with the escrow account.

The problems establishing ownership and chain of title demonstrated in the robosigning scandal can make obtaining a loan modification impossible. One North Carolina homeowner was advised by BAC Home Loans Servicing in 2009 that she was not eligible for a modification since her loan was an FHA loan, and she did not meet the FHA loan modification requirements. A year later, after the woman found her way to a legal services attorney, FHA disclaimed any interest in the loan. Until this question is resolved, no loan modification can be processed, and the accumulating arrearage makes any loan modification increasingly unlikely. In another case, after offering a Brooklyn homeowner two separate permanent HAMP modifications over a period of seven months,

and after the homeowner had completed the terms of her trial modification, the servicer determined that investor restrictions prohibited modifications, apparently because the servicer had previously incorrectly identified the holder.

The cause may be a technical error, or a mistake by the servicer, but if the homeowner is pushed into default, denied a loan modification, or induced not to make payments in reliance on a loan modification, the result is the same: a wrongful foreclosure, at incalculable cost to the homeowners and likely loss to the investors. [19]

B. Servicers' Incentives Incline Them Towards Modifications with Increased Fees and Foreclosures over Sustainable Modifications.

Once a loan is in default, servicers must choose to foreclose or modify. A foreclosure guarantees the loss of future income, but a modification will also likely reduce future income, cost more in the present in staffing, and delay recovery of expenses. Moreover, the foreclosure process itself generates significant income for servicers.[20]

Servicers do not make binary choices between modification and foreclosure. Servicers may offer temporary modifications, modifications that recapitalize delinquent payments, modifications that reduce interest, modifications that reduce principal or combinations of all of the above. Servicers may demand upfront payment of fees or waive certain fees. Or servicers may simply postpone a foreclosure, hoping for a miracle.

For servicers, the true sweet spot lies in stretching out a delinquency without either a modification or a foreclosure. Income from increased default fees and payments to affiliated entities can outweigh the expense of financing advances for a long time. This nether-world status also

boosts the monthly servicing fee and slows down servicers' largest non-cash expense, the amortization of mortgage servicing rights, since homeowners who are in default are unlikely to prepay via refinancing.[21] Finally, foreclosure or modification, not delinquency by itself, usually triggers loss recognition in the pool. Waiting to foreclose or modify postpones the day of reckoning for a servicer. But delay can cost a homeowner the opportunity to obtain a modification.

1. Influence of Advances

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. Financing these costs is one of servicers' biggest expenses.[22] Recovery of these fees (but not the financing costs) is more certain and often swifter via a foreclosure than a modification. Only when a modification offers a faster recovery of advances than a foreclosure, might the financing costs incline a servicer toward a modification.[23]

a) Interest and Principal Advances to Investors

Servicers, under their agreements with investors, typically are required to continue to advance interest on loans that are delinquent.[24] Unpaid principal may or may not be advanced, depending on the PSA.[25] 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.[26]

Servicers' advances are taken off the top, in full, at the post-foreclosure sale, before investors receive anything. [27] 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).[28]

In contrast, when there is a modification, the general rule, announced repeatedly by the rating agencies, is that servicers should only recover their expenses from modifying a loan from either payments made on the modified loan or principal-only payments to the pool.[29] If servicers follow this rule—and not all have,[30] it will take servicers longer to recover their advances post-modification than post-foreclosure.

b) Fee Advances to Third Parties

In addition to interest advances, servicers advance expenses associated with default servicing, such as title searches, drive-by inspections, or foreclosure fees.[31] Taxes and insurance costs are also often advanced.[32] Some PSAs impose caps on these fee advances.[33]

These fee advances may or may not represent actual out-of-pocket expense to the servicer. In many cases, affiliates of the servicer, not true third parties, receive the fees, and the resulting profit wipes out any cost of financing the advance.[34] These fees may also be marked-up: in one case, Wells Fargo reportedly charged a borrower $125 for a broker price opinion when its out-of-pocket expense was less than half that, $50.[35] Such padding more than offsets the cost of financing the advance. Force-placed insurance is frequently placed either through or an affiliate or in exchange for a commission from the insurance company paid back to the servicer—again wiping out any true cost and turning the nominal advance into a profit center for the servicer.[36]

2. Fees Are a Profit Center for Servicers

Most PSAs permit servicers to retain fees charged delinquent homeowners. Examples of these fees include late fees[37] and fees for "default management" such as property inspections.[38] The profitability of these fees can be significant.[39] Late fees alone constitute a significant fraction of many subprime servicers' total income and profit.[40]

Servicers can collect these fees post-foreclosure before the investors receive any recovery.[41] This guaranteed recovery of fees strongly favors foreclosures over modifications that waive fees, including HAMP,[42] and encourages servicers to delay foreclosures in order to maximize the number of fees charged.[43] In a self-perpetuating cycle, the imposition of fees makes a foreclosure more likely, by pricing a modification out of a homeowners' reach.[44]

In addition to pre-foreclosure fees, servicers are usually entitled to recover the costs of selling the home post-foreclosure, before investors are paid.[45] The sometimes substantial fees paid to servicers in foreclosure tend to be invisible to investors.[46]

3. Why Servicers Don't Reduce Principal and Do Capitalize Arrearages

In an era when one in four homeowners is underwater, principal reductions are key to stabilizing the housing market.[47] The double whammy of declining home values and job losses helps fuel the current foreclosure crisis.[48] 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. Without principal reductions, homeowners who lose their jobs, have a death in the family, or otherwise experience a drop in income are more likely to experience redefault and foreclosure.[49] Existing data on loan modifications shows that loan modifications with

principal reductions tend to perform better.[50] In order to bring down the redefault rate and make loan modifications financially viable for investors, principal reductions must be part of the package.[51]

Homeowners are underwater in large part as a result of systematic decisions made by lenders. Appraisal fraud was endemic in purchase money mortgages throughout the country in recent years.[52] Increased appraisal values on refinancings allowed lenders to strip equity from homes and increase their profits. The expansion of negatively amortizing products left additional homeowners further underwater and vulnerable to precisely the cratering of home values experienced in many parts of the country.

Investors have generally been receptive to the possibility of principal reductions, particularly when taken as direct write downs in refinancing.[53] In that case, the loss is distributed throughout the securitization as contemplated in the original waterfall design, and the higher-rated tranches receive their capital and are able to reinvest it elsewhere should they so choose. Refinancing is currently not a likely prospect for most homeowners, but even without refinancing, principal write downs restore rationality to the markets and, due to loss recognition rules embodied in most PSAs, result in the loss being distributed under the waterfall as anticipated at the inception of the securitization trust. At least some investors would prefer to see more principal reductions through modifications in the absence of refinancing.[54]

Nonetheless, servicers' incentives consistently skew against principal reductions. Without accounting sleight-of-hand, servicers are likely to suffer a loss by agreeing to a principal reduction, at least as compared to other forms of modifications. HAMP has failed to mandate principal reductions, even when doing so would be in the investors' best interests. Instead, HAMP mandates principal forbearance, which leaves homeowners facing large balloon payments. As a result of

HAMP's failure to mandate principal reductions (and account for servicer's disincentives to offer principal reductions, even when doing so makes economic sense for the investors), less than 3.3% of all the permanent modifications done under HAMP include principal reduction.[55]

Effect of Servicer Incentives on Default Outcomes

This chart shows whether specific elements of servicers' compensation and expenses create positive, negative, or neutral incentives for them pursue different types of outcomes for homeowners in default.

	Short-Term Forbearance or Repayment Agreement	Interest Rate Reduction	Principal Forbearance	Principal Reduction	Short Sale	Foreclosure
Repurchase Agreements	Positive	Negative	Negative	Negative	Neutral	Neutral
TDR Rules	Positive	Negative	Negative	Negative	Neutral	Neutral
Fees	Positive	Neutral	Negative	Negative	Negative	Positive
Float Interest Income	Neutral	Negative	Negative	Negative	Positive	Positive
Monthly Servicing Fee	Neutral	Neutral	Positive	Negative	Negative	Negative
Residual Interests	Positive	Negative	Negative	Negative	Negative	Negative
Advances	Positive	Neutral	Negative	Negative	Positive	Positive
Staff Costs	Neutral	Negative	Negative	Negative	Negative	Positive

All of servicers' incentives militate against principal reduction. Principal forbearance can be costly for servicers as well, but if servicers have a choice, they will choose forbearance over reduction, even though a forbearance does not provide for long-term sustainability as well as a principal reduction modification does. Principal forbearance, unlike principal reductions, stabilizes the monthly servicing fee because most PSAs appear to allow servicers to include in their calculation of the outstanding balance the amount of principal forbearance, while principal write-downs cannot be included in the amount of the outstanding balance.[56] For a servicer, principal forbearance is preferable to principal reduction: it preserves more monthly servicing fee income for longer.

Servicers, given their druthers, will choose capitalization modifications over either principal forbearance or principal reductions. In a capitalization modification, the homeowner's unpaid principal balance increases as arrearages are added to the outstanding balance. Thus, the servicer's largest source of income, the principal-based monthly servicing fee will increase. Additionally, capitalization modifications, unlike other forms of modification, may allow servicers to pull their advances and other expenses back out of the pool, thus reimbursing themselves faster than is possible under a conventional modification.[57] Unsurprisingly, modifications that include capitalization of arrearages are consistently the largest category of modifications, [58] yet they are harmful to both investors and homeowners. Investors lose because their interest income may be diverted to the servicer, to reimburse the servicer for expenses associated with modifying the loan.[59] Homeowners lose because modifications that capitalize arrearages increase their balances, leaving homeowners owing more than they did pre-modification. Both homeowners and investors lose, because modifications that increase the principal balance are more likely to re-default.[60] Servicers have made these modifications, harmful to both investors and homeowners, with impunity. [61]

C. Federal Baseline Protection Is Needed

1. All Safety Fuses Limiting Servicer Abuses Have Been Blown

We have long since abrogated the two traditional checks to ensure that homeowners cannot be deprived of their home by a stranger: the requirement that the original note be produced and the public recording of assignments. Without the public availability of those documents, it is impossible for most homeowners or any independent third party to verify a servicer's representations as to ownership. There are even fewer checks on the servicer's declaration of default.

Only about half the states follow a judicial foreclosure process, where a judge reviews the documents. In the other states, foreclosure is conducted extra-judicially, with few if any verifications of a servicer's representation as to default and ownership. Even the extra protection afforded by judicial process is spotty, at best, however, particularly in this era of historically high volumes of foreclosure cases.[62] Judges, in foreclosure cases as in other cases, rely on the adversarial process to bring to light problems in either party's case. Where one side is systematically unrepresented, as the vast majority of homeowners are, the process skews away from a balanced review of the equities. Judges are unlikely to detect errors in a servicer's documentation where the homeowner goes unrepresented. In many courtrooms, the foreclosure process resembles a factory assembly line far more than our images of a court of law.

We know from the success of the New York City and Philadelphia mediation programs that where servicers and their lawyers are compelled to treat resolution of a foreclosure dispute as an individual case, and not an assembly line, many foreclosures can be prevented. Those programs consistently report that in at least half of all cases the parties reach a loan modification and the foreclosure is prevented. But servicers have not shown an inclination to provide that careful case-by-case review outside mandatory programs, and standard judicial resources are overwhelmed by the scale of the crisis.

As successful as these local models have been, we cannot rely on either scattered municipalities or even whole states to solve our national foreclosure crisis. For that, we must look to our national government.

2. State Action Is Limited by the Federal Regulatory Agencies

One reason that state action alone is insufficient to address the foreclosure crisis is that the federal banking agencies, particularly the Office of the Comptroller of the Currency (OCC), which charters national banks, have been zealous about exercising their preemption authority.

From 2000 to 2004, the OCC worked with increasing aggressiveness to prevent the states from enforcing state consumer protection standards against national banks. For example, the OCC openly instructed banks that they "should contact the OCC in situations where a State official seeks to assert supervisory authority or enforcement jurisdiction over the bank,"[63] and warned states that national banks need not comply with state laws.[64] The OCC's efforts culminated in 2004, when the agency adopted a regulation preempting all state laws unless their effect on national bank powers was "only incidental."[65] The regulation allows national banks to ignore state laws regarding licensing, terms of credit, disclosure and advertising, solicitations, billing, and other topics.

The OCC also asserted that the subsidiaries of national banks and federal thrifts—though they are creatures of state law, are not banks, and do not have a federal charter—can ignore state law to the same extent that their parents can.[66] The Supreme Court upheld this regulation in 2007.[67] This exercise of preemption authority by the OCC and other federal banking agencies has limited the scope of what state actors can do to contain the current crisis.

The preemption of state laws in the mortgage area by the federal agencies is a significant cause of the current crisis. Bank domination was heaviest in the most dangerous, nontraditional interest-only and payment-option adjustable rate mortgage (ARM) markets: they held 51% of the total market in 2006.[68] Though these loans were nominally made to borrowers with prime-level credit scores, the loans were toxic.[69] Overall, in 2006, national banks, federal thrifts, and their operating subsidiaries were responsible for over $700 billion of the riskiest loans.[70]

Even if the federal banking agencies took a more restrained approach, however, many of the large servicers are national banks, whose primary regulator is the Office of the Comptroller of the Currency.[71] Unsurprisingly, then, many of these servicers are often unresponsive to state regulators or enforcement agencies. For example, in one case handled by Staten Island Legal Services, it took Chase a year after a complaint to the New York State Banking Department to remove an improper and unnecessary escrow account on a second mortgage, and Chase has still not credited the homeowner's account for unnecessary fees. In another case, a Milwaukee advocate, in desperation after Bank of America had failed to respond to her phone calls for months, contacted the Wisconsin Attorney General's office for assistance. In response to the inquiry from the Attorney General's office, Bank of America assigned a case negotiator, but that case negotiator closed the case after failing to respond to more than 50 phone calls and emails from the homeowner's attorney over a six month period. Bank of America agreed to assign a new case negotiator, in response to a second inquiry from the Wisconsin Attorney General's office, but when the homeowner's attorney finally reached the case negotiator, after many attempts and over a month, the case negotiator stated that she is unable to negotiate any terms of a modification, but can only provide status updates. State regulators and enforcement agencies are limited in the clout they can bring to bear against a recalcitrant servicer: they cannot, for example, revoke the charter.

In order to ensure parity and prevent a race to the bottom, minimum federal servicing standards are needed. A federal baseline standard allows states to respond to emerging local trends by providing, for example, mediation programs, or requiring disclosure of the efforts made to modify a loan as a condition precedent to the servicer's seeking to avail itself of the state law foreclosure remedy.

III. Existing Standards Are Inadequate

A. HAMP's Lack of Transparency and Accountability Has Prevented the Program from Delivering on Its Promise

As detailed in my prior testimony before the Senate Banking Committee in July 2009 and November 2010, as well as in numerous reports by the Special Inspector General for TARP, the Government Accountability Office, and the Congressional Oversight Panel, HAMP has failed to live up to its promise.

There are many good features of the HAMP program. HAMP has shown that sustainable loan modifications can be made. The re-default rate for HAMP loan modifications is dramatically lower than for any other form of loan modification.[72] The program has improved incrementally in allowing borrowers in bankruptcy to qualify, in moving significantly towards ending dual-track processing, and in providing an appeals process for borrowers. But the program has remained frustrating for homeowners and their advocates because it remains an essentially voluntary program.

Moreover, HAMP is time-limited, and will expire at the end of next year. Servicing abuses, unfortunately, are not time-limited. The foreclosure crisis has thrown these abuses into sharp relief and afforded us a rare window of opportunity for correcting the market dysfunction that has plagued our mortgage servicing market for decades.

B. Existing and Proposed Guidelines from Fannie Mae, Freddie Mac, and the Federal Housing Finance Authority Promote Foreclosures over Modifications

While Fannie Mae and Freddie Mac have generated a variety of servicing guidelines for loss mitigation over the years, they have not been uniform and, more importantly, they have not ensured that loan modification reviews occurred prior to foreclosure. Instead, the timelines for foreclosure have been the tail that wags the loss mitigation dog. Moreover, noncompliance by servicers with GSE guidelines has not been adequately addressed.

The GSEs, Fannie Mae and Freddie Mac, have each adopted their own, slightly different, versions of HAMP. In three areas the GSE policies have lagged significantly behind HAMP: the lack of an appeals process; the failure to end dual track; and creating hurdles to modifications for homeowners in bankruptcy. The GSE's continuing ban on principal reductions in loan modifications is contradicted by the facts and is the primary barrier to implementing this essential policy change in the industry. Each of these policies results in unnecessary and expensive foreclosures, foreclosures for which the taxpayers must ultimately bear the burden.

1. The Lack of an Appeals Process for GSE Loans Prevents Modifications

Even the new FHFA guidance, discussed below, does not provide redress for homeowners nor does it hold servicers publicly and monetarily accountable if they fail to follow the guidance. Foreclosures and evictions may still proceed while any review is under way, and there is still no clear route of appeal for homeowners wrongfully denied a loan modification or wrongfully foreclosed while in a loan modification.

Neither Freddie nor Fannie has a direct, well-publicized number for homeowners or their advocates to call to resolve disputes regarding loan modifications. Freddie Mac's website entirely defers to servicers, advising homeowners that they "will be contacted by their mortgage servicer" if

they are eligible for a modification.[73] A Nevada advocate reports that certified mail sent to the address on Freddie Mac's website came back unclaimed. Advocates in Colorado, Connecticut, and Maryland report that phone calls to Fannie Mae's Resource Center are not always answered and seldom, if ever, result in any review of the servicer's action. In one case, a Colorado advocate appealed OneWest's denial of a HAMP modification to both the HAMP Solutions Center (HSC) and to Fannie Mae's Resource Center. The representative at HSC attempted several times to contact Fannie with the escalation, and never received a response, as the foreclosure sale date drew ever-closer. The homeowners ended up filing Chapter 13 bankruptcy to prevent the sale from going forward, which, under Fannie's servicing guide, gives OneWest the discretion not to consider them for HAMP. Finally, after the homeowners had filed for bankruptcy, Fannie Mae responded to the HSC representative by summarily repeating OneWest's reason for denial, even though the homeowners had documented that OneWest's denial was based on double counting of the wife's income. A homeowner, or a homeowner's advocate, who wishes to raise a servicer's noncompliance with the GSEs has no reliable, formal channel with which to do so.

The lack of clear, direct access to review by the GSEs for homeowners and their advocates allows servicers to claim plausibly that their hasty and wrongful foreclosures are a result of GSE guidance that pushes foreclosures, forbids certain modifications, particularly modifications involving principal reduction, and puts homeowners squarely in the middle of fights between the GSEs and servicers.

2. Dual Track Problems Are Rife in GSE Loans

Reports of servicers conducting foreclosure sales while a consumer is making payments under a loan modification are epidemic for loans owned by the GSEs. The plight of one Maryland

homeowner made the front pages of The Washington Post last October.[74] Ms. Stovall had been making payments under a loan modification since April when she received an eviction notice in July. She had received warnings of the foreclosure, but when she called, both her servicer and the foreclosure attorney handling the case for the servicer, she was told not to worry, that, "The loan modification and foreclosure programs run parallel with each other and as long as you're in the loan modification process, nothing will happen," and that no sale would be held. Although not reported in the article, Ms. Stovall's loan was owned by Fannie Mae.

Ms. Stovall, like many other homeowners with GSE-owned loans, was foreclosed on despite regular payments and persistent attempts to clarify a confusing situation. Ten months after she received an eviction notice tacked to her door, not much has changed, as the following examples from around the country attest:

- In one California case, Chase has failed to rescind a wrongful foreclosure (due, according to Chase representatives, to a "computer error") that occurred in September 2009, because of a dispute between Chase and Freddie Mac as to whether Chase will repurchase the loan.
- A Staten Island case involving a loan owned by Fannie Mae has a homeowner in foreclosure despite having successfully completed two separate trial modifications (Chase, the servicer, required the homeowner to re-apply for a modification after the first one because the income documentation was "stale," and required them to re-start the second modification because the homeowner overpaid by $62 over three months' time).
- In a Connecticut case, Fannie Mae representatives approved Citimortgage's foreclosure sale of a home and refusal to evaluate a homeowner for a mortgage modification because she had no pay stubs from July or August (the homeowner, a school bus driver, does not get paid during July and August, but has steady income the rest of the year).
- In two recent cases from California, Bank of America foreclosed on GSE loans while a loan modification review was under way.

It is not enough to say, as the GSE policies currently say, that no foreclosure sale may happen while a loan modification is under review. The foreclosure process, once initiated, takes on

a life of its own. The attorney fees mount up; the court timelines must be met. The only way to prevent continued foreclosures while a loan modification review is under way is by halting the foreclosure process entirely while the loan modification application is being reviewed. That means no new foreclosures, no new advertising, no scheduling of the sale, no court hearings, and no motion practice. Only stopping the foreclosure sale absolutely will protect the interests of both homeowners and investors to have the least costly loan modification offered as quickly and efficiently as possible.

The recent announcement by the Federal Housing Finance Authority regarding new servicing standards does not go far enough since it will permit a foreclosure to proceed to the point of sale if the foreclosure is in process when the loan modification application is received. Given the lack of any enforcement mechanism to ensure review prior to the initiation of foreclosure, and the widespread failure of servicers to properly review homeowners for a modification, servicers will continue to initiate foreclosures before conducting the modification review.

3. Fannie Mae Penalizes Homeowners Who Exercise Their Right to File Bankruptcy

For over a year, servicers reviewing homeowners for non-GSE HAMP modifications have been required to consider borrowers in bankruptcy. This policy is in accord with HAMP's general prohibition on waiver clauses and explicit protection for homeowners in litigation. Freddie Mac has largely brought its guidance into line with the standard HAMP guidance, with one exception, but Fannie Mae has not. The current Fannie Mae servicing guide chapter VII section 610.01 still says that for borrowers actively involved in a bankruptcy proceeding the HAMP eligibility is at servicer discretion. While the FAQs offer borrowers some protection, by providing that a borrower cannot

be terminated from a trial modification merely for filing bankruptcy, the FAQs reiterate that if a borrower files bankruptcy prior to the trial modification, the servicer may refuse to consider the borrower's HAMP application.[75] Servicer discretion is seldom exercised in favor of borrowers; in general, the exercise of servicer discretion means denial.

Particularly when combined when the lack of meaningful oversight, homeowners are placed in a terrible catch-22: file a bankruptcy to give the servicer and the escalations process time to complete their review of an erroneous HAMP denial and lose the right to a HAMP modification (for filing the bankruptcy) or accept the servicer's erroneous denial. In many cases, servicers are able to manipulate this dynamic to their advantage by offering a homeowner desperate to halt the foreclosure sale a less-advantageous proprietary modification. As reported by one Colorado advocate, the price of accepting that proprietary modification may be waiver of all rights to obtain a HAMP modification, regardless of eligibility.

Fannie Mae should revise its guidance to permit borrowers in bankruptcy to access HAMP modifications:

- A borrower in an active chapter 7 or chapter 13 bankruptcy case must be considered for HAMP if the borrower, borrower's counsel or bankruptcy trustee submits a request to the servicer.
- A borrower who has received a chapter 7 discharge of personal liability on the mortgage is eligible for HAMP even if the borrower has not reaffirmed the debt (appropriate language shall be added to the Modification Agreement to make clear that the borrower is not assuming personal liability on the debt).
- If a debtor in an active chapter 13 case is in a trial period plan and makes postpetition payments in the amount required by the trial plan, the servicer may not object to confirmation, move for stay relief, or move for dismissal of the bankruptcy case on the grounds that the debtor did not pay the non-modified mortgage payments.

Freddie Mac should address the one area where it deviates from the standard HAMP guidance. Freddie Mac requires the mortgage to be "released" from a chapter 13 bankruptcy as a condition of the modification.[76] This is both unclear and a poor policy decision.

Resolving the problems with GSE loans is of key importance. The GSEs have long been dominant in the private market; with FHA, they now account for 90% of all new originations.[77] Moreover, losses on GSE loans now come out of taxpayer's pockets. We must get loan modification standards right for the GSEs.

4. FHFA's Recent Announcement of Alignment of GSE Servicing Guidelines Makes Some Progress But Leaves Substantial Gaps

On April 28, 2011, the Federal Housing Finance Agency (FHFA) announced a new initiative to align the servicing models of both GSEs.[78] The updated framework is intended to establish uniform servicing requirements as well as monetary incentives and penalties for servicer performance. Primary features of the program include:

- A new loan modification protocol for homeowners who do not qualify for HAMP or in some circumstances for those who fail or default on a HAMP modification. Homeowners will be required to file a hardship affidavit and may be eligible for a new non-HAMP proprietary modification;
- A requirement for servicers to contact borrowers upon delinquency regarding potential assistance;
- A focus solely on homeowner assistance prior to the actual filing of a foreclosure—with a bar to commencing a foreclosure if good-faith efforts to resolve the delinquency are ongoing;
- A formal review before referral to foreclosure that foreclosure alternatives have been pursued;

- Greater incentives to servicers to modify a loan within the first four months of delinquency rather than later; and
- Financial incentives after a foreclosure has commenced for servicers to find alternatives to foreclosure.

The new articulation of a requirement to review a homeowner for a modification prior to foreclosure, and to actively seek out the homeowner for such a review, is an important step forward. Yet there do not appear to be any similar protections for homeowners who seek a modification after foreclosure has been initiated. Many homeowners today are facing such a situation and need a respite from the costs and coercions associated with foreclosure in order to obtain a sustainable loan modification. As discussed above, too often servicers, including perhaps particularly servicers of GSE loans, foreclose when they should be reviewing for a modification. A failure to stop the foreclosure during modification review exacerbates that problem.

In addition, many details of this program still have not been announced. The strength of the alignment is, in great part, dependent on how those issues are resolved. Details (not yet announced) about how the new proprietary modification program will work are essential for determining whether this program will mitigate foreclosures. [79] These concerns are of heightened importance for the GSE loans because their standards have effectively become the industry standards for acceptable servicer behavior. What the GSEs decree for their loan modifications will likely become, without other legislative or regulatory intervention, the de facto ceiling on what kinds of modifications a homeowner can get.

The new rules on communication are important, but the ultimate determining factor is whether the rules result in affordable modifications for homeowners facing hardship. For example, how will it be determined whether a homeowner and servicer are in good faith modification

negotiations and thus that the foreclosure-filing deadline will be extended? If a homeowner has submitted paperwork but the servicer has lost it (perhaps repeatedly, which is not uncommon), the servicer's lapse should not result in the homeowner's foreclosure. The record of servicers losing homeowner documentation or wrongfully denying modifications makes it imperative that the pre-foreclosure review and subsequent foreclosure initiation for failed modification efforts be a rigorous process. Additionally, a modification denial should not trigger the initiation of the foreclosure until the escalation process has completed and denials should be accompanied by full documentation of the servicer's reasoning including NPV inputs and outputs and any relevant investor restrictions and efforts to obtain an exception to such restrictions.

Baseline requirements for the new modifications should include:

- Prioritization of interest rate reductions over term extensions. Such an approach favors the accrual of home equity—a core requirement for stable neighborhoods and fewer defaults.
- No arbitrary floor for interest rate reductions. Interest rates should be allowed to move down to as low as the HAMP rates of 2%, if needed to produce an affordable payment and if the ensuing modification returns a net present value over a foreclosure for taxpayers, the ultimate investors in GSE loans. An arbitrary cutoff guarantees that unnecessary and expensive foreclosures will happen, at a high cost to homeowners who are experiencing severe financial hardship and investors who would have profited from a loan modification.
- Principal reduction, and not just forbearance, when doing so produces a positive return for taxpayers.
- No floor on LTV values. Seniors, in particular, will often have accumulated equity in their homes. They should not be denied a loan modification and forced to seek a refinancing or a reverse mortgage just because they have equity that could be extracted by a predatory lender. They may be forced to a refinancing or reverse mortgage by the exigencies of the net present value test, which will value the foreclosure option more highly than a modification when there is significant equity, but that is no reason to create an absolute bar.

- Modifications for homeowners at risk of imminent default, including a broad understanding of the factors that can push a family into default, including reduction in family income, death or illness of a family member, or predatory lending.
- Automatic conversions to permanent modifications upon payment of the trial period payments, with backdating of the permanent modification so that interest arrears do not accrue during the trial period.[80]

Finally, GSE rules do not explicitly provide a homeowner with an express right to enforce them. National servicing standards must ensure that homeowners facing foreclosure—with a servicer who has not complied with servicing guidelines—can raise that defense to save their homes.

C. The Enforcement Actions by the Federal Banking Agencies are Vague, Establish No Meaningful Standards, and Leave Enforcement to Agencies with a Poor Record on Consumer Protection

On April 13, 2011, the federal banking agencies announced enforcement actions against mortgage servicers and other firms relating to problems with foreclosures.[81] While each agency issued its own consent orders, there are some significant weaknesses shared among the different consent orders.

First, the reviews are time limited by focusing only on 2009 and 2010. Abuses occurring before or after this time will not be looked at. National servicing standards could fill the gap by providing protection on a going forward basis.

Second, the settlements provide few details of required standards. The consent orders provide no guidelines on loss mitigation or on evaluations for core servicing abuses, including application of payments, assessment of fees, or force placed insurance. The lack of detail allows the servicers, the perpetrators of the illegalities recognized by the banking agencies in issuing the consent decrees, to control the independent review process and obscure many violations. In

combination, the lack of detail and the unusual deference extended to the servicers, undercuts the possibility of meaningful change going forward.

Third, the agencies fail to address dual track, one of the most pressing problems that must be solved to control the foreclosure crisis. Although the agencies purport to address the typical dual track of pursuing foreclosure at the same time as any loss mitigation, they only require a foreclosure action to stop where a homeowner has already obtained a trial or permanent loan modification. This turns the need for a stop to foreclosures during loan modification reviews on its head. The establishment of a foreclosure stop in these circumstances is a routine part of how modifications are administered; if you are paying on your loan, then you should not be subject to foreclosure. (Of course, this is a part of the routine that servicers often honor in the breach, as discussed above). This foreclosure stop does not address the root of dual track: allowing an evaluation for a loan modification to occur simultaneously with the foreclosure, resulting all too often in unnecessary and expensive foreclosures, as discussed above.

Fourth, the consent decrees have no provisions for transparency in their implementation. Sadly, the banking agencies have historically failed to protect homeowners. Without transparency, there cannot be accountability for promises of an improved performance in the future.

Fifth, homeowners have no express right to enforce these agreements. It is unclear what, if anything, will happen if the servicer in conducting the review finds that a homeowner has been or is being wrongfully foreclosed on. Even homeowners whom the servicers acknowledge, after conducting their review, are being wrongfully foreclosed on, may find themselves turned out of their homes. Homeowners can not rely solely on the outcome of a secret, vague process to ensure they do not lose their homes.

Finally, while the Federal Reserve and the FDIC have clearly stated that these actions in no way are intended to interfere with the actions currently underway by the U.S Department of Justice and the state Attorneys General, the OCC has not made such a statement. The OCC's history of seeking to interfere with state enforcement of consumer protection laws does not inspire confidence that the agency will allow the work of the Attorneys General to go forward unimpeded. As discussed above, during the years leading up to the current foreclosure crisis, the OCC aggressively tried to block state enforcement actions that could have dealt effectively with many of the industry practices that are wreaking havoc upon the American public today. These consent orders appear to continue that pattern of attempting to block effective action at the state level, while permitting abusive practices by federally-regulated institutions to continue unchecked.

Millions of homeowners have been victimized by the fraudulent and abusive practices of mortgage servicers whose staff are trained for collection activities rather than loss mitigation, whose infrastructure cannot handle the volume and intensity of demand, and whose business records are a mess. The federal agency consent orders do not begin to adequately address these issues. They do not provide the accountability and rigor required to right this foreclosure crisis. National servicing standards with rigor and accountability are still needed.

D. The Proposed U.S. Department of Justice and State Attorneys General Settlement with the Servicers Has Promise, But Leaves Enforcement and Regulatory Gaps

The potential settlement between the US Department of Justice and Attorney Generals has great promise, but many unanswered questions. The details of the settlement have not been revealed, if they have been finalized. Enforcement of the settlement remains a key concern, as does

the possibility that servicers may rely on their agreements with the OCC to argue preemption of any settlement with state authorities, despite the presence of DOJ. The extent to which this settlement can muster the level of detail and accountability necessary to reform the servicing industry is an open question.

The Attorney Generals in this action are filling a vacuum created by Congress's silence. As elected officials, responsive to their state constituencies, the AG's have stepped in where Congress has been afraid to go.

IV. National Servicing Standards Should Be Established To Promote Sustainable Homeownership, Protect Investors, and Preserve Communities.

The nation urgently needs national servicing standards that prioritize loan modifications over foreclosure and rein in abuses in fees, insurance, and payment processing. Two Senate bills introduced in the current Congress seek to address these issues: Preserving Homes and Communities Act of 2011, S. 489, introduced by Senator Reed of Rhode Island, and the Foreclosure Fraud and Homeowner Abuse Prevention Act of 2011, S. 824, introduced by Senator Brown of Ohio. The Foreclosure Prevention and Sound Mortgage Servicing Act of 2011, H.R. 1567, introduced in the House by Representative Waters similarly seeks to hold the servicers accountable. In addition, Senator Whitehouse has introduced S. 222, the Limiting Investor and Homeowner Loss in Foreclosure Act, to clarify that bankruptcy courts have the authority to set up loss mitigation programs including foreclosure mediation.

Bold legislation like these would change the dynamic between servicers and homeowners, by aligning the interests of all the affected parties, rather than allowing servicers to line their pockets at the expense of homeowners, investors and communities. Such legislation also would provide a key tool to homeowners: a defense to foreclosure where a homeowner has been denied a proper loan modification review. Even if mortgage servicing regulation improves, homeowners must be able to save their own homes where servicers violate core loan modification rules.

A. National Servicing Standards Must End the Dual Track Processing of Loan Modifications and Foreclosures

1. The Two-track System Increases Foreclosures

Processing loan modifications and foreclosures at the same time inevitably leads to accidental foreclosures and accompanying financial and emotional tolls on homeowners. Foreclosure and loan modification are handled by different departments at the servicer, with only imperfect communication, as exemplified by the homeowner's experiences discussed in II.A.2.[82] Once a foreclosure is put in place, even high-level bank officials may not be able to stop it, as happened with a California homeowner and Bank of America employees recently. Homeowners assured that they will be receiving a loan modification by one department may nonetheless find themselves facing a foreclosure.[83]

In part because loan modifications often require more deviations from the norm, loan modifications often take more time to work out than foreclosures do. But the two-track system pushes the foreclosure forward regardless, with the result that foreclosures frequently occur while

homeowners are negotiating a loan modification, sometimes even after they have been approved for a loan modification, with sometimes devastating results, as these examples illustrate:

- Bank of America foreclosed immediately after accepting the first payment on a repayment agreement from a California homeowner. After rescinding that sale and re-starting the modification review process, Bank of America refilled a new notice of default, effectively restarting the foreclosure process. The new sale date is May 27, 2011.

- A New Jersey couple who were attempting to negotiate a loan modification ended up being foreclosed on by the servicer. The judge in their case refused to set aside the default judgment aside, and let the foreclosure stand, even though the loan was in violation of federal law. That case is now on appeal, and the homeowners remain in limbo and at risk of losing their home, even though documents in the case indicate that a modification would provide a better return to the investor than a completed foreclosure.

- An Illinois homeowner applied for a trial modification with Bank of America in January 2011. While he was still awaiting approval or denial, and having re-supplied documents numerous times, Bank of America initiated foreclosure proceedings in early May.

- A California couple was foreclosed on twice while awaiting loan modification review from Bank of America. Bank of America rescinded the first foreclosure sale, and asked the homeowners to re-apply, but proceeded to foreclosure sale without ever resending the application packet.

- A California family learned that, because of "a computer error," Chase has sold their home at a foreclosure sale, despite the fact that they were making regular payments under a modification agreement.

- A Washington state family lost nearly $200,000 in equity when the servicer proceeded to foreclosure while the family was making regular payments under a temporary modification agreement. The homeowner learned of the foreclosure sale from a realtor; representatives from the servicer, Chase, insisted at first that the foreclosure sale had not happened when the homeowner contacted them. Nonetheless, the purchaser of the property succeeded in evicting the family, who are now living in an apartment.

- In one unusual case in West Virginia, a foreclosure trustee refused to proceed with a sale and referred the homeowners to legal counsel when Bank of America attempted to foreclose on homeowners while they were under review for a loan modification.

Even if a foreclosure never happens, the cost of the modification increases as the servicer imposes various foreclosure-related (and often improper) fees on the homeowner,[84] and the homeowner suffers the financial, credit, and emotional toll of defending a foreclosure. These fees are lucrative to the servicer, but can price a modification out of a homeowner's reach.[85] For example, one New York homeowner has been trying to get a mortgage modification since 2008 to resolve problems occasioned by a $1100 increase in her monthly payments, probably due to force-placed insurance. In May 2010, the homeowner appeared to qualify for a HAMP modification but by December 2010, the accrued interest on her loan placed her unpaid principal balance beyond HAMP guidelines. The two-track system was instituted to encourage servicers to minimize delay,[86] but it does not in the current market even serve investors' interests well, since it does not reduce the costs skimmed by the servicer from the foreclosure sale.

Regardless of when the loan modification application is received with respect to the foreclosure filing, the simultaneous processing of a loan modification and a foreclosure results in many unnecessary and expensive foreclosures. Fees mount during the pendency of the foreclosure case: attorneys appear in court; advertising is ordered; title searches are prepared; fees are incurred for service. Foreclosures must be stopped during the pendency of a loan review whether the application (or what the servicer has denominated as the application) is received before or after the servicer initiates foreclosure. To do otherwise encourages servicers to rush to foreclose (since once in foreclosure, they can proceed to sale) and to issue summary denials. Ultimately, a rush to foreclosure is costly for investors and homeowners.

A Washington Post article from October of last year highlighted several Maryland homeowners whose homes were foreclosed on while they were making payments on a

modification.[87] Homeowners reported selling family heirlooms to hire lawyers to undo the foreclosure, as well as panic attacks and crying jags. Ending with a foreclosure after a modification attempt is worse for most homeowners than no modification. Most homeowners would prefer the clean denial to the crazy rollercoaster ride of yeses and nos—a clean denial allows homeowners to move on with their lives; a yes, followed by a no, followed by a yes, followed by an eviction, exhausts homeowners financially and emotionally and destroys their credit.

It is time to stop dual track processing.

2. Loan Modification Review Should Occur Before Foreclosure Has Been Initiated and Before Any Foreclosure-related Fees Have Been Incurred

Homeowners should be reviewed for a modification prior to the initiation of a foreclosure in order to contain fees, expedite processing, and reduce the opportunities for error. This is not an open-ended or indefinite proscription: rather, it provides clear guidance to servicers that they can no longer continue to sit on loan modification applications indefinitely. Servicers are free to initiate the foreclosure as soon as they conduct the review; specific guidance as to necessary outreach and strict timelines should help to constrain servicers to expedite loan modification review.

3. If A Foreclosure Has Been Started at the Time of a Loan Modification Application or Review, Both Judicial and Nonjudicial Foreclosures Must Be Frozen During Review

For many homeowners, the initiation of foreclosure proceedings is the motivating force to apply for a loan modification. Sometimes, the initiation of foreclosure proceedings is the first time the homeowner understands that the servicer believes that the homeowner is in default. Not

infrequently, homeowners believe that they are current or have brought their loans current recently, often on the advice of the servicer, at the time of foreclosure. A homeowner who believes she is current is not going to apply for a loan modification. Often, the need for a loan modification becomes apparent only after the foreclosure is initiated.

Servicers' use of serial trial modifications further complicates matters, since the servicer may initiate foreclosure after one trial modification and before the second. Many of the homeowners foreclosed upon while undergoing a loan modification review were placed by servicers in multiple trial modifications, complicating any attempts to unravel when the modification review was completed with respect to the foreclosure filing.

Staying all foreclosures during the pendency of a loan modification review would encourage servicers to expedite their reviews, rather than delaying them, and would provide transparency and fairness to homeowners.

B. National Servicing Standards Must Require the Servicer to Offer the Homeowner a Modification, Where a Modification Exists that Provides a Net Present Value to the Investor Over a Modification.

1. A Standardized Net Present Value Test Provides for Screening of Loan Modifications that Benefit the Investor.

Homeowners obviously lose when servicers wrongfully foreclose. They lose their homes, they lose their equity, they lose their social networks. Homeowners facing foreclosure experience stress and strain, to say the least. Even if homeowners pushed into foreclosure are able to obtain a modification, their resources may well be exhausted by the struggle to obtain a modification, and the modification may leave them only slightly better off than they were before the modification.

But investors lose as well. Particularly in a market where no equity cushion exists to absorb servicers' excesses, the fees and costs come out of the supposed security for the investors' money. According to some data, investors are now losing nearly 60% of the loan value on each foreclosure, over $145,000 per foreclosure.[88] In that context, the failure to perform modifications—and the corrosive effect of excess fees—eats away at any return investors could hope to have.[89] Reporting in the American Banker has illustrated the detrimental impact of force-placed insurance in particular on investor returns.[90]

HAMP only mandates loan modifications when the Net Present Value test predicts that the loan modification will return money to the investors compared to doing nothing. It weighs the odds of cure (vanishingly small in the current market), the chances of redefault (lower than you might expect with a HAMP mod), and the expected return on any ultimate foreclosure. When servicers fail to convert trial plans to permanent HAMP modifications, or wrongly deny HAMP modifications, they are costing investors money—hard money in the form of incentive payments from the government and hard money in the form of lost future payments from the homeowner.

A standardized NPV test should be required under any national servicing standards to ensure that servicers are modifying loans where and when they should.

a) Modifications should have an optimization model

HAMP currently allows servicers to input terms into the Net Present Value test. The NPV test then spits out a pass or a fail. This allows servicers to potentially stack the deck against a modification by presenting terms that will never be approved. The current HAMP NPV test does not inquire as to whether there is a modification that would work for both homeowner and investor, even if the modification presented by the servicer does not.

The NPV test should be designed so that a homeowner who fails the NPV test is reviewed for a modification with different terms. Switching between forbearance, principal reduction, and interest rate reduction, or permitting term extension before the interest rate reduction can all change the outcome on the NPV test. While the standard order should be mandated so that interest rate and principal reduction are considered early in the process, trading a lesser amount of principal reduction for a modification is a positive outcome for both homeowners and investors.

Any optimization model must be automated. It cannot be subject to servicer discretion. Servicer discretion has resulted in many, many homeowners being denied a modification, to the detriment of both homeowners and investors.

b) The NPV Test must be public

Many advocates and mediators, lacking access to Treasury's NPV test, continue to rely on the FDIC's Loan Mod in a Box spreadsheet. Maine, Hawaii, and Washington State all require that foreclosure mediation programs use the FDIC's Loan Mod in a Box spreadsheet to determine whether a loan modification should occur or not (Washington State only requires the use of the FDIC's Loan Mod in a Box if the loan is not HAMP-eligible).

The FDIC Loan Mod in a Box is likely a good approximation of the HAMP NPV test. The HAMP NPV test was based, in part, on the FDIC Loan Mod in a Box. But it is only an approximation. In one case, Chase claimed that the homeowner had failed the NPV test by $17,000, while the FDIC Loan Mod in a Box spreadsheet produced a pass on the NPV test in excess of $30,000. Often, it appears that, even using the servicer's inputs, the homeowner should pass the NPV. In another case, a New Jersey advocate received in discovery a document that appears to show that the present value of a modification exceeds the present value of a foreclosure, even

though the servicer denied the modification on the basis of the NPV test. Without access to the actual NPV calculation, homeowners, judges, and mediators are left without any means to resolve these disputes.

Section 1482 of the Dodd-Frank Act mandated that Treasury make available to the public a portal so that homeowners, their advocates, and mediators could check the accuracy of servicers' NPV calculations. We are nearly 10 months past the enactment of Dodd-Frank, and Treasury has still not made such a portal available to the public. Any national servicing standards must mandate a public NPV test.

2. Modifications Must Be Sustainable and Fair

a) Loan modifications must be affordable

(1) Reduction to 31% of Income

HAMP modifications have re-default rates roughly half that of other loan modification programs.[91] Their re-default rate is low because they are driven by a payment reduction down to an affordable level. Future standards should build on HAMP's success in this area.

(2) Allow for Deeper Reductions If People Have High Back End DTI

For some homeowners, payments at 31% are not affordable. For those homeowners, monthly payments below 31% should be offered. Second mortgages or high medical debt can render a first mortgage payment of 31% or less unaffordable. Homeowners' actual, reasonable living expenses may mean that 31% is not, in fact, a sustainable and affordable payment when the total

dollars available are quite low. Treasury should require and subsidize modifications below 31% where the homeowner has low residual income or high fixed expenses.

(3) Second Liens Must Be Accounted For

Servicers will often service both the first and second liens. Frequently, servicers themselves hold the second lien. Servicers who hold second liens may prefer to gamble on a market recovery rather than accept the incentive payments under HAMP and recognize their losses now. Many servicers have chosen not to participate in the second lien program absent a federal mandate.

Failure to deal the second lien results in unsustainable loan modifications and invites gamesmanship and moral hazard on the part of servicers.

b) Modification should be based on a waterfall that prioritizes principal reduction

Practically, principal reductions may be key to the success of any foreclosure mitigation program. Being "underwater" increases the risk of default, particularly when coupled with unaffordable payments.[92] Built into the HAMP NPV calculations is an assumption that default increases as a function of how far underwater the homeowner is. In order to bring down the redefault rate and make loan modifications financially viable for investors, principal reductions must be part of the package.

HAMP permits principal reductions, but does not mandate them, not even in the most extreme cases. HAMP does require forbearance, but only as a method for reducing payments. While forbearance provides affordable payments, it prevents a homeowner from selling or refinancing to meet a needed expense, such as roof repair or college tuition, and sets both the homeowner and the

loan modification up for future failure. For all of these reasons, future loan modification programs must mandate principal reduction where it produces a net benefit to the investors.

c) Modifications should reduce the interest rate before extending the term

While HAMP requires that the interest rate be reduced before the term is extended, many proprietary modifications do not. Inverting the order of the waterfall produces loan modifications that are more costly to the homeowner and more risky for the investor.

Term extension may provide homeowners with immediate payment relief, but it does so at the cost of pushing those payments—plus interest--out into the future. One result is that homeowners with term extensions will take much longer to pay down principal—meaning that homeowners who are underwater will stay underwater for perhaps decades longer. Another result is that the interest risk—that future rates will be lower than present rates—is exacerbated. Particularly since mortgage rates are near record lows, yet refinancing options are few and far between, homeowners should not be locked into high rates for an extended period of time. Switching the waterfall so term extensions are offered before interest rate reductions gives homeowners the illusion of payment relief, but locks them into debt service for much longer.

That increased period of debt service increases the risk for investors. While a term extension, on paper, does not change the return to the investor (since interest will continue to accrue on the deferred payments), the increased length of time to repay increases the risk that the investor will not get repaid. To take one example, homeowners in their 30's are likely to repay a 30-year mortgage before hitting their retirement years, but are less likely to be able to repay a 40-year mortgage before hitting their retirement years, and thus more likely to default.

While term extensions are preferable to capitalization modifications, they suffer, long-term, from some of the same risks posed by a failure to reduce the principal balance. Term extensions leave homeowners owing more for longer, and paying more over the life of the loan. Reversing the waterfall does not protect investors from losses incurred through too great an interest rate reduction; the Net Present Value test already does that. Reversing the waterfall reduces the benefit for homeowners of a loan modification and increases the investor's risk.

d) Modifications should be permanent

Many proprietary modifications are limited to a period of a few years, requiring the homeowner and the servicer to revisit the modification process again. Given servicers' difficulties in getting the modification review correct in the first instance, homeowners should not be subjected to a second review.

Permanent modifications allow all parties to the modification to adjust their financial expectations accordingly. Homeowners need and deserve the stability of fixed and predictable payments. The financial markets are notorious for loathing uncertainty. Permanent modifications provide predictability for all parties.

e) Additional modifications should be available where homeowner faces additional unexpected hardship

Even after a loan modification is done successfully and is performing, homeowners may still become disabled, lose their jobs, or suffer the death of a spouse. These subsequent, unpredictable events, outside the control of the homeowner, should not result in foreclosure if a further loan modification would save investors money and preserve homeownership. Foreclosing on homes where homeowners have suffered an involuntary drop in income without evaluating the feasibility of

a further modification is punitive to homeowners already suffering a loss and does not serve the interests of investors.

Some servicers provide modifications upon re-default as part of their loss mitigation program. This approach should be standard and mandated.

f) Spouses, children, and ex-spouses should be offered a modification in accord with existing federal law.

The Garn-St Germain Act provides that mortgages should be freely assumable between family members living in the home, whether they acquire title through death or divorce or devise. Servicers currently routinely block modifications when family members seek to assume the mortgage. But if a modification in those circumstances passes the NPV test, there is no reason not to allow it, and the weight of existing federal law to support the assumption of the mortgage and the curing of the default.

g) Bankruptcy should not be a bar to modification

Any national servicing standards should allow modifications for homeowners in bankruptcy. For over a year, HAMP has required that modifications be allowed for borrowers in bankruptcy who are otherwise eligible. National servicing standards should, like the revised HAMP guidelines, explicitly provide that servicers must consider a homeowner seeking a modification even if the homeowner is a debtor in a pending bankruptcy proceeding.

Some servicers have explained their reluctance to do loan modifications in bankruptcy by citing a fear of violating the automatic stay in bankruptcy. Neither the automatic stay nor the discharge order should be a bar to offering an otherwise eligible homeowner a loan modification.

HUD, in guidance to FHA servicers, has explicitly recognized that offering a loan modification does not violate the automatic stay or a discharge order.[93]

Servicers should be required, upon receipt of notice of a bankruptcy filing, to send information to the homeowner's counsel indicating that a loan modification may be available. Upon request by the homeowner and working through homeowner's counsel, servicers should offer appropriate loan modifications in accordance with the national servicing standards prior to discharge or dismissal, or at any time during the pendency of a chapter 13 bankruptcy, without requiring relief from the automatic stay, and, in the case of a chapter 7 bankruptcy, without requiring reaffirmation of the debt. The bankruptcy trustee should be copied on all such communications. All loan modifications offered in pending chapter 13 cases should be approved by the Bankruptcy Court prior to final execution, unless the Court determines that such approval is not needed. If the homeowner is not represented by counsel, information relating to the availability of a loan modification should be provided to the homeowner with a copy to the bankruptcy trustee. The communication should not imply that it is in any way an attempt to collect a debt.

Additionally, payment rules under national servicing standards should take into account the fact that payments may be passed through the bankruptcy trustee, rather than directly from homeowner to servicer. There is often an initial lag between passing the payments from the bankruptcy trustee to the servicer; homeowners should not be penalized for a delay over which they have no control and which is occasioned solely by their exercise of their right to file bankruptcy.

Finally, the modification documents should explicitly prohibit servicers from requiring homeowners to reaffirm mortgage debts. Because reaffirmations of home mortgages have the potential to deny homeowners a fresh start, many bankruptcy judges refuse to approve them.

Congress recognized this concern with an amendment to the Bankruptcy Code in 2005 that permits mortgages to be serviced in the normal course after bankruptcy even if the mortgage has not been reaffirmed. These purported reaffirmation agreements made outside the mandatory notice and review procedures of section 523(c) and (d) of the Bankruptcy Code have no effect, are not enforceable, and the government should not be involved in encouraging the practice.

h) Waiver should be forbidden in modifications

HAMP has forbidden waiver from its inception and even explicitly authorized loan modifications for homeowners engaged in active litigation with their servicer. Waivers of legal rights may not always be enforceable, but they have a chilling effect on homeowners' exercise of their rights. There is no reason to authorize servicers to require a get out of jail free card from homeowners in order to process a loan modification that is in the best financial interests of the investors. Permitting such waivers will encourage abusive servicer behavior and will impede loan modification processing for homeowners savvy enough to seek legal counsel as to the extent of their waiver.

Despite HAMP's prohibition, waiver continues to be a significant problem.[94] Recent reporting by ProPublica has found that several servicers continue to request waiver, particularly, but not exclusively, in non-HAMP, or proprietary, modifications.[95] In recent months, Bank of America has asked homeowners in New York, Maine, Indiana, Connecticut and North Carolina to waive all legal defenses in order to obtain a loan modification.[96] Bank of America employees have claimed both that such waivers occur when non-standard modifications are done and that such waivers are part of a standard package and cannot be removed.[97] Increasingly, homeowners in both HAMP and

non-HAMP modifications are being asked to sign waivers of specific claims, often related to allegations of robosigning or standing.[98]

Servicers continue to press homeowners to waive their rights to a HAMP modification. A Colorado homeowner was told by Bank of America employees that waiver of her rights to a HAMP review was a condition of suspension of the foreclosure sale, despite the fact that there was an ongoing review of the denial of her HAMP application.

National servicing standards must follow HAMP's lead and clearly prohibit waivers.

3. The Application Process Must Be Simplified

Any discussion of the loan modification process indicates a structure so Byzantine as to be Kafka-esque. Rube Goldberg designs appear simple (and filled with a gentle humor) compared to the grim bureaucracy involved in obtaining a loan modification. Countless loan modifications are denied because of this needless complexity.

a) National servicing standards should require minimum levels of outreach pre-foreclosure

Mail can get lost; voice mail messages can be accidentally deleted. Families go on vacation or have medical emergencies. Standards for minimum acceptable levels of outreach, akin to those in HAMP, should be set forth.

b) Single point of contact and document tracking must be mandated

Servicers lose documents, over and over and over again. Homeowners call endlessly, and are shuffled from person to person. From the homeowner's perspective, one of the biggest obstacles to

loan modification is finding a live person who can provide reliable information about the loan account and who has authority to make loan modification decisions. Federal law should require that mortgage servicers provide homeowners with contact information for a real person with the information and authority to answer questions and fully resolve issues related to loss mitigation activities for the loan. Requiring a single person to have custody of a loan modification application from start to finish might ease some of the confusion experienced by homeowners. Document tracking might help homeowners demonstrate that they have, in fact, submitted documents and prevent unnecessary denials for failure to submit documents.

Neither of these procedural steps are panaceas, as illustrated by the case of a Wisconsin homeowner whose attorney finally got a single point of contact, only to have that single point of contact fail to return phone calls or emails for a month. And document tracking systems are subject to both computer and human error. Many proposed and in-place document tracking systems rely on access to housing counselors, computers and the Internet, or both. There are parts of the country where there are no HUD-certified housing counselors operating, and even if most homeowners have some Internet access through public libraries, at least, the digital divide remains real.[99]

Nonetheless, these procedural steps, if implemented and enforced, would improve servicer's efficiency in processing loan modification applications and reduce inappropriate denials.

c) Automatic conversion to permanent modifications should be required

The numbers and narratives both tell the same story. Tens of thousands of homeowners are faithfully making monthly trial modification payments with the understanding that a permanent

modification will be the reward, yet that final modification is still elusive. The only way to ensure that homeowners obtain finalized agreements—and receive them on time so they can avoid additional increases in arrears and further damage to their credit—is to make conversions from trial modifications to permanent agreements an automatic process. Even homeowners who receive permanent modification offers in the mail find that this does not mean the process is over, since servicers often delay by weeks or months the countersigning of the document. One Bank of America representative recently told an Illinois housing counselor that Bank of America never returns signed permanent modification documents to homeowners. Where the servicer initiates foreclosure after the homeowner has entered a permanent modification, as many do,[100] servicers often find themselves scrambling to prove that there was an agreement. Automatic conversions will streamline this last step in the process and reduce litigation.

4. Transfer of Servicing Should Not Impede Modifications

New servicers must accept and continue processing prior loan modification requests; new servicers must honor loan modification agreements entered into by prior servicers. These are requirements under the HAMP Servicer Participation Agreements, but a source of frequent wrongful foreclosure, as illustrated by the following examples:

- An Illinois homeowner received a modification from Citi in March of 2010. When the servicing of his loan was transferred to LBPS in November of 2010, LBPS told him they had no record of the modification agreement with Citi, and that he should continue to make regular payments, which they would place in a suspense account pending their receipt of the agreement from Citi. In March of 2011, LBPS begins rejecting his payments and then sends him a new modification proposal, on significantly worse terms (instead of a fixed interest rate, the new modification would have an adjustable rate).
- A Wisconsin family, after making payments under an oral trial modification for over a year, was placed into foreclosure when servicing was transferred from CitiMortgage to Vericrest Financial.

Homeowners and consumers are expected to honor the terms of their contracts; servicers must ensure that they do not breach their contracts with homeowners through a transfer of servicing.

C. Fees Must Be Limited

As discussed in II.B.2 above, fees serve as a profit center for many servicers and their affiliates. They increase the cost to homeowners of curing a default. They encourage servicers to place homeowners in default and can doom modifications. Fees cost both borrowers and investors.

Borrowers are not in a position to police default fees. The fees may be relatively small in an individual case. Moreover, a desperate borrower may agree to pay even an unaffordable fee, only to end up quickly back in foreclosure. Such a result is costly for everyone but the servicer.

1. Foreclosure Related Fees Must Be Reasonable

Fees include late fees, valuation, home inspection, force-placed insurance, attorney fees, title insurance, auction, legal, property preservation fees, and REO sales fees, among others. All of these fees should be reasonably related to the actual cost of providing the service. There should be no fee for home preservation services if payment submitted to the servicer within 60 previous days: it is unreasonable in those circumstances to assume that the homeowner has departed for parts unknown and property preservation services are needed.

Servicers should be limited to one reasonable appraisal fee before an evaluation for a loan modification is completed. Additional valuations should be limited to no more than one every six months, absent a compelling change in circumstances. Title work should be limited to that reasonably necessary, and foreclosure attorney fees must be restricted to work actually performed.

2. Payments Should Be Applied to the Homeowner's Account

Payments should be credited as of the date received. Payments should be applied first to principal and interest. The use of suspense accounts should be curtailed.

3. Fees Should Be Disclosed

No fee should be charged unless advanced notice of such type of fee and circumstances has been provided. Also, the servicer should be required to comply with contract and not charge fees k doesn't allow for. Mandatory disclosure should occur on monthly and annual statements of the fees incurred. Mandatory disclosure of fees that may be charged should be provided at transfer of servicing and annually. This notice should not include wide ranges that are meaningless but meaningful notice regarding the amount and circumstances in which the fee may be imposed.

4. Late Fees Should Be Regulated As They Are Under the Uniform Consumer Credit Code

Sec. 2.502(2) of the Uniform Consumer Credit Code (1974 version) reads: "A delinquency charge under subsection (1) may be collected only once on an installment however long it remains in default." This is a broader reach than under the FTC Credit Practices Rule. Under the Credit Practices Rule, you can't charge late fees on late fees--that is, if one payment is late, and a late charge is assessed but not paid, you can't charge late fees on all subsequent payments until the late fee is paid. The UCCC standard is broader than that, and forbids pyramiding of late fees even if the underlying payment itself is not made (instead of charging separate late fees on each of the subsequent payments, which were timely made, as is often done now).That is, being late once should result in one late fee.

Sixteen states have already adopted this language.

5. Force-Placed Insurance

Servicers should be required to continue an existing policy or reestablish a policy if there is a lapse in payment. Premium payment information should be provided to the creditor/servicer at closing, and updated if the policy changes, whether or not there is an escrow, so that the existing policy can be continued in the event of a lapse. If there is no escrow, the servicer should advance the fee to pay the premium and collect the premiums in increments of 1/12 per month or through creation of an escrow account under RESPA. This entire process should be disclosed at the outset.

D. National Servicing Standards Should Restrict Robosigning & Ensure that Homeowners Have Actual Notice of Any Foreclosure Proceeding

The recent report issued by the Government Accountability Office recognizes the perpetual under regulation of mortgage servicing and highlights the importance of establishing national servicing standards.[101] We appreciate the letter sent by Senator Menendez and other requesters of the GAO report to the federal banking regulators urging action on national servicing standards.

The state foreclosure process should remain a creature of state law, but federal measures could and should ensure servicer compliance with such state requirements. Foreclosure notices should be personally served and default notices should be signed under penalty of perjury.

E. National Servicing Standards Must Provide for Accountability and Transparency

1. Transparency in Loan Modification Process

a) The Net Present Value analysis should be available to the public, and inputs and outputs should be provided to the homeowner

As discussed in section B.1.b), the NPV test itself must be made public. The inputs themselves must also be disclosed to the homeowner at the time of denial. Homeowners often find, when the NPV inputs are revealed, that there are gross inaccuracies in the numbers. For example, a Minnesota family's disclosed NPV inputs revealed fluctuating expenses thousands of dollars in excess of the family's actual expenses as well as significant underreporting of income. A Brooklyn family found that their income was overstated by thousands of dollars. Revealing the numbers at the time of denial expedites review and reduces unnecessary disputes.

b) The amount of the unpaid principal balance should be disclosed

Disputes over the amount included in the capitalization of arrears are legion. Servicers frequently present the homeowner with an unpaid principal balance that is thousands or tens of thousands of dollars more than the homeowner's records indicate it should be. Inflated principal balances line servicers' pockets at the expense of both homeowners and investors, as discussed in II.B.3 above.

Servicers should be required to disclose the components of the unpaid principal balance, affording homeowners a chance to correct discrepancies.

c) Denials should also include documentation of relevant investor contracts and correspondence regarding any related limitations and efforts to modify otherwise

As I have discussed elsewhere,[102] investor denials are often pretextual. Recently, a California homeowner was denied based on investor restrictions, only to find out when her advocate called for clarification that the servicer believed the homeowner to be dead. Even when the grounds for denial are more clearly related to the investor contracts and not mistaken facts, a review of the relevant investor contracts frequently reveals that there are no restrictions on modifications or the restrictions are other than the servicer has represented. Providing homeowners documentation of the basis of the investor denial will expedite dispute resolution and provide a powerful incentive for servicers to check their facts before issuing a denial based on investor restrictions.

d) Servicers should be required to make publicly available detailed information about loan modifications

Despite their central role in the debate over foreclosures, little data is publicly available on the nature or extent of loan modifications, or who receives them. This information should be available by servicer at the census tract level, and should include the race of the borrower, as well as the salient characteristics of the modifications. Such public disclosure could be modeled after the disclosures mandated under the Home Mortgage Disclosure Act. Loan modifications are too important to leave concealed from public debate.

e) Deadlines and appeals will promote fairness

National servicing standards should set time deadlines for review and response on both sides. Moreover, there should be an appeals process available to homeowners denied modifications prior to initiation of foreclosure. Homeowners should not be foreclosed upon while they are awaiting the results of an appeal.

2. Transparency in Servicing Could Be Improved Through Transfer Notices and Periodic Statements

a) Transfer notices should advise if the homeowner is current and whether there are any unpaid fees

Transfer notices should advise if the homeowner is current and whether there are any unpaid fees. If a fee is not in the "goodbye letter" and "hello letter" to homeowner as having been incurred, it should be waived. Where the notice indicates the homeowner is not current or fees/late charges have been incurred, the servicer must provide to the homeowner a payment history at transfer of servicing. At transfer of servicing, the servicer must indicate to the homeowner whether a loan modification is pending. If a loan modification was entered into prior to transfer, the servicer must acknowledge the loan modification is in effect.

Additionally, if a fee is not on a monthly statement as having been incurred, it should be considered to have been waived. Monthly statements should also advise of the dispute procedure for contesting fees or other servicer abuses.

b) Periodic statements, servicing transfer notices, and escrow account statements should be provided notwithstanding delinquency or default status

If a homeowner is 30 days or more in arrears or in default, she should still receive a periodic statement. When homeowners don't receive their monthly statements, they and their advocates have more difficulty unraveling where things went wrong. Reports from California, Wisconsin, and New York confirm that many homeowners who believe they have a permanent modification and are making payments under what they understand the terms of that modification to be are caught off

guard by servicer's refusal of payments, claimed arrearages, and foreclosure action due to the non-receipt of monthly servicing statements.

3. Dispute Procedures for All Servicer Disputes

While the Real Estate Settlement Procedures Act currently requires servicers to respond to homeowners' request for information and disputes within 60 days (and this time frame has been shortened under the Dodd-Frank Act), in practice many such inquires go unanswered. Despite this failure to respond, servicers are still permitted to proceed to collection activities, including foreclosure. Essential changes to this law governing servicers should ensure that homeowners facing foreclosure would no longer be at the mercy of their servicer. There should be transparency in the servicing process by allowing the homeowner to obtain key information about the loan and its servicing history. Servicers should be prohibited from initiating or continuing a foreclosure proceeding during the period in which an outstanding request for information or a dispute is pending, if the request for information or dispute is connected to the basis for foreclosure. Basic fairness mandates that no one should lose their home because the servicer has not yet corrected an error. Tight timeframes for the servicer's response should keep the dispute resolution process from being a source of endless delay in the foreclosure process.

Key provisions of any dispute procedure include the following:

- The homeowner must have the right to dispute any act or omission of the servicer, and any failure to comply with the servicing standards.
- The response time periods should be those provided under Dodd-Frank.
- All foreclosures should be suspended during the pendency of the dispute, if the dispute is connected to the basis for foreclosure (such as a dispute over payments).

4. Funding for mediation programs with standards and legal representation of homeowners

All too often servicers deny a modification, add fees, or institute a foreclosure without cause. Most of the time when servicers do those things, homeowners have no effective means of challenging the illegality of the servicers' actions or even bringing the servicer to focus on the individual facts and circumstances of the particular loan in order to reach a resolution. Court-supervised mediation and legal representation can even the playing field.

Court-supervised mortgage mediation programs help borrowers and servicers find outcomes that benefit homeowners, communities and investors. Evidence indicates that mediation programs can cut in half the number of completed foreclosures—a far more impressive result than that achieved under HAMP. The quality of programs varies widely, however, and most communities don't yet have mediation available. Government funding for mediation programs would expand their reach and help develop best practices to maximize sustainable outcomes.

Servicer excesses have come to light only through the diligent work of a small and dedicated group of attorneys. Homeowners need legal help to navigate complex and inaccurate paperwork and court filings hastily processed by banks. Yet the vast majority of homeowners go unrepresented. No legal services program has sufficient staff to represent all homeowners with meritorious defenses to foreclosure. Few have sufficient staff to represent even a third of the applicants for service.

Funding for foreclosure defense is particularly hard hit. The Institute for Foreclosure Legal Assistance (IFLA), a nonprofit organization, has been the major source of private foreclosure-

related grants for legal services programs, but it will run out of funding in 2011. Many state and local funding sources are also drying up.

The Dodd-Frank Wall Street Reform Act, HR 4173 Sec. 1498, authorizes $35 million in funding for legal services programs to assist low- and moderate-income homeowners and tenants in foreclosure, but the money has not been appropriated.

5. Violation of the Servicing Standards Should Constitute a Defense to Foreclosure

The servicing standards, to be meaningful, must be self-enforcing. Servicers should not be allowed to violate servicing standards and deprive a family of their home. Homeowners must be allowed to raise a violation of the servicing standards as a defense to foreclosure, either judicial or nonjudicial. Failure to comply with any of the loan modification provisions, whether failure to offer a loan modification, or offering a noncompliant loan modification, or instituting foreclosure while the homeowner is under review for a loan modification, should serve as defense to judicial or nonjudicial foreclosure. As another lever for enforcement, certification with the local recorder of deeds office should be required before foreclosure filing.

The servicing standards should also address the deeply problematic situation that arises when a servicer has indisputably foreclosed in clear violation of servicing rules and the house has been sold to a bona fide purchaser before the error can be rectified. In many states, the house cannot be taken back from the BFP and restored to its rightful owner. For this reason, the guidelines should address appropriate compensation to the homeowner. Otherwise, the law will leave injured homeowners without a meaningful remedy.

F. National Servicing Standards Should Be a Floor, Not a Ceiling, and Should Not Preempt Stronger State Laws

As discussed earlier, the history of federal regulatory preemption of state efforts to protect homeowners is one reason today's crisis is as severe as it is. States have been productive laboratories for homeowner protections and any federal servicing standard should continue to allow for state innovation.

G. National Servicing Standards Should Apply to All Servicers, Including Those of Government-Insured Loans

The federal government insures loans for certain market segments, in order to encourage lending. These loans—made or insured by the Federal Housing Administration (FHA), the Veteran's Administration (VA), and the Rural Housing Services (RHS)—are by and large made to vulnerable populations, who may have restricted access to alternative credit. Abuses in these products are unfortunately, not unknown.[103]

Although the baseline servicing standards are generally higher for these products, enforcement is lax. Servicers of government-insured mortgage routinely foreclose on homeowners without conducting the prescribed pre-foreclosure loss mitigation activity or sometimes even any loss mitigation activity.[104] Homeowners who seek help from the administrative oversight bodies seldom receive help.[105] The National Servicing Center for FHA loans has told homeowners' advocates that it disclaims any role in forcing servicers to comply with the guidelines.

V. Conclusion

Thank you for the opportunity to testify before the Committee today. The foreclosure crisis continues to swell. Servicers have exacerbated the crisis, as they profit from foreclosures. As revealed in the recent robosigning scandal, servicers' lawless behavior threatens the integrity of our legal and economic systems. The need to act is great. Dual track must be ended, once and for all. Homeowners who qualify must have the right to be offered a sustainable loan modification prior to foreclosure. Passage of legislation or adoption of regulations to reform the servicing industry, to allow for loan modifications in bankruptcy, and to address the tax consequences of loan modifications also would aid in protecting homeowners from indifferent and predatory servicing practices and reducing the foreclosure surge. Together, these measures would save many homes and stabilize the market. We look forward to working with you to address the economic challenges that face our nation today.

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[1] The **National Consumer Law Center, Inc.** (NCLC) is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of eighteen practice treatises and annual supplements on consumer credit laws, including *Truth In Lending* (6th ed. 2007) and *Cost of Credit: Regulation, Preemption, and Industry Abuses* (3d ed. 2005) and *Foreclosures* (2d ed. 2007), as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low-income people, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to deal predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. This testimony was written by Alys Cohen, Staff Attorney, and Diane E. Thompson, Of Counsel.

[2] The **National Association of Consumer Advocates** (NACA) is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

[3] *Cf.* 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); 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).

[4] The U.S. foreclosure rate (percentage of outstanding mortgage loans in foreclosure) at the end of the second quarter of 2010 was 4.57%. Mortgage Banker's Ass'n, National Delinquency Survey Q2 2010, at 3. The foreclosure rate for non-farm mortgages peaked in 1933, below 1.4%. David C. Wheelock, *The Federal Response to Home Mortgage Distress: Lessons from the Great Depression,* 90 Federal Reserve Bank of St. Louis Rev. 133, 138–39 (2008).

[5] *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.").

[6] Staff of the Joint Economic Comm., 110th Cong., 2d Sess., State by State Figures: Foreclosure and Housing Wealth Losses (2008), *available at* http://jec.senate.gov/index.cfm?FuseAction=Reports.Reports&ContentRecord_id=392cb915-9c45-fa0d-5a46-f61f6e619381&Region_id=&Issue_id=.

[7] *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* http://www.responsiblelending.org/mortgage-lending/research-analysis/soaring-spillover-accelerating-foreclosures-to-cost-neighbors-436-billion-in-2009-alone-73-4-million-homes-lose-5-900-on-average.html (estimating losses to neighboring property values due to the foreclosure crisis at $1.86 trillion dollars); 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).

[8] Servicers may have been able to use robosigning allegations to reduce their obligation to make advances—thus saving them money while shifting more of the risk of failure to the top-rated tranches held by pension funds and other large institutional investors. Kate Berry, *Pipeline: A Roundup of Credit Market News and Views,* Am. Banker, Nov. 11, 2010 (citing research by Amherst securities). The requirement to make advances can be suspended when the servicer judges that losses are irrecoverable. If exposure of robosigning requires additional expense and time, servicers may claim that the losses are now irrecoverable. This is an exception to the usual rule that servicers never stop making advances.

[9] *Compare* Comptroller of the Currency & Office of Thrift Supervision, OCC and OTS Mortgage Metrics Report: Disclosure of National Bank and Federal Thrift Mortgage Loan Data, 4th Quarter 2010 at 22

(2010) http://www.ots.treas.gov/_files/490069.pdf (reporting 473,415 "home retention actions," including HAMP modifications and payment plans, initiated in the fourth quarter of 2010) *with* Mortgage Banker's Ass'n, National Delinquency Survey Q2 2010, at 4 (reporting that 4.63% of 43,579,051 , or 2,017,711, mortgage loans in the U.S. were in foreclosure in the 4th quarter of 2010). The OCC-OTS Mortgage Metrics report puts a positive spin on these numbers by comparing the total home retention actions started to the number of new foreclosures. But the goal of modifications should be to stop existing foreclosures as well as prevent new ones, and, as the National Delinquency numbers show, the number of existing foreclosures far outstrips the efforts at modification. Indeed, this nearly 5:1 ratio understates the scope of the problem, since most modification programs aim at loans 60 days or more delinquent. Looking at the 60+ day delinquency rates, we see that, as of the 4th quarter of 2010, the eligible pool of loans to be modified is approaching 4.4 million loans, almost ten times the number of new home retention actions.

[10] *See* http://www.propublica.org/article/homeowner-questionnaire-shows-banks-violating-govt-program-rules.

[11] Additional examples can be found in my November testimony before the entire committee. *Problems in Mortgage Servicing From Modification to Foreclosure: Hearing Before the S. Comm. on Banking, Housing, & Urban Affairs*, 111th Cong. 9-10 (2010) (statement of Diane E. Thompson, Of Counsel, Nat'l Consumer Law Center).

[12] Megan McArdle, *Housing Prices Still in Steep Decline,* Atlantic (May 9, 2011), http://www.theatlantic.com/business/archive/2011/05/housing-prices-still-in-steep-decline/238619/

[13] *Cf.* Matthew Tomiak & William Berliner, *The Complex New World of RMBS Shortfalls* , Am Securitization J, Winter-Spring 2010, at 16, 17

[14] Cong. Oversight Panel, December Oversight Report: A Review of Treasury's Foreclosure Prevention Programs 30 (2010).

[15] *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).

[16] *See, e.g.,* 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).

[17] See, e.g., Jeff Horwitz, Ties to Insurers Could Land Mortgage Servicers in More Trouble: Force-Placed Polices Impose Costs on Both Homeowner, Investor, Am. Banker, Nov. 10, 2010.

[18] *See, e.g.,* Kate Berry, *Pipeline: A Roundup of Credit Market News and Views,* Am. Banker, Nov. 11, 2010 (citing research by Amherst securities) (reporting on a Florida case)

[19] *Cf.* 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); 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).

[20] A fuller treatment of servicer incentives may be found in Diane E. Thompson, Nat'l Consumer L. Center, Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior (Oct. 2009), *available at* http://www.nclc.org/issues/general-mortgage-servicing-policy-analysis.html.

[21] *See, e.g.,* Ocwen Fin. Corp., Annual Report (Form 10-K) 30 (Mar. 12, 2009):

> Servicing continues to be our most profitable segment, despite absorbing the negative impact, first, of higher delinquencies and lower float balances that we have experienced because of current economic conditions and, second, of increased interest expense that resulted from our need to finance higher servicing advance balances. Lower amortization of MSRs [mortgage servicing rights] due to higher projected delinquencies and declines in both projected prepayment speeds and the average balance of MSRs offset these negative effects. As a result, income . . . improved by $52,107,000 or 42% in 2008 as compared to 2007.

[22] Ocwen 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).

[23]*Cf.* Wen 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).

[24]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 16 (Working Paper No. 2008-46).

[25]*See, e.g.,* Ocwen Fin. Corp., *supra* note 21, at 4 (advances include principal payments); Brendan J. Keane, Moody's Investor Services, Structural Nuances in Residential MBS Transactions: Advances 4 (June 10, 1994) (stating that Countrywide was in some circumstances only advancing interest, not principal).

[26]Keane, *supra* note 25, at 3.

[27]Cordell et al., *supra* note 24, at 11; Ocwen Fin. Corp., *supra* note 21, at 4 (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) [hereinafter Prospectus Supplement, IndyMac et al.] (servicers repaid all advances when foreclosure is concluded); 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)..

[28]*See, e.g.,* Ocwen Fin. Corp. *supra* note 21 at 11 ("[I]n the majority of cases, advances in excess of loan proceeds may be recovered from pool level proceeds."); Prospectus Supplement, IndyMac et al., *supra* note 27, at 71 (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).

[29] *See, e.g.,* MONICA PERELMUTER, WAQAS SHAIKH& MICHAEL STOCK, STANDARD & POOR'S, CRITERIA: REVISED GUIDELINES FOR U.S. RMBS LOAN MODIFICATION AND CAPITALIZATION REIMBURSEMENT AMOUNTS 3 (Oct. 11, 2007); Jeremy Schneider & Chuye Ren, Standard & Poor's, Ratings Direct, Analysis of Loan Modifications and Servicer Reimbursements for U.S. RMBS Transactions with Senior/Subordinate Tranches (Apr. 10, 2008).

[30] *See* Jeff Horwitz, *A Servicer's Alleged Conflict Raises Doubts About 'Skin in the Game' Reforms*, Am. Banker (Feb. 25, 2011).

[31]Cordell et al., *supra* note 24 at 17; *cf.* American Securitization Forum, Operational Guidelines for Reimbursement of Counseling Expenses in Residential Mortgage-Backed Securitizations (May 20, 2008), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_Counseling_Funding_Guidelines%20_5%20_2 0_08.pdf (stating that payments of $150 for housing counseling for borrowers in default or at imminent risk of default should be treated as servicing advances and recoverable from the general securitization proceeds).

[32]*See, e.g.*, Ocwen Fin. Corp., *supra* note 21 at 4.

[33]Marina Walsh, *Servicing Performance in 2007*, Mortgage Banking 72 (Sept. 2008).

[34]*See* 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/0823205/100607countrywidecmpt.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; Peter S. Goodman, *Lucrative Fees May Deter Efforts to Alter Troubled Loans*, N.Y. Times, July 30, 2009; 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). 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).

[35]*In re* Stewart, 391 B.R. 327, 346 (Bankr. E.D. La. 2008), *aff'd*, 2009 WL 2448054 (E.D. La. Aug. 7, 2009); *see also* Complaint ¶ 18, *Fed'l Trade Comm'n v. Countrywide*, *supra* note 34 (alleging a subsidiary of Countrywide routinely marked up property preservation fees by 100%); Jeff Horwitz, *Ties to Insurers Could Land Mortgage Servicers in More Trouble: Force-Placed Polices Impose Costs on Both Homeowner, Investor*, Am. Banker, Nov. 10, 2010 (reporting on fee markups in force-placed insurance).

[36] *See, e.g.*, Jeff Horwitz, Ties to Insurers Could Land Mortgage Servicers in More Trouble: Force-Placed Polices Impose Costs on Both Homeowner, Investor, Am. Banker, Nov. 10, 2010.

[37]*See, e.g.*, 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). *But see* Prospectus Supplement, IndyMac et al., *supra* note 27at S-11 (late payment fees are payable to a certificate holder in the securitization).

[38]*See, e.g.*, Prospectus Supplement, IndyMac et al., *supra* note 27 at S-73:

> 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.

[39]*See In re Stewart*, 391 B.R. 327, 343, n.34 (Bankr. E.D. La. 2008) ("While a $15.00 inspection charge might be minor in an individual case, if the 7.7 million home mortgage loans Wells Fargo services are inspected just once per year, the revenue generated will exceed $115,000,000.00."), *aff'd*, 2009 WL 2448054 (E.D. La. Aug. 7, 2009); Complaint ¶ 15, *Fed'l Trade Comm'n v. Countrywide*, *supra* note 34.

[40]*See, e.g.*, Ocwen Fin. Corp., *supra* note 21, at 34 (revenue from late charges reported as $46 million in 2008 and made up almost 18% of Ocwen's 2008 servicing income); Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 Housing Pol'y Debate 753, 758 (2004); Gretchen Morgenson, *Dubious Fees Hit Borrowers in Foreclosures*, N.Y. Times (Nov. 6, 2007) (reporting that Countrywide received $285 million in revenue from late fees in 2006).

[41]*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."); 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).

[42]*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 6 (Public Pol'y Paper No. 09-4, July 6, 2009), *available at* http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf. ("In addition, the rules by which servicers are reimbursed for expenses may provide a perverse incentive to foreclose rather than modify."). Under the Department of the Treasury's Home Affordable Modification Program, servicers are required to waive unpaid late fees for eligible borrowers, but all other foreclosure related fees, including, presumably, paid late fees, remain recoverable and are capitalized as part of the new principal amount of the modified loan. *See* Home Affordable Modification Program, Supplemental Directive 09-01 (Apr. 6, 2009).

[43]Peter S. Goodman, *Lucrative Fees May Deter Efforts to Alter Troubled Loans*, N.Y. Times, July 30, 2009 ("So the longer borrowers remain delinquent, the greater the opportunities for these mortgage companies to extract revenue—fees for insurance, appraisals, title searches and legal services.").

[44] *See* Katherine Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims*, 87 Tex. L. Rev. 121 (2008) ; Jones v. Wells Fargo Home Mortg. (*In re* Jones), 366 B.R. 584 (Bankr. E.D. La. 2007), *aff'd* Wells Fargo v. Jones, 391 B.R. 577, 595 (diversion" of mortgage payments to cover inspection charges led to increased deficiency and imperiled bankruptcy plan).

[45]*See, e.g.*, Prospectus Supplement, IndyMac et al., *supra* note 27 at S-73 (noting that the servicer is entitled to retain the costs of managing the REO property, including the sale of the REO property).

[46]Peter S. Goodman, *Lucrative Fees May Deter Efforts to Alter Troubled Loans*, N.Y. Times, July 30, 2009.

[47]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.

[48]*Preserving Homeownership: Progress Needed to Prevent Foreclosures: Hearing Before the Senate Comm. on Banking, Housing & Urban Affairs*, 111th Cong. 4–5 (July 16, 2009) (testimony of Paul Willen).

[49]This is especially so since the HAMP modification program does not permit a second HAMP modification for any reason, even if there is a subsequent, unavoidable drop in income. *See* Making Home Affordable[SM] Program, Handbook for Servicers of Non-GSE Mortgages v.1.0, at 17 (2010).

[50]Roberto G. Quercia, Lei Ding, & Janneke Ratcliffe, Center for Community Capital, Loan Modifications and Redefault Risk: An Examination of Short-Term Impact (Mar. 2009), *available at*http://www.ccc.unc.edu/documents/LM_March3_%202009_final.pdf; Diane Pendley & Thomas Crowe, Fitch Ratings, U.S. RMBS Servicers' Loss Mitigation and Modification Efforts 9 (May 26, 2009), at 2, 10–11 (redefault rate is lowest for modifications with a greater than 20% principal reduction); Zhiqin Huang, Witold Czubala, Jipil Ha, Peter McNally, *Modified Current Loans Are Three Times as Likely to Default as Unmodified Current Loans,* Moody's Resi Landscape 9, 10 (Feb. 1, 2011); Hassan Shamji & Bulat Mustafin, *Measure of Modifications: A Look Across Servicers,* Moody's Resi Landscape 11, 12 (Feb. 1, 2011); Diane Pendley, Thomas Crow, Stephanie Whited, Margaret Sweeney, Michael Laidlaw, Shasi Srikantan, Fitch Ratings, U.S. RMBS Servicers Loss Mitigation and Modification Efforts Update II at 16 (June 2010); ROD DUBITSKY, LARRY YANG, STEVAN STEVANOVIC& THOMAS SUER, CREDIT SUISSE, SUBPRIME LOAN MODIFICATIONS UPDATE 6-7 (2008); Andrew Haughwout, Ebiere Okah, and Joseph Tracy, Second Chances: Subprime Mortgage Modification and Re-Default (Fed. Res. Bank of NY Staff Reports No. 417, Aug. 2010), *available at* http://www.newyorkfed.org/research/staff_reports/sr417.pdf.

[51]*See, e.g.,* Bernanke, Speech at Federal Reserve, *supra* note 5 ("[P]rincipal write-downs may need to be part of the toolkit that servicers use to achieve sustainable mortgage modifications."); James R. Hagerty, *Mortgage Mess Breeds Unlikely Allies,* Wall St. J. (Feb. 9, 2010) (quoting Laurie Goodman, senior managing director at mortgage-bond trader Amherst Securities Group LP, "Principal reduction is the only answer.").

[52]National Consumer Law Center, The Cost of Credit: Regulation, Preemption, and Industry Abuses § 6.1 (4th ed. 2009), 11.6.6.

[53] *Preserving Homeownership: Progress Needed to Prevent Foreclosures: Hearing Before the Senate Comm. on Banking, Housing & Urban Affairs,* 111th Cong. (July 16, 2009) (testimony of Curtis Glovier, on behalf of the Mortgage Investors Coalition); *see also* Karen Weise, When Denying Loan Mods, Servicers Often Wrongly Blame Investors, ProPublica, July 23, 2010, http://www.propublica.org/article/when-denying-loan-mods-loan-servicers-often-blame-investors-wrongly (quoting managing director of brokerage securities firm as saying investors would prefer to see more modifications).

[54]*See* Karen Weise, *When Denying Loan Mods, Servicers Often Wrongly Blame Investors,* ProPublica, July 23, 2010, http://www.propublica.org/article/when-denying-loan-mods-loan-servicers-often-blame-investors-wrongly (quoting managing director of brokerage securities firm as saying investors would prefer to see more modifications).

[55]Comptroller of the Currency & Office of Thrift Supervision, OCC and OTS Mortgage Metrics Report: Disclosure of National Bank and Federal Thrift Mortgage Loan Data 25(3dQuarter 2010), http://www.ots.treas.gov/_files/490058.pdf (reporting that of 289,226 permanent HAMP modifications made through September 30, 2010, 9537 involved principal reductions) (calculated by adding the number of modifications reported for each quarter, reported immediately underneath the date in the rightmost set of columns, and adding the number of modifications reported with principal reductions, as reported in the fifth row of the leftmost columns) .

[56] *See* American Securitization Forum, Discussion Paper on the Impact of Forborne Principal on RMBS Transactions 8-9 (June 18, 2009), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_Principal_Forbearance_Paper.pdf.

[57] *See* Jeff Horwitz, *A Servicer's Alleged Conflict Raises Doubts About 'Skin in the Game' Reforms*, Am. Banker (Feb. 25, 2011).

[58] Comptroller of the Currency & Office of Thrift Supervision, OCC and OTS Mortgage Metrics Report: Disclosure of National Bank and Federal Thrift Mortgage Loan Data, 4th Quarter 2010 at 50 (2010), http://www.ots.treas.gov/_files/490069.pdf.

[59] *See* Jeremy Schneider & Chuye Ren, Standard & Poor's, Ratings Direct, Analysis of Loan Modifications and Servicer Reimbursements for U.S. RMBS Transactions with Senior/Subordinate Tranches (Apr. 10, 2008) (indicating that servicer use of capitalization modifications to reimburse servicers for modification expenses is a suspect accounting practice and may subject the pool to a credit rating downgrade)..

[60] Zhiqin Huang, Witold Czubala, Jipil Ha, Peter McNally, *Modified Current Loans Are Three Times as Likely to Default as Unmodified Current Loans*, Moody's Resi Landscape 9, 10 (Feb. 1, 2011); Hassan Shamji & Bulat Mustafin, *Measure of Modifications: A Look Across Servicers*, Moody's Resi Landscape 11, 12 (Feb. 1, 2011)(" If this capitalization is large enough, it can outweigh benign changes such as rate reductions and term extensions."); Diane Pendley, Thomas Crow, Stephanie Whited, Margaret Sweeney, Michael Laidlaw, Shasi Srikantan, Fitch Ratings, U.S. RMBS Servicers Loss Mitigation and Modification Efforts Update II at 16 (June 2010); ROD DUBITSKY, LARRY YANG, STEVAN STEVANOVIC& THOMAS SUER, CREDIT SUISSE, SUBPRIME LOAN MODIFICATIONS UPDATE 6-7 (2008); Andrew Haughwout, Ebiere Okah, and Joseph Tracy, Second Chances: Subprime Mortgage Modification and Re-Default (Fed. Res. Bank of NY Staff Reports No. 417, Aug. 2010), *available at* http://www.newyorkfed.org/research/staff_reports/sr417.pdf.

[61] *See* Jeff Horwitz, *A Servicer's Alleged Conflict Raises Doubts About 'Skin in the Game' Reforms*, Am. Banker (Feb. 25, 2011).

[62] *See, e.g.,* Complaint, Merrigan v. Bank of New York, No. 09-CA-05578 (Fla. Dist. Ct. App. Apr. 6, 2011) , *available at* https://www.aclu.org/files/assets/florida_foreclosure_20110407_0.pdf (challenging Florida's foreclosure "rocket dockets" on due process grounds).

[63] Office of the Comptroller of the Currency, Interpretive Letter No. 957 n.2 (Jan. 27, 2003) (citing OCC Advisory Letter 2002-9 (Nov. 25, 2002)) (viewed June 19, 2009, at http://www.occ.treas.gov/interp/mar03/int957.doc , and available at 2003 OCC Ltr. LEXIS 11).

[64] *See, e.g.,* Office of the Comptroller of the Currency, Preemption Determination and Order, 68 Fed. Reg. 46,264, 46,264 (Aug. 5, 2003).

[65] 12 C.F.R. §§ 7.4007(c), 7.4008(e), 7.4009(c)(2).

[66] 12 C.F.R. § 7.4006 (OCC).

[67] Watters v. Wachovia Bank, N.A., 127 S. Ct. 1559 (2007).

[68] Lauren Saunders, Nat'l Consumer L. Ctr., Preemption and Regulatory Reform: Restore the State's Traditional Role as "First Responder" 13 (Sept. 2009).

[69] *See, e.g.,* Allen J. Fishbein & Patrick Woodall, Consumer Federation of America, Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders (May 2006), *available at*

http://www.consumerfed.org/pdfs/Exotic_Toxic_Mortgage_Report0506.pdf; *Mortgage Lending Reform: A Comprehensive Review of the Current Mortgage System, H. Subcomm. Fin. Institutions and Consumer Credit, H. Fin. Services Comm.*, at 7-10 (Mar. 11, 2009)(statement of Margot Saunders, Of Counsel, Nat'l Consumer L. Ctr.) (describing dangers of payment-option adjustable rate mortgages).

[70]Lauren Saunders, Nat'l Consumer L. Ctr., Preemption and Regulatory Reform: Restore the State's Traditional Role as "First Responder" 13 (Sept. 2009).

[71]Six of the top ten servicers in 2009 were national banks, whose primary regulator was the Office of the Comptroller of the Currency. Those six are Bank of America, Wells Fargo, Chase, Citi, U.S. Bank, and PNC Mortgage. Numbers 11 and 12 on the 2009 list, HSBC and Metlife, are also national banks. 1 Inside Mortgage Finance, The 2010 Mortgage Market Statistical Annual 174 (listing top 50 mortgage servicers in 2009).

[72] Comptroller of the Currency & Office of Thrift Supervision, OCC and OTS Mortgage Metrics Report: Disclosure of National Bank and Federal Thrift Mortgage Loan Data, 4th Quarter 2010 at 6 (2010) http://www.ots.treas.gov/_files/490069.pdf.

[73] http://www.freddiemac.com/singlefamily/service/mha_modification.html, last visited May 11, 2011.

[74] Dina ElBoghdady, *Amid mortgage mess, owners blindsided*, Wash. Post., Oct. 30, 2010, at A1.

[75] *See also* FAQ 1305, https://www.efanniemae.com/sf/guides/ssg/relatedservicinginfo/pdf/hampfaqs.pdf.

[76] Freddie Mac, Seller-Servicer Guide, C657.1.

[77] Inside Mortgage Finance, Apr. 29, 2011, at 4.

[78] Press Release, Federal Housing Finance Agency, *Fannie Mae and Freddie Mac to Align Guidelines for Servicing Delinquent Mortgages, available at* http://www.fhfa.gov/webfiles/21190/SAI42811Final.pdf (April 28, 2011).

[79] Many of these recommendations are similar to those discussed later in our views on national servicing standards but are stated here because they demonstrate the potential limitations in the FHFA alignment.

[80] Homeowners who fail any trial modification should be given a chance to repay the arrears through a term extension rather than through a lump sum payment.

[81] *See, e.g.*, http://www.occ.gov/news-issuances/news-releases/2011/nr-occ-2011-47.html.

[82] *See, e.g.*, Elizabeth Renuart, Odette Williamson & Mark Benson, Foreclosure Prevention Counseling: Preserving the American Dream 102-103 (2nd ed. 2009).

[83]*See, e.g.*, *Problems in Mortgage Servicing From Modification to Foreclosure: Hearing Before the S. Comm. on Banking, Housing,& Urban Affairs*, 111th Cong. 28–29 (2010) (statement of Diane E. Thompson, Of Counsel, Nat'l Consumer Law Center).

[84]*See* Katherine Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims*, 87 Tex. L. Rev. 121, 144-68 (2008) (reporting that servicers appear to be imposing often improper default-related fees on borrowers in bankruptcy proceedings).

[85] As fees rise, they are added to the principal balance that must be repaid. The result often is that homeowners can no longer afford the monthly payment necessary to repay the loan. Additionally, servicers sometimes demand payment of these fees upfront, which request becomes impossible to satisfy as the fees mount into the thousands of dollars. Finally, many modification programs put a limit on how far in arrears a homeowner may be, including the capitalized fees. *See, e.g., Problems in Mortgage Servicing From Modification to Foreclosure, Part II: Hearing Before the S. Comm. on Banking, Housing,& Urban Affairs*, 111th Cong. 8 (2010) (statement of Donald Bisenius, Executive Vice President, Freddie Mac) (noting that it is harder to bring a borrower current the more delinquent the borrower is); *Problems in Mortgage Servicing From Modification to Foreclosure: Hearing Before the S. Comm. on Banking, Housing,& Urban Affairs*, 111th Cong. 10-11, 14 (2010) (statement of Diane E. Thompson, Of Counsel, Nat'l Consumer Law Center). *Cf.* Hassan Shamji & Bulat Mustafin, *Measure of Modifications: A Look Across Servicers*, Moody's Resi Landscape 11, 12 (Feb. 1, 2011)(noting that capitalization of fees can doom a modification to re-default).

[86] *See* Problems in Mortgage Servicing From Modification to Foreclosure, Part II: Hearing Before the S. Comm. on Banking, Housing,& Urban Affairs, 111th Cong. 8 (2010) (statement of Donald Bisenius, Executive Vice President, Freddie Mac) ("The dual track process enables the commencement of the foreclosure process, so that . . . the servicer can move forward with the foreclosure as expeditiously as possible . . . ."). *Cf.* Diane Pendley, Kathleen Tillwitz, Karen Eissner, Thomas Crowe, Stephanie Whited, Fitch Ratings, Rating U.S. Residential Mortgage Servicers 11-12 (2006) (discussing the importance of timelines for processing a foreclosure and a "parallel track" for loan modifications and foreclosures).

[87]Dina ElBoghdady, *Amid mortgage mess, owners blindsided*, Wash. Post., Oct. 30, 2010, at A1.

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

[89] *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); 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, including the imposition of excessive fees).

[90] Jeff Horwitz, *Ties to Insurers Could Land Mortgage Servicers in More Trouble: Force-Placed Polices Impose Costs on Both Homeowner, Investor*, Am. Banker, Nov. 10, 2010.

[91] Comptroller of the Currency & Office of Thrift Supervision, OCC and OTS Mortgage Metrics Report: Disclosure of National Bank and Federal Thrift Mortgage Loan Data, 4th Quarter 2010 at 6 (2010) http://www.ots.treas.gov/_files/490069.pdf.

[92] *See, e.g.,* Kristopher Gerardi, Christopher L. Foote, & Paul S. Willen, *Negative Equity and Foreclosure: Theory and Evidence* (Fed. Reserve Bank of Boston Pub. Pol'y Paper No. 08-3 , June 2008); Andrey Pavlov & Susan Wachter, *Aggressive Lending and Real Estate Markets* (Dec. 20, 2006), *available at* http://realestate.wharton.upenn.edu/newsletter/pdf/feb07.pdf.

[93]HUD Mortgagee Letter 2008-32, October 17, 2008.

[94]*See, e.g., Problems in Mortgage Servicing From Modification to Foreclosure: Hearing Before the Senate Comm. on Banking, Housing & Urban Affairs*, 111th Cong. 29 (Nov. 16, 2010) (statement of Diane E. Thompson) (describing waiver in a PNC loan modification); *Preserving Homeownership: Progress Needed to Prevent Foreclosures:*

Hearing Before the S. Comm. on Bank., Hous. & Urban Affairs, 111th Cong. 22 (July 16, 2009)(statement of Diane E. Thompson)(describing problems with waivers in HAMP modifications).

[95] Paul Kiel, *Borrowing Trouble: Some lenders are modifying mortgages only after homeowners waive their right to sue*, ProPublica, May 8, 2011, http://www.slate.com/id/2293391/.

[96] *Id.*

[97] *See, e.g., id.*

[98] *See, e.g., id.*

[99] While 57% of households with less than $30,000 annual income access the internet from home, only 42% own a desktop computer and 38% a laptop computer. Jim Jansen, Pew Research Ctr., Use of the Internet in Higher-Income Households, 2, 9 (2010), *available at* http://pewinternet.org/~/media//Files/Reports/2010/PIP-Better-off-households-final.pdf.

[100] *See* II.A.1, *supra.*

[101]Government Accountability Office, Mortgage Foreclosures: Documentation Problems Reveal Need for Ongoing Regulator Oversight (May 2011), *available at* http://www.gao.gov/new.items/d11433.pdf.

[102] *Problems in Mortgage Servicing From Modification to Foreclosure: Hearing Before the S. Comm. on Banking, Housing, & Urban Affairs*, 111th Cong. 8-17 (2010) (statement of Diane E. Thompson, Of Counsel, Nat'l Consumer Law Center).

[103] *See, e.g.,* United States v. Sloan, 505 F. 3d 685 (7th Cir. 2007); United States v. Agboola, 417 F. 3d 860 (8th Cir. 2005); Vaughn v. Consumer Home Mortg., 293 F. Supp. 2d 206 (E.D. N.Y. 2003).

[104] *See generally* National Consumer Law Center, Foreclosures 3.2.2, 3.3..3, 3.4.2.5 (3d ed. 2010) (collecting cases involving FHA, VA, and RHS loans, respectively).

[105] *See, e.g.,* Amended Complaint, Tone, et al., v. Vilsack, No. 10-CV-00891 (S.D. Ohio Feb. 10, 2011) (allegations involving failure to enforce servicing requirements for RHS loans).

PREPARED STATEMENT OF LAURIE F. GOODMAN

SENIOR MANAGING DIRECTOR, AMHERST SECURITIES

MAY 12, 2011

I am honored to testify today. My name is Laurie Goodman and I am a Senior Managing Director at Amherst Securities Group, a leading broker/dealer specializing in the trading of residential mortgage-backed securities. I am in charge of the strategy and business development efforts for the firm. We perform extensive, data-intensive research as part of our efforts to keep ourselves and customers abreast of trends in the residential mortgage-backed securities market. I would like to share some of our thoughts with you today.

A few quick numbers will serve as background. There is $10.6 trillion worth of 1-4 family mortgages outstanding in the United States. Of those, one half, or $5.4 trillion, is in Agency MBS (mortgage-backed securities), $3.0 trillion consists of first lien mortgages in bank, thrift and credit union portfolios plus the unsecuritized loans on Freddie Mac and Fannie Mae's balance sheet, and $1.2 trillion is in private label MBS. Second liens, which are mostly held on bank balance sheets, total just under $1 trillion. It is important to note that while private label securitizations represent only 12.8 percent of the first lien market, they represent 40 percent of the loans that are currently 60+ days delinquent.

Servicers play a critical role in the housing finance market. They are the cash flow managers for the mortgage system. If the borrower is making his payments, the servicer collects and processes those payments, forwarding the proceeds to the investor in a securitization. If there is an escrow account, the servicer is charged with making the tax and insurance payments. If the loan goes delinquent, the servicer is responsible for running the loss mitigation efforts, an endeavor that many servicers, especially so-called "prime" mortgage servicers, had little experience at prior to the crisis. It was never contemplated that these servicing platforms would be used to perform default management on the current scale. As a result, they have never built up a loss mitigation infrastructure. A set of national servicing standards, addressing minimum infrastructure requirements to handle the servicing of delinquent borrowers within a servicing platform is the best way to address this issue, and I am pleased to have input on this important topic.

The servicer is generally paid a fixed percentage of the outstanding loan balance for servicing a mortgage. This fee is generally too large for servicing loans that are not delinquent, and too small to cover the costs of servicing loans which have gone bad. There are other sources of income as well. The borrower often makes his payment early in the month, and the monies are not required to be remitted until mid-month, giving the servicer the right to invest these proceeds in the meantime (float). When the borrower goes delinquent, servicers charge late fees. There are a number of ancillary fees that are charged during the loss mitigation process. Finally, servicing a loan allows a firm to cross-sell other financial products to the borrower, including auto loans, credit cards, and home equity lines of credit. As a result, the servicer often interacts with the borrowers across a number of different products, some of which may be in the investment portfolio of a related entity. There are some costs as well—the servicer will generally advance tax and insurance payments, and in private label securitizations are usually obligated to advance principal and interest to the extent deemed recoverable.

The purpose of my testimony is to discuss conflicts of interest facing mortgage servicers that may stop them from acting in the best interests of mortgage investors and homeowners, and to discuss which of these conflicts can be addressed through national mortgage servicing standards. Let me begin by pointing out that the interests of mortgage investors and homeowners are largely aligned for 2 reasons. First, the mortgage market is reliant on investors to continue to extend credit, thereby providing the necessary capacity to encourage competitive rates for borrowers in pursuit of home financing. Second, foreclosure is, without question, the worst outcome for both investors and borrowers. It is a long and drawn-out process in which a borrower is forced from his home, and an investor typically suffers a loss on his investment in the mortgage loans of between 50–80 percent of the balance of the loan amount after the home is sold and the various costs are deducted.

The interests of both the borrowers and investors can be marginalized when the loan is serviced by a conflicted party. Here are the inherent conflicts we see.

CONFLICT #1: Large first lien servicers have significant ownership interests in 2nd liens and often have no ownership interest in the corresponding first lien mortgage loans that are made to the same borrower and secured by the same property.

In such cases, the first liens are typically held in private label securitizations, the second lien and the servicing rights are owned by the same party, often a large bank. The 4 largest banks (Bank of America, Wells Fargo, JPMorgan Chase, Citigroup) collectively service 54 percent of all 1-4 family servicing in the United States. They own approximately 40 percent ($408 billion out of $949 billion) of second liens and home equity lines of credit outstanding. The securitized second lien market is very small. Thus when a first lien in a private label securitization is on a property that also has a second lien, that second lien is very likely to be held in a bank portfolio, and if it is inside a bank portfolio it is often in one of the big 4 banks.

This is a conflict because the servicer has a financial incentive to service the first lien to the benefit of the second lien holder. Many time this incentive conflicts with the financial interest of the investor or borrower. We outline some of the consequences of this conflict.

Consequence: Short Sales and Deeds-in-Lieu Are Less Likely To Be Approved. An example makes this more intuitive. Assume that a borrower has a $200,000 first lien and a $30,000 second lien ($230,000 lien total) on a home that suffered a valuation reduction down to only $160,000. The borrower is paying on his second lien, but not on the first lien. The borrower receives a short sale offer at the market value of the property, and asks the servicer (a large financial institution) to consider it. If the servicer accepts the offer, the second lien (held on the balance sheet of the financial institution) must be written off immediately. If the servicer is also the second lien holder, he may be more inclined to reject the short sale offer. In this case, accepting the short sale offer was clearly in the best interests of both borrower and first lien investor. Similarly, a servicer will be less likely to accept a deed-in-lieu of foreclosure. We believe that national servicing standards should explicitly address this issue.

Consequence: Loan Modification Efforts Are Sub-Optimal. Loan modification programs have two issues: they do not address the borrower's total debt burden, and they do not address a borrower's negative equity position. As a result, the redefault rate has been enormous. We believe that both of these shortcomings share, at their core, one common trait: conflicted servicers. We look at each in turn.

Modifications Fail To Address the Borrower's Total Debt Burden. In a loan modification, only the mortgage debt is affected. That is, most modification programs, including HAMP, the Government's Home Affordable Modification Program, look at the payments on a borrower's first mortgage plus taxes and insurance, and compare that to the borrower's income. This is called the front-end debt-to-income ratio, and an attempt is made to reduce the payments to a preset percentage of the borrower's income. Consider a bank who services a borrower's first lien, second lien, credit card and auto loan. The first lien is in a private label securitization, all other debts are on a bank's balance sheet. The bank is obligated to modify only the mortgage debt, leaving the credit card and auto debt intact. Moreover, the second lien mortgage debt is generally treated *pari passu* with the first lien. There are situations in which only the first lien is modified, and the second lien is kept intact, making even less impact on the borrower's total debt burden.

Since there is no sense of an overall debt restructuring, the borrower is often left with a mortgage payment that is affordable, but a total debt burden that is not. For example, the Treasury HAMP report shows that the borrowers who received permanent modifications under the Home Affordable Modification Program had their front-end debt-to-income ratio reduced from 45.3 percent to an affordable 31.0 percent, while the median back-end debt-to-income ratio (or total debt burden as a percent of income) was reduced from 79.3 percent before the modification to a still unsustainable 62.5 percent afterwards. The result: a high redefault rate on modifications. For a successful modification, a borrower's total debt burden needs to be completely restructured.

Modifications Fail Because They Do Not Address a Borrower's Negative Equity Situation. Consider the 2MP program, the HAMP program which applies to second liens. Essentially this program treats the first and second lien holders *pari passu* when the borrower's first lien is modified. If there is a rate reduction on the first lien, there is also a rate reduction on the second lien; if there is a principal write-down on the first lien, the second lien also receives a principal write-down. This makes no sense, as the junior lien is by definition subordinate to the first lien, and as such should be written off before the first lien suffers any loss. And if a modification is done outside of HAMP (and there are more non-HAMP or proprietary modi-

fications than there are HAMP modifications) the servicer is not compelled to address second liens at all.

The negative equity position of many borrowers would be dramatically improved if the second lien was eliminated or reduced more in line with the seniority of the lien. Indeed, loan modification programs would be markedly more successful if principal reduction were used on the first mortgage and the second lien were eliminated completely. Our research has shown that a principal reduction modification has the highest likelihood of successfully rehabilitating a borrower, and will ultimately result in the lowest redefault rate.

Principal Reductions Are Used in Loan Modifications Less Frequently Than They Should Be, Due to Conflicted Servicers. Even with the current *pari passu* treatment on first and second liens, we believe there are fewer principal reduction modifications on loans owned by private investors than there would be if a related entity of the servicer did not own the second lien. That is, we believe banks are reluctant to take a write-down on a second lien that is paying and current; as a result, they do a first lien modification which is less effective, to the detriment of the borrower/homeowner as well as to the private investors who own the first lien loan. In addition we believe conflicted servicers are counseling borrowers to remain current on their second liens, thereby allowing them to postpone the write down on the second lien, and increasing the likelihood of a *pari passu* modification.

Principal Reductions Are Also Used Less Frequently Due to Distortions in the Compensation Structure. Servicing fees are based on the outstanding principal balance. Thus, when a principal reduction is done, the servicing fee is reduced, as it is based on a lower principal amount. Since it costs more to service delinquent loans than the servicer is receiving in fees, and this is exacerbated by the write down, it adds to the reluctance to do the principal write down.

With servicers trying to minimize the write off of second lien holdings and maintain servicing fees, it is no surprise that we see distorted outcomes for borrowers and investors in loans that banks service for private investors.

Here is some evidence of the distortion. We can see a marked difference in servicing behavior for first liens owned by banks and those where the first lien is NOT owned by a bank portfolio. According to the OCC/OTS Mortgage Metrics report of Q4 2010, banks did a principal reduction on 17.8 percent of their first lien portfolio loans. These were loans in which they own the first lien, generally own the second lien (if there is one), and modified the first lien to achieve the highest net present value. By contrast, those same financial institutions did a principal reduction on only 1.8 percent of loans owned by private investors and 0 percent of Fannie Mae, Freddie Mac, and Government-guaranteed loans. While there are major obstacles to principal reduction in the case of GSE (Government Sponsored Enterprise) loans or Government-guaranteed loans, there are few obstacles to doing principal reduction on private investor loans. Only a few PSAs (Pooling and Servicing Agreements) prohibit such behavior. And the OCC/OTS Mortgage Metric Report numbers for Q4 2010 were not a fluke; in the immediately preceding calendar quarter Q3 2010, banks did principal reductions on 25.1 percent of their own loans, but on only 0.2 percent of loans owner by private investors.

Solution: To Increase the Use of Principal Reductions as a Loan Modification Tool. National servicing standards should require that servicers perform the modification with the highest net present value, which will usually be a principal reduction. Under HAMP, the servicer is required to test the borrower for a modification using both the original HAMP waterfall, as well as the Principal Reduction Alternative, which moves principal reduction to the top of the waterfall. If the Principal Reduction Alternative has the highest net present value, servicers are not obligated to use it. Use of the Principal Reduction Alternative is voluntary, at the discretion of the servicer. HAMP should be amended to require the use of the Principal Reduction Alternative, if it has the highest net present value of the alternatives tested.

Consequence of Pari Passu *Treatment of First and Second Liens: Higher First Lien Borrowing Costs.* We believe a large error was made in opting to treat the first and second liens *pari passu* for modification purposes. The consequence of this is that first mortgages will become more expensive, as investors realize they are less well protected than their lien priority would indicate. It is very important to realize that under present law and practices, a second mortgage can be added after the fact, without the first lien investor even knowing it. But addition of a second lien significantly increases the probability of default on the first mortgage. However, as presently constructed, if a borrower gets into trouble, the first and second mortgages are treated similarly for modification purposes. Since that raises the risk for the first lien investor, it should also increase the cost of debt for the first lien borrower. (We haven't seen this reflected in pricing yet, as few mortgages have been originated for

securitization; most mortgages issued since the *pari passu* decision were insured either by the GSEs or the U.S. Government.)

Solutions To Maintain Lien Priority

What can be done about conflicts of interest inherent in an entity servicing a pool of loans and owning the second lien (while the first lien is owned by an outside investor)? There are at least 3 alternative solutions for newly originated mortgages. The first two require congressional consent, while the third would require actions by the bank regulatory authorities. These solutions to the reordering of lien priorities are beyond the scope of national servicing standards.

Alternative 1. This solution would contractually require first lien investors to approve any second lien (or alternatively, approve any second lien with a CLTV [(combined loan-to-value, the ratio of the sum of all the liens on the property to the mortgage amount) exceeding a preset level, such as 80 percent]. If the first lien holder does not approve it, yet the borrower still takes out a second lien, the first lien must be paid off immediately (the "due on sale" clause is invoked). This may sound harsh, but it really is not. Currently, if a borrower wants to refinance his first lien, the second lien must explicitly agree to resubordinate his lien. The infrastructure to arrange these transactions exists and works smoothly. Prohibition of excessive indebtedness is common in corporate finance. This is done through loan covenants that limit the amount of junior debt that can be issued without the consent of the senior note holders. This alternative may be required to restart the private mortgage markets and would require an amendment to the Garn-St. Germain Depository Institutions Act of 1982. That act prohibits the senior lien holder from invoking the due-on-sale clause if the borrower opts to place a second lien on the property.

Alternative 2. Place an outright prohibition on second mortgages where the combined CTLV exceeds a designated level, such as 80 percent, at the time of origination of the second lien.

Alternative 3. Establish a rule that a lender cannot service both the first and second liens while owning only the second lien.

CONFLICT #2: Affiliate Relationships With Providers of Foreclosure Services.

The servicer often owns a share in companies that provides ancillary services during the foreclosure process, and charges above-market rates on such. Entities that provide services during the foreclosure process that are possibly owned by servicers include force-placed insurance providers and property preservation companies. (These companies provide maintenance services as well as property inspection services.) Even when a servicer is not affiliated with the company providing the service, they often mark up the fees considerably.

What is the consequence of affiliates of the servicer charging above market fees? Such fees are added to the delinquent amount of the loan, making it much harder for a borrower to become current. Moreover, when a loan is liquidated, the severity on the loan (the percentage of the current loan amount lost in the foreclosure/liquidation process) will be much higher, to the detriment of the investor(s) in that mortgage. It also tends to make servicers less inclined to resolve the loan through a short sale, as fee income that will be earned in the interim (as the loan winds its way through a lengthy foreclosure process) is quite attractive.

Problem: Distortion in the Servicing Fee Schedules. We have heard assertions that, since servicers are inadequately paid for servicing delinquent loans, the related fees are a way to make up the difference. It is absolutely the case that servicers are definitely underpaid for servicing delinquent loans. However, they are overpaid for servicing performing loans. Moreover, *ex ante* (at the inception of the loan), the servicer had agreed to service the loans at the agreed-upon price. It's just that *ex post* (at the present time), given the amount of delinquent loans that accumulated versus original expectations, their original agreement has turned out to be a bad deal. But in the real world, a deal is a deal! For instance, my own firm Amherst Securities Group can't agree to a consulting contract at a fixed price, then come back and renegotiate because it is more work than we thought it would be.

Problem: No Disclosure of Fees. Servicers will tell you that the services they provide are essential, and they would be provided at similar prices by any third party. By owning or having an interest in a wider array of services, the servicers also have more control over the timing and can more closely monitor the quality of the servicers provided. However, neither borrowers nor investors have any way to confirm this. The ancillary fees are not broken out in a form that is transparent to anyone outside.

Partial Solution: Make Better Fee Disclosure a Part of National Servicing Standards. The New York State Banking Department, in their Regulations for Servicing

Loans (part 419), requires that servicers must maintain a schedule of common fees on its Web site, and must include a "plain English" explanation of the fee, and any calculation details. In addition, the servicer should only collect a fee if the amount of that fee is reasonable, and fees should be charged only for services actually rendered and permitted by the loan instruments and applicable law. Attorneys fees charged in connection with a foreclosure action shall not exceed "reasonable and customary" fees for that work. At the minimum, this type of language should be adopted for national servicing standards.

Force-Placed Insurance Highlights the Conflicts of Interest. The servicer, or an affiliate of the servicer often own a share of a force-placed insurer. This insurance is used to protect the home when the borrower is no longer maintaining his existing policies. Given the conflicts, it is unrealistic to expect a servicer to make an unbiased decision on when to buy this insurance (there is a tendency to buy it without trying to retain the homeowner's policy that was already in place) as well as how to price it (there is a tendency to price too high).

There have already been several attempts to address this issue. The New York State requirements explicitly address force-placed insurance (hazard, homeowner's, or flood insurance), and details situations in which it should not be used. A servicer is prohibited from (1) placing insurance on the mortgaged property when the insurer knows or has reason to know the borrower has an effective policy for the insurance; (2) failing to provide written notice to a borrower when taking action to place insurance; and (3) requiring a borrower to maintain insurance exceeding the replacement cost of improvements on the mortgage property.

The State Attorneys' General proposed settlement (circulated in March of this year but not yet approved) contains similar provisions governing the placement of force-placed insurance. The servicer must make reasonable efforts to continue or reestablish the existing homeowner's policy if there is a lapse in payment. The servicer must advance the premium if there is no escrow or insufficient escrow. If the servicer cannot maintain the borrower's existing policy, it shall purchase force-placed insurance for a commercially reasonable price.

However, the Attorneys' General proposed settlement went one step further than the New York State requirements—it suggested the elimination of the conflict of interest by prohibiting these servicers from placing insurance with a subsidiary or affiliated company or any other company in which the servicer has an ownership interest.

Solution: Force-Placed Insurance Conflicts. National Servicing Standards can be used to require servicers to keep existing homeowner's policies in place as long as possible, as both the New York State requirements and the proposed Attorneys' General settlement do. If it is not possible to reestablish the existing homeowner's policy, measures must be included to make sure the pricing of the purchase is reasonable. Moreover, following the lead of the Attorneys' General settlement, national servicing standards should prohibit the placement of force-placed insurance with a subsidiary, affiliated company, or any other company in which the servicer has an ownership interest.

Solution: Dealing With Other Ancillary Fees. Under the Attorneys' General proposed settlement, the servicer cannot impose its own mark-ups on any third party fees. Subsidiaries of the servicer (or other entities where the servicer or related entity has an interest in such a third party) are prohibited from collecting third party fees. Moreover, servicers are prohibited from splitting fees, giving or accepting kickbacks or referral fees, or accepting anything of value in relation to third party default or foreclosure-related services. We at Amherst Securities Group agree with these recommendations. These ideas should become a part of a meaningful set of national servicing standards.

CONFLICT #3: Conflicts of Interest in the Governance of a Securitization, Including Enforcement of "Representations and Warranties".

While the enforcement of "rep and warrants" (representations and warranties) does not directly affect borrowers, we believe it is a very important topic for investor, and serves to highlight the conflicts between servicers and investors.

Violations involving reps and warrants are becoming increasingly common as seen in recent litigation. That is, loans in a securitization often do not conform to the representations made about the characteristics of these loans. For example, a loan may have been represented as an owner-occupied property when in fact it is not; or a borrower lied about income to a degree that should have been picked up in the origination process; *etc*. Once a rep and warrant violation is discovered, at present the trustee is charged with enforcement [the remedy is generally that the sponsor or originator repurchases that particular loan out of the pool at par (an amount equal to the original balance on the loan less any paid down principal)]. However,

the trustee does not have the information to detect the violations, they do not have direct access to the loan files. Moreover, as they have little incentive to detect rep and warrant violations, since the trustee is not compensated for detecting violations and the benefits of doing so actually accrue elsewhere (to the investors).

Servicers (who do have the information to identify rep and warrant violations) often have a financial disincentive to do so, as they would be putting the loan back to an affiliated entity. For example, the largest banks often serve as originators, deal sponsors (underwriters) and servicers on securitizations. There is nothing wrong with this, as long as there is a mechanism to allow for enforcement of the reps and warrants.

Solution: Properly Enforcing Reps and Warrants. It is critical to have a party that is incented to enforce them, and has both access to the information and enforcement authority. This can best be achieved through an independent third party charged with protecting investor rights, who is paid on an incentive basis. Some current deals nominally have a third party charged with protecting investor rights, but that party is not empowered, does not have access to necessary information (the loan files), and is not paid on an incentive basis. This set of conflicts should be addressed the PSAs (purchase and sale agreements) for new securitizations. National Servicing Standards should direct servicers to make sure that there is an adequate enforcement mechanism for reps and warrants.

CONFLICT #4: The Servicing Fee Structure Is Unsuitable to This Environment.

There are many situations in which transferring the servicing of a loan on which the borrower is delinquent to a servicer that specializes in loss mitigation would be the best outcome for both borrowers and investors. A number of special servicers have had considerable experience tailoring modifications to the needs of individual borrowers and tend to provide more hand holding to the borrower post-modification than what a major servicer is staffed to provide. Consequently, the redefault rates on modified loans are much lower with specialized servicers who focus on loss mitigation.

Servicing transfer issues are made very difficult, as many deals do not provide for adequate servicing fees to encourage such a transfer. We made the point earlier that servicers are compensated too highly for servicing current loans, not highly enough for servicing delinquent loans. If compensation is inadequate, it will be very difficult to convince a special servicer to service the loan.

Solution: Revamp the Servicing Fee Structure. There has been a considerable amount of discussion about revamping the structure of servicing fees, to allow for lower fees for performing loans and higher fees for nonperforming loans. The FHFA has organized a number of meetings to discuss these issues, and has outlined the alternatives. If fees were to be altered such that fees for servicing current loans were lowered while fees for servicing delinquent loans were raised, it would allow the special servicer to be adequately compensated for his high-touch efforts. This, in turn, would make it much easier to transfer delinquent loans to servicers who would do a better job at loss mitigation.

There has been some concern about the incentive issues that would arise. Given higher servicing fees for servicing nonperforming loans, will servicers be disincented to make a proactive phone call when a borrower misses one payment? Will the originator/affiliate be less concerned about the quality of loans they originate? We think there is a very simple solution to this—give the GSEs or private label investors the ability to move the servicing when the higher fees are scheduled to take effect.

CONFLICT #5: Transparency for Investors Is Woefully Inadequate.

Many of the conflicts are obscured by servicers as a result of the poor reporting they provide on a monthly basis. We believe that with more transparency, many of these conflicts would be more visible and servicers will be less inclined to act against the interests of first lien borrowers and investors. In a private label securitization there is often a large difference between the monthly cash payment the investor expected to receive and what is actually received. Moreover, an investor is unable to delve into the cash flow information further, as he lacks the information on the actions of the servicer that would be necessary to reconcile the cash flows. When I receive the statement from my bank each month, I balance my checkbook, reconciling the differences. Investors want to be able to do exactly this with the cash flows from the securitizations in which they have an interest. There are several culprits:

- *Insufficient transparency on liquidations.* When a loan is liquidated, investors often receive only one number—the recovered amount. Servicers provide no

transparency on what the home has been sold for, what advances were made on the loan, what taxes and insurance were, what property maintenance fees were, nor what the costs of getting the borrower out of the house were. A breakdown of these costs/fees would help investors understand severity numbers that were different (often much higher!) than anticipated. It would also allow investors to better compare behavior across servicers, allowing for identification of the most efficient servicers, and exposing the underperformers.

- *Insufficient transparency on servicer advances.* A servicer usually advances principal and interest payments on delinquent loans, allowing for a payment to the investor even if the borrower is not paying. These advances are required to be made as long as the servicer deems them to be recoverable. There is often little information on which loans are being advanced on, which makes it very difficult for investors to figure out how much cash they should expect.
- *Insufficient transparency on modifications.* Similarly, when a loan is modified, investors often can't tell how that loan has been modified. Has there been an interest rate reduction, a term extension, a principal forbearance, or principal forgiveness? How long will any reduced interest rate be in effect, and how will it reset? Were any delinquent payments forgiven? While some servicers are better than others at reporting this information, investors are often forced to infer (guess!) it from the payments.
- *Insufficient transparency on principal and interest recaptures.* When a servicer modifies a loan, the servicer is entitled to recapture the outstanding principal and interest advances. Those amounts, payable to the servicer, have the first claim rights on cash flows of the securitization. Investors often receive less money than anticipated due to these recaptures. There is certainly nothing wrong with servicers recapturing funds they advanced, but investors want to know how much has been recaptured and from which loans.

[NOTE: As an aside, we have often heard assertions that servicers have an incentive to speedily move a borrower along in the foreclosure process, as they can recover their advances. That charge has never made any sense to us. By modifying a loan, servicers can recover advances. Moreover, by modifying, the servicer receives bonuses from the U.S. Government from using the Home Affordable Modification Program (HAMP). Finally, the longer the process, the more ancillary fee income is generated for the servicer.]

The result of the lack of transparency is that investors can't reconcile the cash flows on the securitization they have invested in. They don't know how much is being advanced, what are the terms of the modifications on the modified loans, and how much of the principal and interest advances the servicer is recapturing when doing the modification.

Solution: Transparency. We believe the remittance reports for future securitizations should contain loan-by-loan information, and that loan-by-loan information should be rolled up into a plain English reconciliation. National servicing standards should encourage this transparency.

Conclusion

In summary, we have discussed five conflicts of interest between servicers and borrowers/investors. They involve the following:

1. Servicers often own junior interests in deals they service, but in which they do not own the first liens
2. The servicer often owns a share in companies which can be billed for ancillary services during the foreclosure process, and charges above market rates on these services
3. There are conflicts of interest in the governance of the securitization, including the enforcement of rep and warrant issues
4. Servicing transfers can be problematic due to a misaligned servicer compensation structure
5. transparency for investors is missing

PREPARED STATEMENT OF DAVID H. STEVENS

PRESIDENT AND CHIEF EXECUTIVE OFFICER, MORTGAGE BANKERS ASSOCIATION

MAY 12, 2011

Introduction

Chairman Menendez, Ranking Member DeMint, and Members of the Subcommittee, thank you for the opportunity to testify on behalf of the Mortgage Bankers Association (MBA).[1] My name is David Stevens, and I am President and CEO of MBA. Immediately prior to assuming this position, I served as Assistant Secretary for Housing at the United States Department of Housing and Urban Development (HUD), and Federal Housing Administration (FHA) Commissioner.

My background prior to joining FHA includes experience as a senior executive in finance, sales, mortgage acquisitions and investments, risk management, and regulatory oversight. I started my professional career with 16 years at World Savings Bank. I later served as Senior Vice President at Freddie Mac and as Executive Vice President at Wells Fargo. Prior to my confirmation as Commissioner of the FHA, I was President and Chief Operating Officer of Long and Foster Companies, the Nation's largest, privately held real estate firm.

Thank you for holding this hearing on the important subject of the creation of national servicing standards. I would first like to provide some background information as a preface to my remarks, express support for the need for national standards, highlight what MBA has done so far in examining that need, recommend steps for the process of developing comprehensive servicing standards, and suggest principles for those standards.

Background

As the housing crisis evolved, industry and policy maker responses evolved along with it. An understanding of these developments and their context is crucial to a full appreciation of the challenges facing the mortgage industry as it works to help borrowers avoid foreclosure and in identifying viable long-term solutions.

The "Great Recession" was the most severe economic downturn that the U.S. experienced since the Great Depression of the 1930s. It led to the failure or consolidation of many of the country's leading financial institutions, and from January 2008 to February 2010, the U.S. economy lost almost 8.8 million jobs. Government reacted with unprecedented policy initiatives, both in terms of fiscal stimulus and other Government interventions, and monetary stimulus in the form of near zero interest rates and massive purchases of mortgage-backed securities and other assets.

The housing and mortgage markets both contributed to and suffered from this crisis. Although not an exclusive list, several factors were at play: excessive housing inventory, lax lending standards that favored nontraditional mortgage products and reduced documentation, the easing of underwriting standards on the part of Fannie Mae and Freddie Mac, passive rating agencies and regulation, homebuyers chasing rapid home price increases, undercapitalized financial institutions, monetary policy that kept interest rates too low for too long, and massive capital flows into the U.S. from countries that refused to allow their currencies to appreciate.

According to the Federal Housing Finance Agency (FHFA), home prices nationally decreased a cumulative 11.5 percent during the past 5 years, with much larger cumulative declines of 40 to 50 percent in the States of Arizona, California, Nevada, and Florida, known throughout the crisis as the "Sand States." Household formation rates fell sharply in response to the downturn, with many families combining households and household expenses to save money. And consumers cut spending across the board, as they tried to rebuild savings after the shocks to their wage income and the declines in the stock market and housing values. The residual effects continue today: even though construction of new homes remains near 50-year lows, in-

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[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, DC, the association works to ensure the continued strength of the Nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: *www.mortgagebankers.org*.

ventories of unsold homes on the market remain high, with nearly 4 million properties currently listed, and homebuyer demand remains weak.

Regardless of which factors caused the recession, we do know that the nature of the crisis changed over time. Initially, rising rates from the Federal Reserve and suddenly tighter regulatory requirements regarding subprime and nontraditional loan products stranded borrowers who had counted on being able to refinance loans in late 2006 and into 2007.

As a result, serious delinquency rates on subprime ARM loans (loans 90 days past due) increased by 50 percent in 2006 and then more than doubled through 2007.[2] Even before their first interest rate reset, these loans failed at unprecedented rates. Subprime ARMs originated from 2005–2007 have performed far worse than any others in recorded data.

Without access to credit for new buyers, home prices in the Sand States markets began to fall dramatically. With investors increasingly questioning loan performance, the private-label MBS market froze in August 2007 and has remained essentially paralyzed ever since. Compounding the problem, lending to prime, jumbo mortgage borrowers effectively stopped. As liquidity fled the system, fewer potential buyers could access credit, and home prices declined further. According to the National Bureau of Economic Research (NBER), the economy officially fell into recession in December 2007.

The unemployment rate in January 2008 was 5 percent. Eighteen months later, it would be nearly twice as high, following the near collapse of the financial sector in the fall of 2008. From that point forward, joblessness and loss of income began to drive mortgage delinquencies and foreclosures. Serious delinquency rates on prime fixed-rate loans were at 1.1 percent in the beginning of 2008. By the end of 2009, they approached 5 percent. These loans were traditionally underwritten and well-documented with no structural features that impacted performance. Many borrowers simply could not afford their mortgage payments as they did not have jobs.

Important policy initiatives were launched during this time period. Servicers began large-scale efforts to modify subprime and nontraditional loans. Initially, individual servicers and the GSEs undertook these efforts voluntarily, but Government and industry efforts led to standardization of processes through the Home Affordable Modification Program (HAMP). HAMP also benefited proprietary modification programs, which could leverage these standardized processes. Importantly, the HOPE NOW Alliance[3] estimates that, as of March 2011, almost 3.8 million homeowners have received proprietary modifications since mid-2007. Another 7.2 million borrowers received other home retention workouts, including partial claims and forbearance plans, a key tool supported by the Administration to assist borrowers who are unemployed.[4] The Treasury Department and HUD also report that borrowers received an additional 670,186 permanent HAMP modifications.[5] More than 11 million home retention workout options have been provided to consumers in 4 years. This is a significant accomplishment that took significant manpower and coordination in the face of unprecedented turmoil in the mortgage servicing industry and servicers should be recognized for what they have accomplished despite the industry's problems.

However, other public policy efforts, such as those designed to delay the foreclosure process, have typically not been effective over the longer term. Frequently, there can be a tradeoff between late-stage delinquencies and foreclosure starts, as new regulatory or statutory requirements delay foreclosure starts one quarter, resulting in a temporary increase in the delinquency "bucket." In most cases, though, foreclosure starts rebounded in subsequent quarters as backlogs were drawn down.

In summary, the worst recession in living memory has led to the worst mortgage performance in our lifetime. Servicers have been overwhelmed by national delinquency rates running four to five times higher than what had been typical during

[2] MBA's National Delinquency Survey.

[3] Established in 2007, HOPE NOW is a voluntary, private sector, industry-led alliance of mortgage servicers, nonprofit HUD-approved housing counselors and other mortgage market participants focused on finding viable alternatives to foreclosure. HOPE NOW's primary focus is a nationwide outreach program that includes (1) over five million letters to noncontact borrowers, (2) regional home ownership preservation outreach events offering struggling homeowners face to face meetings with their mortgage servicer or a counselor, (3) support for the national Homeowner's HOPE™ Hotline, 888-995-HOPE™, (4) Directing homeowners to free resources through our Web site at *www.HOPENOW.com* and (5) Directing borrowers to free resources such as HOPE LoanPort™, the new web-based portal for submitting loan modification applications.

[4] HOPE NOW, Data Report (March 2011).

[5] March 2011, Making Home Affordable Program Report.

the prior 40 years for which MBA has data. In spite of these market circumstances, servicers have worked to help borrowers avoid foreclosure whenever possible.

MBA Supports the Concept of National Servicing Standards

Presently, servicers face an overwhelming multitude of servicing standards and rules, from Federal laws, such as the Real Estate Settlement Procedures Act, Truth in Lending Act, and the Dodd-Frank Act (just to name a few), to 50 State laws (plus DC), local ordinances, Federal regulations, State regulations, court rulings or requirements, enforcement actions, FHA requirements, Veteran Affair's (VA) requirements, Rural Housing Service (RHS) requirements, Fannie Mae standards, Freddie Mac standards, and contractual obligations, such as the pooling and servicing agreement (PSA). Almost every aspect of the servicer's business is regulated in some fashion, but the rules are not always clear, placing servicers in a position of having to guess as to the requirements. Also, the evolutionary nature of the housing crisis caused significant, near constant changes in these rules. Since the introduction of HAMP, a substantial number of major changes and additions have been made to the program. Many recent judicial challenges to the well-settled law of ownership rights to notes and mortgages have placed the very basis of secured lending at risk by disrupting note holder's and investor's ability to enforce their security interests.

Adding to the complexity is the fact that no two servicing standards are alike. Fannie Mae, Freddie Mac, and FHA guidelines may cover the same subjects, but the requirements differ for each. Each of the guidelines addresses foreclosure processes, outlining penalties for not performing specified collection and foreclosure procedures in particular stages of delinquency, foreclosure, or bankruptcy. This results in the need for servicers to create specialized teams for each investor. FHFA has undertaken a project to align certain portions of Fannie Mae's and Freddie Mac's servicing guidelines and create uniform requirements. This is a very positive step and we applaud the effort.

State laws also play into the complexity of servicing regulation. Each of the 50 States and the District of Columbia has its own laws governing the foreclosure process and other servicing activities. Some States require judicial foreclosure proceedings while others are nonjudicial foreclosure States. Thus, the servicer must manage the nuances of the laws in the various States through its servicing systems and work processes. MBA supports uniformity among judicial foreclosure laws and nonjudicial foreclosure laws, which have historically been within the domain of the States.

As a result of the unprecedented volumes of nonperforming loans during the current cycle, servicers have experienced difficulties in their ability to adjust systems and work processes quickly to meet the ever-changing regulatory environment, including changes to loan modification programs, and the time required to hire and train employees for these new processes. We believe a national servicing standard would be beneficial to streamline and eliminate overlapping requirements. However, a national servicing standard must be truly national in scope and not simply another standard layered atop the already overwhelming number of servicer requirements.

In developing servicing standards, we must also pay careful attention to the interdependence of servicing and the impact that changes to the system will have on the economics of mortgage servicing, tax and accounting rules and regulations, and the effect of the new requirements on Basel capital requirements and on the To Be Announced (TBA) market. Servicing does not operate in a vacuum; instead it is part of the broader ecosystem of the mortgage industry. When making changes to the current model we need to be mindful of unforeseen and unintended consequences that could result ultimately in higher costs for consumers and reduced access to credit.

MBA's Servicing Initiatives

On December 8, 2010, MBA announced the creation of a task force of key industry members to examine and make recommendations for the future of residential mortgage servicing. The Council on Residential Mortgage Servicing for the 21st Century (Council) is being led by MBA's Vice Chairman, Debra W. Still, CMB, the President and Chief Executive Officer of Pulte Mortgage LLC. In announcing the formation of the Council, MBA Chairman Michael Berman, CMB, stated, "The residential mortgage servicing sector has been operating in a time of unprecedented challenges, presenting us with a unique opportunity to explore potential improvements to business practices, regulations and laws affecting the servicing sector and consumers. As the national trade association representing the real estate finance industry, we will bring together industry experts to take a comprehensive look at the current

state and ongoing evolution of residential mortgage servicing and make recommendations for the future."

The Council convened a 1-day public session on January 19, 2011, in Washington, DC, titled, "MBA's Summit on Residential Mortgage Servicing for the 21st Century." This Summit brought together industry leaders, consumer advocates, economists, academics and policy makers who took a detailed look at the issues that have challenged the industry and started the process of identifying the essential building blocks for the future of servicing.

Keynote speakers and panelists at the Summit discussed problems and perceptions from their respective vantage points. Many speakers identified the need for a national servicing standard, the need to change the compensation structure to better incent servicers in the area of dealing with nonperforming loans, and the need for potential changes in laws and regulations related to foreclosures and other facets of servicing.

In analyzing the issues that surfaced during the Summit, the Council identified three major areas for further study and development of policy recommendations:

- Review of existing servicing standards and practices especially in the areas of large volumes of nonperforming loans, foreclosure practices, and loss mitigation practices, including loan modifications. The Council formed a working group to study and make policy recommendations related to a national servicing standard.
- Evaluation of the legal issues related to the foreclosure process, chain of title and other issues. The Council formed a working group to study and make policy recommendations related to legal issues surfaced during the Summit and any additional statutory or regulatory changes deemed appropriate for servicing in the 21st Century.
- Analysis of proposed changes in servicer compensation proposed by the FHFA, Ginnie Mae, Fannie Mae, and Freddie Mac. The Council formed a working group to analyze the proposed compensation structure from the vantage of various stakeholders including large and small servicers, depository and nondepository servicers, and portfolio lender/servicers and MBS issuer/servicers.

While MBA will continue to release several documents to the public during the next several weeks, today we issued a white paper that will act as an educational tool and provide background information and an environmental scan of the events leading up to the current crisis. The white paper provides information on what a servicer does, how a servicer is compensated, and the perspectives of consumers, regulators, and the legal community with regard to servicer performance in the current crisis and their policy recommendations. It also contains an industry analysis of the criticisms against servicers in order to separate real problems from "urban myths." The last chapter highlights the Council's next steps to set the course for the future of servicing in the 21st century.

The "urban myths" document summarizes several issues and misperceptions raised by regulators and consumer groups that have crept into the public consciousness during the servicing debate and dialogue. For example, the document dispels beliefs that a servicer's compensation structure is misaligned whereby servicers have higher incentives to foreclose on a delinquent borrower rather than to modify a loan.

The final document in the initial wave will be the Council's preliminary views on the four fee proposals currently under consideration by FHFA, Fannie Mae, Freddie Mac, and Ginnie Mae. Since servicers come in different sizes, ownership structures, specialties, *etc.*, each servicer has its own unique motivations or "hot buttons" for owning servicing.

The Council's analysis will contrast specific attributes of each of the four fee structures against the current fee structure.

MBA expects to have a preliminary recommendation with respect to national servicing standards later this year. The Council plans to release in the coming months its preliminary recommendations related to foreclosure laws, chain of title issues, and other legal and regulatory obstacles to the servicer doing its job in dealing effectively with borrowers in default.

Additional Industry Efforts

In addition to implementing the various loss mitigations programs, including HAMP, the industry has supported many other proconsumer efforts:

- Free Borrower Counseling:[6] Many servicers and investors pay HUD-approved counselors to counsel borrowers on options to avoid foreclosure. Housing counseling is also supported through NeighborWorks America and HUD grantees. These counselors are instrumental in helping to educate borrowers about specific program details and to collect documents necessary to complete loss mitigation evaluations. Counseling is free to borrowers. HOPE NOW, of which MBA is a member, supports the Homeowner's HOPE™ Hotline, 888-995-HOPE™, which is managed by the nonprofit Homeownership Preservation Foundation, and operates 24 hours a day, 7 days a week in several languages. The hotline connects homeowners to counselors at reputable HUD-certified nonprofit agencies around the country. As of March 2011, there have been more than 5 million consumer calls into the hotline since inception, and it serves as the Nation's "go-to" hotline for homeowners at risk. The U.S. Government uses this hotline for their Making Home Affordable program and noted in its December 2010 report that 1.8 million calls have been fielded by the hotline to date, and more than one million borrowers have received housing counseling assistance.
- HOPE LoanPort™ (HLP): HLP is an independent nonprofit created by HOPE NOW and its members as a data intake facility to improve efficiency and effectiveness of communications among borrowers, counselors, investors and mortgage servicers. HLP was created to help address the frustration among borrowers, policy makers, counselors, and servicers in the document submission process. HOPE LoanPort™'s web-based system allows a uniform intake of an application for a loss mitigation solution though HAMP, all Federal programs and proprietary home retention programs. It allows for all stakeholders to see the same information, in a secure manner, and delivers a completed loan package to the servicer for action. This web-based portal increases accountability, stability and security for submitted information and increases borrower confidence that that their information will be reviewed and will not be lost. Servicer and counselor steering teams, working together have made the decisions on how best to create and improve the HOPE LoanPort™ system. This portal was designed by a core group of nonprofits including NeighborWorks® America and HomeFree-USA, and six industry servicers who shared in this unique and important mission.

Recommended Steps in Developing National Servicing Standards

Several regulators have recently specified their own distinct standards regarding mortgage servicing, a trend that concerns MBA deeply. The State of New York implemented standards late last year for loans serviced in the State of New York. The Office of the Comptroller of the Currency (OCC) released proposed standards, and has separately issued consent orders to specific banks that impose servicing standards through enforcement action as opposed to the normal Federal rulemaking process. The Federal Reserve and the Office of Thrift Supervision (OTS) have likewise issued consent orders to banks and thrifts that they regulate, which contain prescriptive servicing requirements. Several State attorneys general have proposed a settlement with some larger servicers that would impose restrictive standards as an alternative to civil litigation.

Additionally, the SEC and the Bank Regulators are currently attempting to impose servicing standards in the proposed origination rules related to a qualified residential mortgage (QRM) under the Dodd-Frank Act. In order to be considered a QRM and exempt from risk retention requirements, the proposal would require compliance with certain servicing standards. Specifically, the QRM's "transaction documents" must obligate the creditor to have servicing policies and procedures to mitigate the risk of default and to take loss mitigation action, such as engaging in loan modifications, when loss mitigation is "net present value positive." The creditor must disclose its default mitigation policies and procedures to the borrower at or prior to closing. Creditors also would be prohibited from transferring QRM servicing unless the transferee abides by "the same kind of default mitigation as the creditor."

MBA is extremely concerned with the inclusion of servicing standards in a QRM definition. The QRM exemption was very clearly intended under the Dodd-Frank Act to comprise a set of loan origination standards only. The specific language of the Act directs regulators to define the QRM by taking into consideration "underwriting and product features that historical loan performance data indicate lower the risk of default." Servicing standards are neither "underwriting" nor "product fea-

[6] MBA's Research Institute for Housing America recently released a study, "Homeownership Education and Counseling: Do We Know What Works?" which examined the benefits of prepurchase and postpurchase counseling. *http://www.housingamerica.org/Publications/HomeownershipEducationandCounseling:DoWeKnowWhatWorks.htm*

tures," and while they may bear on the incidence of foreclosure, they have little, if any, bearing on default. Combining origination standards that terminate at loan closing and servicing standards that commence at closing and continue for decades in a single QRM regulation is problematic, as the regulation must address two distinct functions and time frames. Accordingly, MBA strongly believes they have no place in this proposal.

Embedding servicing standards within the proposed QRM regulations will have unintended consequences that could actually harm borrowers. Specifying a servicing standard as part of QRM is directly contrary to achieving a national standard, as QRM as proposed would only represent a small share of the market. The proposal requires loss mitigation policies and procedures to be included in transaction documents and disclosed to borrowers prior to closing. Such a requirement codifies the servicer's loss mitigation responsibilities for up to 30 years at the time of origination. While servicers today have loss mitigation policies to address financially distressed borrowers, these policies continue to evolve as regulator's concerns, borrower's needs, loan products, technology, and economic conditions evolve. One need only look at the variety of recent efforts that have emerged during the housing crisis such as HAMP, the Home Affordable Foreclosure Alternatives, FHA HAMP, VA HAMP, and proprietary modifications. A further example is the different set of loss mitigation efforts necessitated by Hurricane Katrina. In both situations, inflexible loss mitigation standards would not have been in the best interest of the public or investors.

The QRM proposal is also likely to make servicing illiquid by combining "static" loss mitigation provisions in legal contracts and borrower disclosures with the inability to transfer servicing unless the transferee abides by those provisions, even if more borrower-friendly servicing options become available.

The proposal also calls for servicers to disclose to investors prior to sale of the MBS the policies and procedures for modifying a QRM first mortgage when the same servicer holds the second mortgage on the property. This adds another level of complexity to the concerns raised above, notwithstanding the irrelevance of these provisions to underwriting, origination, and statutory intent.

MBA believes that national servicing standards should start with a full analysis of existing servicer requirements and State laws on foreclosure. The new standards should be promulgated in a process that includes open dialogue with all stakeholders, including Federal regulators, State regulators, consumer advocates, servicers, and investors in mortgages and MBS. MBA welcomes the opportunity to participate and play a constructive role in such a process.

Principles for National Servicing Standards

MBA believes that one consistent set of standards would be beneficial for servicers and consumers. In developing a national servicing standard, specific principles should to guide decision making. We suggest, at a minimum, the following principles:

a. National Servicing Standards Must Be Truly "National"

Of paramount importance to the industry is that any national servicing standard be truly national and not yet another requirement on top of the myriad existing obligations. Servicers would not have the burden of looking to varying standards created by different entities (*e.g.,* Federal regulators, State laws, Government agencies, *etc.*). Servicers could reduce staff and third-party experts currently needed to follow, track and comprehend varying standards. Errors would be reduced. Consumers would benefit by reduced complexity and, ideally, easy-to-understand requirements.

b. Process Must Be Transparent and Involve Key Stakeholders

The process to create national servicing standards must include servicers and investors as these parties must ultimately implement the new standards and the standards will potentially restrict servicing activities and impose additional costs. Although it is likely that the newly authorized Bureau of Consumer Financial Protection (CFPB) will finalize the standards, given its expansive role in consumer protection, industry input must be a crucial part of the process for the standards to be workable.

c. Process Must Recognize Existing Requirements

As previously indicated, servicers are subject to a multitude of laws, regulations, and requirements. In many cases, remedies already exist for a majority of the perceived problems. In setting national standards, regulators must recognize existing rules and adopt them without change when they have been fully vetted through the rulemaking process.

d. Rules Should Allow Flexibility To Deal With Market Changes

Rather than prescribe the exact methodology in which servicers must conduct their day-to-day operation, a national servicing standard should describe the ultimate result the Government wishes to achieve. Servicers and investors would be allowed to devise the means to achieve the objective that best suits their business model and capital structure. Moreover, flexibility would allow servicers to address different market conditions and consumer needs. The best example to illustrate the importance of flexibility is by comparing today's borrower's needs, whereby modifications are critical, to borrowers affected by Hurricane Katrina, whereby forbearances were paramount as borrowers awaited hazard insurance and Road Home funds.

e. Standards Should Create Uniform and Streamlined Processes

Processes that servicers must follow need to be simple and uniform. Markets operate best with certainty, and servicers need straightforward processes that do not differ by product, investor, regulator or State. As stated above, one set of standards will limit errors and litigation risk, and promote customer satisfaction. Simple processes will yield the best results for all consumers and servicers.

f. Standards Must Treat Borrowers Fairly/Recognize Borrower Duties

MBA strongly believes that borrowers should be treated fairly and with compassion. Customers should obtain respectful service, should have access to the opportunities to retain home ownership for which they qualify, and should understand their options. We also believe that borrowers have duties. These include responding to servicer offers of assistance, contacting the servicer early in the delinquency, and diligence in providing required documents and other fulfillment requirements of loan modification programs. These principles, for both the servicer and the borrower, must be recognized in the development of national servicing standards.

g. Standards Must Treat Servicers Fairly

National servicing standards should ensure the fair treatment of servicers and recognize the economic realities of the servicing business. Standards must recognize the costs of delinquency and foreclosure, including late fees and other compensatory fees necessary to offset the cost of delinquency. Many of the suggested standards question these charges, yet these fees are necessary to ensure quality customer service, to enable advance payments to bondholders as required, and to provide the loss mitigation products borrowers seek. We urge policy makers, therefore, to balance the needs of borrowers and servicers.

Potential Components of National Servicing Standards

Regulators, congressional leaders, consumer advocates, and academia have proposed various servicing standards to address perceived problems as well as borrower complaints. These proposals differ significantly, but the goals appear clear: to improve the customer's experience while in the loss mitigation process, to avoid confusion, and to ensure that borrowers are treated fairly and given access to loss mitigation. We agree with these goals.

We would like to address several concepts currently under consideration as part of the dialogue concerning various proposed national standards.

a. Single Point of Contact

Some regulators and consumer advocates are promoting a single point of contact to simplify communications with servicers during the loss mitigation process. MBA supports clear and helpful communication with the borrower. However, a single-point of contact may have unintended consequences, potentially leaving consumers more frustrated and with greater delays. There is no unified definition of "single point of contact." A plain English definition would imply that a single person would be assigned to each borrower and that the borrower would communicate only with this person. This is not feasible in the current environment and would create numerous problems as servicer call volumes fluctuate significantly throughout the day, week, and month.

First, a single point of contact eliminates the specialty training necessary to deliver accurate and timely assistance to borrowers, as borrower assistance may range from questions regarding their payment history or escrow processes to complicated modifications such as HAMP or short sales. A single person cannot be expert in each of these highly complex and regulated areas. The result will be delays, miscommunication, and/or errors.

Second, given the current environment, it will be impossible to appropriately staff to meet demands as they fluctuate widely. By the sheer reality of the situation, borrowers may be subject to significant delays and response times if limited to one individual. Even if a borrower were able to talk to other knowledgeable servicing team

members, we are concerned that said borrower could decline and request a return phone call from the single point of contact. As a result, the borrower will suffer delays and frustration with regard to his or her issues and concerns.

Third, a single point of contact raises concerns regarding staff departures, work schedules, business travel, vacations, illness, *etc.* The reality is a single point of contact can never be truly a single person. In its purest sense, a single point of contact disrupts a servicer's efforts to provide the best service in a specific area of expertise. Borrowers must be willing to communicate with other staff familiar with the borrower's account, and servicers must have the flexibility to structure staff the best way to achieve the principle of superior customer service.

b. Dual Track

Policy makers and consumer advocates continue to call for the elimination of so-called "dual tracking." Dual tracking occurs when the servicer continues intermediate foreclosure processes while loss mitigation activity is underway. Interim foreclosure processes, such as notices, rights to hearings, and the like are required by State law or the courts and would continue during preliminary loss mitigation efforts to ensure the borrower received due process and to avoid unnecessarily delaying foreclosure should the borrower not qualify. It is important to realize, however, that servicers will not go to foreclosure sale (*e.g.,* the borrower will not lose the house) if the borrower has provided a complete loss mitigation package sufficient to evaluate the borrower for loss mitigation and has provided such information in a reasonable time before the foreclosure sale date.

Successful loss mitigation, however, requires diligence and priority on the part of the borrower. Borrowers should submit full application packages as soon as possible and prior to initiation of foreclosure. Servicers should not be expected to stop foreclosure processes, or even a foreclosure sale, if the borrower waits until the last minute to request assistance. Moreover, some courts do not allow a foreclosure sale to be canceled within 7–10 days of the scheduled sale date.

The halting of the foreclosure process is difficult due to investor requirements. As noted above, Fannie Mae, Freddie Mac, and FHA all require servicers to meet various foreclosure timelines. Failure to meet these timelines, without a waiver, results in penalties to the servicer. For example, FHA requires that the servicer start foreclosure within 6 months of the date of default. Failure to meet this strict deadline by even one day, without a waiver, means the servicer does not get reimbursed for almost all of its interest costs (*e.g.,* the accumulating arrearage).

Moreover, State law often provides that various steps must occur at specific times or costly steps, such as newspaper publication, must be repeated at significant cost to the servicer, foreclosing attorney, Government agencies, and, ultimately, taxpayers with regard to Government programs.

Delays have significant monetary impact on the investor and servicer. Delays extend the period of necessary advances a servicer must pay to investors, increase costs to Government agencies due to larger claim filings, result in the loss of equity in the property if market values decline, and allow more time for the property to deteriorate. In addition to merely delaying foreclosure, a pause can result in real hard dollar costs, which today are not fully reimbursed to the servicer or the foreclosing attorneys who incur them. This is not a sustainable model and can result in millions of dollars of unreimbursed costs. A national standard must consider these "cost" issues.

c. Mandatory Principal Write-Down

The issue of mandatory principal write-down continues to be suggested as a means to achieve affordability. While there is no doubt principal write-down promotes affordability, there are other means to achieve the same affordability without the disparate impact on servicers or noteholders. Such options include rate and/or term modifications and principal forbearances. A principal forbearance takes a portion of the principal and sets it aside in calculating a reduced monthly mortgage payment. It is similar to a principal write-down, but appropriately gives a portfolio lender or investor the right to recoup the set aside principal at a later time, such as when the house is sold. FHA, HAMP, and FHA partial claims are principal forbearance programs, and we believe they are effective tools.

The concept of mandatory principal write-down—as opposed to principal forbearance—is extremely problematic in secured credit transactions for the many reasons MBA has expressed in previous policy debates regarding Chapter 13 bankruptcies. The same issues surface if servicers are required to accept principal reductions over interest rate or term modifications or principal forbearances in the loss mitigation waterfall:

- First, the servicer is a mere contractor in the securitization function and thus cannot obligate the note holder or investor to take a permanent loss on the loan. Fannie Mae and Freddie Mac do not accept principal write-downs and FHA and Ginnie Mae do not reimburse for voluntary or mandatory principal write-downs. Servicers, therefore, cannot impose it.
- Second, with regard to private label securities, the securitization documents must specifically provide for this option or the servicer risks litigation. Most securitization transaction documents do not provide for principal write-downs, and some specifically prohibit principal write-downs. We understand there are differences in views from the various MBS tranche holders. Principal write-downs would benefit senior security holders to the detriment of subordinate holders. However, it is inappropriate to forcibly reallocate winners and losers in contradiction to the contract created to protect against these very default scenarios.
- Third, note holders and investors must be able to rely on the contractual terms of their mortgage agreements given the secured nature of a mortgage transaction. It is inequitable to mandate that secured note holders or investors to write down principal.
- Fourth, without statutory changes, mandatory principal write-downs by the servicer could eliminate Government mortgage insurance[7] and private mortgage insurance[8] that currently protect servicers/investors against losses. If mandatory principal write-downs were required without a change to agency guidelines/statutes, servicers—not the investors—would be required to absorb the principal loss. This is an inappropriate role of a servicer, who never priced their compensation to accept first dollar loss. However, servicers have been voluntarily writing down principal balances of loans when appropriate and more often on loans they own and will continue to do so.

In sum, MBA opposes involuntary principal write-down and believes it will inhibit the housing market's recovery.

d. Misalignment of Servicer and Investor Incentives

Another common theme is that servicer incentives are misaligned with the interests of investors. While servicing compensation may not appropriately compensate the servicer for the multitude of additional requirements imposed on them during this crisis,[9] we do believe that there are significant incentives within the existing fee structure that encourage appropriate loss mitigation. Fannie Mae, Freddie Mac, and Ginnie Mae ultimately designed their programs and concluded that servicers should not be paid their servicing fee while the loan is delinquent. The theory is that if the servicer is not paid for managing the very expensive default process, they will expend resources to cure the delinquency or otherwise ensure cash flow—ultimately the goal of the investor. This incentive is real for the servicer.

The greatest financial incentive supporting modifications over foreclosures for servicers is the reinstatement of servicing income and the servicing asset. A modification immediately reinstates the servicing fee income and retains the servicing asset. Assuming a borrower remains current under the modified terms, the servicer will continue to receive its base monthly servicing fee income (25 basis points for GSE servicing and approximately 44 basis points for Ginnie Mae servicing) over the life of the loan. In contrast, such income ceases during the period of delinquency. In the case of GSE and FHA programs, the servicer never gets reimbursed the servicing fee if the loan goes to foreclosure. In private label securitizations, the servicing fee ultimately is reimbursed to the servicer when the Real Estate Owned (REO) is sold, but the reimbursement is without interest. In summary, foreclosures result in

[7] Today, FHA insurance and VA guarantees protect the servicer against principal loss due to foreclosure. However, FHA and VA cannot pay the servicer a claim for principal reductions. Authorizing statutes do not permit it. Conversely, if the loan went to foreclosure, the servicer would have the benefit of the insurance/guarantees and not suffer a principal loss.

[8] Private mortgage insurance is comparable to Government insurance in that it protects lien holders from principal loss in the event of foreclosure. Private mortgage insurance protections will be lost in the amount of the lien strip.

[9] Fannie Mae, Freddie Mac, and FHA recognized over a decade ago that servicers could reduce their losses by performing "extraordinary" servicing, which involved very complex loss mitigation options. MBA was involved in those discussions, which ultimately resulted in the incentive payments for successful loss mitigation efforts. Unfortunately loss mitigation has become even more complex, with the agencies requiring more and more from servicers and foreclosure attorneys without compensation. This is not appropriate and, thus, we agree that some additional compensation is required. Investor contracts should not impose unlimited cost burdens on servicers.

an early termination or, in the case of private label securities, deferment of servicing fee income. Modifications, on the other hand, result in the immediate reinstatement and continuation of such servicing income. Also, the continuation of servicing fee income through a loan modification or other cure provides retention of the servicing asset that is otherwise written off upon foreclosure.

Modifications also stop costly advances of principal, interest, tax, insurance and other expenses, such as property preservation costs, and provide for quick reimbursement of these outstanding advances. In the case of private label securities, servicers generally must advance principal and interest from the due date of the first unpaid installment until the property is liquidated through the sale of REO. According to LPS's Mortgage Monitor Report, "as of February 2011, the average length of time a loan in foreclosure is delinquent was nearly 537 days." The average number of days a property remains in REO is in the range of 116–176 days, according to Clear Capital and the Five Star Institute. In many cases, the servicer does not receive full reimbursement for those advances. For example, FHA curtails 60 days of interest advanced and one-third of foreclosure attorney's fees on all foreclosure claims. The GSEs also curtail property preservation expenses and attorney's fees when foreclosure steps must be repeated due to a foreclosure pause. In sum, servicers are incented to modify the loan to reduce the interest costs and capital allocation associated with carrying advances.

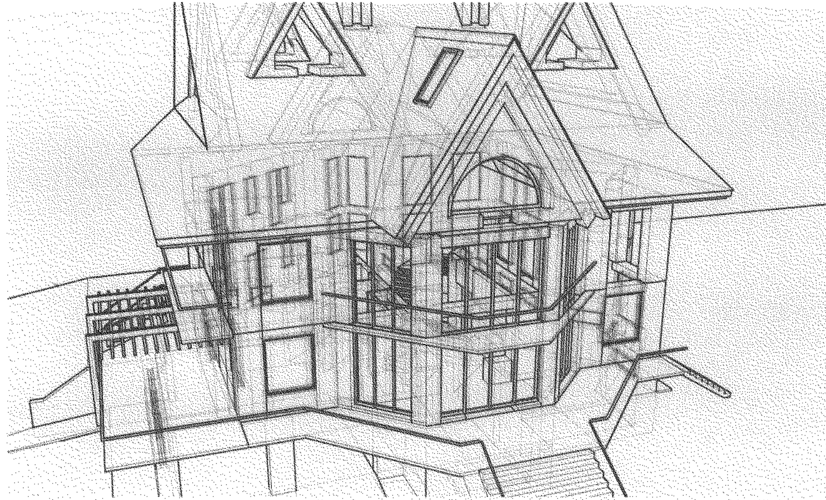
Conclusion

MBA supports reasonable national servicing standards that apply fair practices for borrowers, servicers, and investors alike and that seek to eliminate the patchwork of varying Federal, State, local and investor requirements. However, national servicing standards must be truly national. Creating different State and local requirements would only compound the complexities servicers already face within current market conditions.

Servicers must also be included as stakeholders in the development of the standards. It is important to understand why processes are in place to avoid unintended consequences. Existing standards should be given careful consideration before being replaced. Servicer's use and development of successful loss mitigation efforts to date should also be recognized.

We recognize that our industry can and must do better. Given the overwhelming nature of the crisis and the ever-changing requirements, servicers have tried to meet competing obligations in a rapidly changing environment, and we believe that national servicing standards can help us accomplish the goal of preventing foreclosures whenever possible.

At the same time, in moving toward national servicing standards, policy makers must fully recognize the economics of mortgage servicing and balance laudable public policy goals against business and market realities. Our industry stands ready to play a constructive role in the dialogue about how best to achieve this balance.



Residential Mortgage Servicing for the 21st Century

White Paper

This publication is intended for educational purposes only
and is not intended to provide legal or other professional advice.

Residential mortgage loan servicers have come under heavy scrutiny in the last several years as a record number of homeowners have fallen behind on their monthly mortgage payments and have lost their homes to foreclosure. In response, mortgage lenders, servicers, investors, policymakers and other stakeholders have launched innumerable programs and initiatives to stem the tide of foreclosures that have caused borrowers to lose their homes and communities to deteriorate.

In spite of all of these efforts, the depth and breadth of the credit crisis has been overwhelming for the even the best intentioned mortgage servicers and for the long term, essential changes must be made to the servicing business model.

That is why, in December of 2010, the Mortgage Bankers Association (MBA) launched the Council on the Future of Residential Mortgage Servicing for the 21st Century. The Council was tasked with providing recommendations to industry and government for improving the future state of mortgage servicing.

On January 19, 2011 the Council hosted the Summit on Residential Mortgage Servicing for the 21st Century. The meeting brought together industry leaders, consumer advocates, economists, academics and policymakers to take a detailed look at the issues that have vexed the industry and sought to identify the essential building blocks for the future of loan servicing.

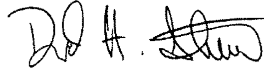
This white paper is the first work product of the Council. It is meant to be an educational tool to provide background information and an environmental scan of the events leading up to the current crisis. It provides information on what a servicer does; how a servicer is compensated; and the perspectives of consumers, regulators, and the legal community with regard to servicer performance in the current crisis and common misperceptions about servicer incentives during the loss mitigation process.

In the coming months, the Council will continue its work focused in three primary areas – servicer compensation, best practices in loss mitigation and customer service, and improvement to the foreclosure process. In the end, it is our intent to come up with workable solutions to ensure that, going forward, all stakeholders will have the tools at their disposal to better align their efforts with what is best for homeowners, investors, and the nation as a whole.

As in any crisis, the problems we face today lead all of us to question the way we do things. Our challenges force us to ask, what went wrong, and they prompt us to search for lessons learned.

MBA, and its members, are committed to being leaders in affecting the necessary changes to the residential loan servicing paradigm. We have invited, and will continue to welcome, all interested stakeholders to join us in this effort. Only together can we restore confidence in our industry and preserve the dream of sustainable homeownership for future generations.

Sincerely,



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Executive Summary

During the last few years, the housing market has been hit with real property value declines in many markets, high unemployment rates, and unprecedented borrower defaults on home mortgages. Servicers of residential mortgages have faced extraordinary challenges in trying to help borrowers avoid foreclosure. The following white paper summarizes some of the key challenges faced by mortgage servicers, lessons learned during the recent housing crisis and issues and opportunities that need to be further explored to improve residential mortgage servicing in the future.

What has been called the "Great Recession" started in the housing market, but soon spread into a broader economic event, where the most notable attribute was a sharp increase in the unemployment rate. This fueled further mortgage loan delinquencies, which remain at historically high levels. Initially, the delinquent loans were predominately subprime mortgages and non-traditional mortgage products. However rising unemployment rates caused many borrowers who lost their jobs to default on traditional mortgage products that had been conservatively underwritten.

The Great Recession brought about the failure or consolidation of many of the country's largest financial institutions and the failure of the vast majority of the subprime segment of the market. It led to unprecedented policy initiatives, both in terms of fiscal stimulus and other government interventions, including monetary stimulus in the form of near zero interest rates and massive purchases of mortgage-backed securities and other assets. It also led to new government-sponsored loan modification programs in an attempt to keep millions of defaulting borrowers in their respective homes. It also brought about a significant decline in the price of homes, especially in the states of Florida, California, Arizona and Nevada. These states had witnessed unusually high price increases before the Great Recession, and non-traditional mortgage products were emphasized. Mortgage servicers scrambled to hire and train additional collection and foreclosure personnel and to develop the infrastructure and software to roll out the government HAMP loan modification programs and revamp proprietary modification programs.

Critics of the government's and mortgage servicers' response claim that the loan modification programs are helping too few borrowers, borrowers are having difficulties reaching the servicers, modifications are taking too long to process, and foreclosures and modification efforts are happening simultaneously. Modification statistics show a different picture whereby just under four and a half million homeowners have been rescued from foreclosure through HAMP and other modification programs. In spite of these successes, the recent "robo-signing" issue put consumer and regulator concerns regarding the servicing process on the front page of the daily newspapers across the country and at the top of policymakers' minds. On another front, the Basel Commission, who recommends changes to risk-based capital requirements for banks worldwide, adopted an annex to existing capital standards that, if adopted by bank regulators in the United States, would place a significant limit on the amount of servicing that could be held by banks. This rule would significantly impact the landscape of the mortgage servicing segment of the industry.

In this environment, on December 8, 2010, MBA announced that it had assembled a task force of key MBA members to examine and issue recommendations for the future of residential mortgage servicing. The Council on Residential Mortgage Servicing for the 21st Century (Council) is being led by Debra W. Still, CMB, President and Chief Executive Officer of Pulte Mortgage LLC of Englewood, Colo. and MBA's Vice Chairman. In announcing the formation of the Council, MBA Chairman Michael Berman, CMB, stated,

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"The residential mortgage servicing sector has been operating in a time of unprecedented challenges, presenting us with a unique opportunity to explore potential improvements to business practices, regulations and laws affecting the servicing sector and consumers. As the national trade association representing the real estate finance industry, we will bring together industry experts to take a comprehensive look at the current state and ongoing evolution of residential mortgage servicing and make recommendations for the future."

The Council convened a one-day public summit on January 19, 2011, in Washington, DC, titled, "MBA's Summit on Residential Mortgage Servicing for the 21st Century" (Summit). This meeting brought together industry leaders, consumer advocates, economists, academics and policymakers who took a detailed look at the issues that have challenged the industry and started the process of identifying the essential building blocks for the future of servicing.

Keynote speakers at the Summit and the panelists discussed problems and perceptions from their respective vantage points. Many speakers identified the need for a national servicing standard, the need to change the compensation structure to better incent servicers in the area of dealing with non-performing loans (NPLs), and potential changes in laws and regulations related to foreclosures and other facets of servicing.

This white paper is the first product of the Council. It is meant to be an educational tool to provide background information and an environmental scan of the events leading up to the current crisis. The white paper provides information on what a servicer does; how a servicer is compensated; and the perspectives of consumers, regulators and the legal community with regard to servicer performance in the current crisis and their policy recommendations. It also contains an industry analysis of the criticisms against servicers in order to separate real problems from "urban myths."

The last chapter highlights the Council's next steps to set the course for the future of servicing in the 21st century.

In analyzing the issues that surfaced during the Summit, the Council identified three major areas for further study and development of policy recommendations:

- Review of existing servicing standards and practices especially in the area of dealing with large volumes of NPLs, foreclosure practices, and loss mitigation practices, including loan modifications. The Council formed a working group called the National Servicing Standards Working Group to study and make policy recommendations related to a national servicing standard.
- Evaluation of the legal issues related to the foreclosure process, chain of title and other issues. The Council formed a working group called the Legal Issues Working Group to study and make policy recommendations related to legal issues identified during the Summit and any additional statutory or regulatory changes deemed appropriate for servicing in the 21st century.
- Analysis of proposed changes in servicer compensation proposed by the Federal Housing Finance Agency (FHFA), Ginnie Mae, Fannie Mae and Freddie Mac. MBA formed a working group called the Economics of Servicing Working Group to analyze the proposed compensation structure from the vantage of various stakeholders including large and small servicers, depository and non-depository services, investors in mortgages and MBS, and regulators.

The Council looks forward to working with policymakers, consumer groups and other mortgage market participants to work through these issues and develop servicing standards, regulatory and statutory changes, and servicing economics that will improve servicing in the future while also protecting the economics and viability of the servicing business model.

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I. Primer on Residential Mortgage Servicing

What Does a Residential Mortgage Servicer Do?

The mortgage servicer is the party that collects monthly mortgage payments from borrowers, remits principal and interest to the investors in those loans, pays property tax and hazard insurance bills from escrow funds collected from borrowers in their monthly mortgage payment, and performs collection, loss mitigation and foreclosure activity with respect to delinquent borrowers.

The servicer may service loans on behalf of itself or an affiliate, it may service as a contractor of the trustee in the case of mortgages included in mortgage-backed securities (MBS), or it may service whole loans for an outside third-party investor. When servicing for trustees of MBS and for outside third parties, the servicer acts as a contractor of the investor. As such, the servicer is guided and controlled by the servicing agreement, which establishes requirements for servicing performing and non-performing loans, including parameters and controls to avoid servicers taking action that is adverse to the investors' interests. The servicer must balance these contractual requirements and restrictions with its interests in serving its borrower customers.

Monthly payments from borrowers go towards paying principal and interest. For borrowers that pay taxes and insurance through the servicer, the monthly remittance also includes a pro-rata portion of the annual or semi-annual real property taxes and hazard insurance bills. These cash receipts are segregated into two types of accounts: 1) principal and interest funds (P&I) are placed in bank accounts in trust for the benefit of investors and; 2) tax and insurance funds (T&I) are placed in bank accounts in trust for the benefit of borrowers. Investor funds are remitted to the investor usually monthly, but sooner for some investors, if the funds represent a payoff of the mortgage. Escrow funds are disbursed by the servicer on behalf of the borrower when tax and insurance bills come due.

Fannie Mae, Freddie Mac, Ginnie Mae and the Federal Housing Administration (FHA) servicing guidelines direct the servicer's collection and loss mitigation activities for servicing on behalf of Fannie Mae, Freddie Mac, Ginnie Mae and FHA. These guidelines provide the servicer and the investor with a clear understanding of the servicing contract and help to promote liquidity in the MBS market. For private label MBS, the pooling and servicing agreements (PSAs) dictate the level of servicing activities, including collection and loss mitigation activities. The servicer's duties are defined by and limited to, those servicer guides and pooling and servicing agreements.

Servicers' maintain records in order to provide detailed accounting of the loan balance and payment activity of the mortgage and for balance and payment activity of the T&I escrow accounts. When servicing MBS, detailed balance and disbursement activity is also maintained at the pool level, and for certain MBS, at the individual investor level.

Appendix B provides a more detailed description of the servicing function.

What Are the Servicer's Revenues and Expenses?

When examining the economics of servicers, it is first important to understand all revenues and costs associated with servicing operations, some of which are often overlooked.

Revenues

During 2003–2010, servicing revenues averaged 36–43 basis points for large prime servicers and 31–39 basis points for small prime servicers. The components of servicing revenues include servicing and subservicing fees net of guarantee fees, ancillary fees such as late payments, and interest earnings on P&I and T&I accounts held in escrow prior to remittances to

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investors, insurers and tax authorities (float benefit). Since 2007, servicing revenues have been declining. Contributing factors to the decline include: longer foreclosure timelines (during which agency servicers do not receive a service fee); declines in total mortgage debt outstanding; uncollectable excess servicing (any amounts of interest received by the servicer in excess of "normal" servicing fee); and changes in guarantee fees.

Expenses

Servicing costs include more than simply the direct cost to service. The key components of the total servicing costs include direct servicing costs, unreimbursed foreclosure and REO-related servicer expenses, corporate allocations, and various types of interest expenses primarily for advances and prepayments. Fully-loaded total servicing costs averaged 12–18 basis points for large prime servicers and 15–21 basis points for small prime servicers during 2003–2010. Since 2007, all components of servicing costs increased, except for interest expenses. While default-related advances increased during this period, many servicers (particularly those bank-affiliated servicers) have been helped by low short-term interest rates that have kept down the cost of funding such advances.

Net Operating Income and Net Financial Income

Servicing net operating income is defined as total revenues less total servicing expenses. From 2003 through 2010, large prime servicers' net operating income ranged from 22–30 basis points, while small prime servicers' net operating income ranged from 16–19 basis points. Servicing net financial income, on the other hand, incorporates gains and losses on the valuation of mortgage servicing rights net of hedging. During 2003–2010, net servicing financial income has ranged from a loss of 9 basis points to income of 13 basis points for large prime servicers and a loss of 8 basis points to income of 5 basis points for small prime servicers.

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II. Environmental Scan

From January 2008 to February 2010, the U.S. economy lost almost 8.8 million jobs. According to FHFA, home prices nationally decreased a cumulative 11.5 percent during the past five years, with much larger cumulative declines of 40 to 50 percent in the states of Arizona, California, Nevada and Florida (known throughout the crisis as the ("Sand States"). Even though construction of new homes remains near 50-year lows, inventories of unsold homes on the market remain high, with nearly four million properties currently listed, as homebuyer demand remains weak. Responding to the downturn, household formation rates fell sharply, with many families combining households and household expense to save money. Consumers cut spending across the board, as they tried to rebuild savings after the shocks to their wage income and the declines in stock market and housing market values.

This "Great Recession" was the most severe economic downturn that the U.S. had experienced since the Great Depression of the 1930s. It led to the failure or consolidation of many of the country's leading financial institutions. It resulted in unprecedented policy initiatives, both in terms of fiscal stimulus and other government interventions, and monetary stimulus in the form of near zero interest rates and massive purchases of mortgage-backed securities and other assets.

The housing and mortgage markets both contributed to and suffered from this crisis. Among the contributing factors: overbuilding, lenient lending standards (particularly with respect to documentation) that favored non-traditional mortgage products, the easing of underwriting standards on the part of Fannie Mae and Freddie Mac, passive rating agencies and regulation, homebuyers chasing rapid home price increases, undercapitalized financial institutions, monetary policy that kept interest rates too low, for too long, and massive capital flows into the U.S. from countries that refused to allow their currencies to appreciate.

Regardless of which factors were the causes, we do know that the nature of the crisis changed over time. Initially, rising rates from the Federal Reserve and suddenly tighter regulatory requirements ("guidance") around subprime and non-traditional loan products stranded borrowers who had counted on being able to refinance loans in late 2006 and into 2007.

As a result, serious delinquency rates on subprime ARM loans increased by 50 percent in 2006 and then more than doubled through 2007. Even before their first reset, these loans were failing at unprecedented rates. The subprime ARMs originated from 2005-2007 have performed much worse than any others in recorded data.

Without access to credit for new buyers, home prices in the overbuilt markets in the Sand States began to nosedive. With investors increasingly beginning to question performance, the private-label MBS market froze in August 2007 and has remained essentially frozen since. To make matters worse, lending to prime, jumbo borrowers effectively stopped. As liquidity left the system, fewer potential buyers could get credit, and home prices declined further. According to the National Bureau of Economic Research (NBER), the economy fell into recession in December 2007.

The unemployment rate in January 2008 was five percent. Eighteen months later, it would be nearly twice as high, following the near collapse of the financial sector in the fall of 2008. From that point, mortgage delinquencies and foreclosures were being driven by joblessness and loss of income. Serious delinquency rates on prime fixed-rate loans were at 1.1 percent in the beginning of 2008. By the end of 2009, they were approaching five percent. These loans were traditionally underwritten, and well documented with no structural features that impacted performance. Borrowers simply couldn't pay if they didn't have a job.

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Important policy initiatives were launched through this time period. Servicers began large-scale efforts to modify subprime and non-traditional loans. Initially, these efforts were undertaken by individual servicers, but government and industry efforts led to standardization of processes through the Home Affordable Modification Program (HAMP), which also benefitted proprietary modification programs, which could leverage these standardized processes. Since July 2007, the Hope Now Alliance estimates that just under four and a half million homeowners received permanent loan modifications through HAMP or proprietary modification programs.

For several years, the four states of Florida, Arizona, Nevada and California have dominated the national delinquency and foreclosure numbers, accounting for 40 percent or more of total foreclosure starts in recent quarters and almost 60 percent of foreclosure starts for subprime and prime ARMs. As of the fourth quarter of 2010, more than 14 percent of all loans in Florida were in foreclosure, and almost one quarter of all loans were past due by one payment or more or in the foreclosure process.

Efforts to delay the foreclosure process have typically not been effective over the longer-term. Frequently, there can be a tradeoff between late-stage delinquencies and foreclosure starts, as new regulatory or statutory requirements delay foreclosure starts one quarter, resulting in a temporary increase in the delinquency bucket. In most cases, foreclosure starts have rebounded in subsequent quarters as the backlog is worked through.

In summary, the worst recession in living memory has led to the worst mortgage performance. Servicers have been overwhelmed by national delinquency rates running four to five times higher than what had been typical during the prior 40 years for which MBA has data.

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III. Summit for Residential Servicing for the 21st Century (Summit)

On January 19, 2011, MBA hosted a one-day summit in Washington, DC. This meeting brought together industry leaders, regulators, consumer advocates, economists, academics, and government policymakers for a detailed look at the issues that have challenged the industry. The purpose of the meeting was to recognize the issues that need to be examined and to identify the essential building blocks for the future of servicing.

MBA hosted three keynote speakers during the Summit:

- The Honorable Sheila Bair, Chairman, Federal Deposit Insurance Commission (FDIC)
- The Honorable David H. Stevens, Assistant Secretary for Housing and Commissioner of the Federal Housing Administration, U.S. Department of Housing and Urban Development
- Richard Neiman, Superintendant of Banks, State of New York

These speakers offered an insight on what regulators and government policymakers think about servicers' performance during the recent crisis and some changes that they believe are necessary for the future.

Panel I: Servicing in Unprecedented Times: Strategies, Direction, and Lessons Learned

This panel included Cindy Gertz, Director of Operations, Office of Homeownership Preservation of the U.S. Department of Treasury, Bryan Palmer, Director at Freddie Mac, Tom Marano, Chief Capital Markets Officer and CEO of Mortgage Operations for Ally Financial, Inc., and J. David Motley, President of Colonial National Mortgage. The purpose of this panel was to review the performance of the servicing industry during the recent crisis, key challenges and possible strategies for the future.

Panel II: Secondary Marketing Perspective

This panel included Honorable Ted Tozer, President of Ginnie Mae, Robert Lee, Senior Vice President of Mortgage Industry Advisory Corporation, Andrew BonSalle, Senior Vice President of Fannie Mae, Tom Deutsch, Executive Director of the American Securitization Forum (ASF), and Richard Dorfman, Managing Director of the Securities Industry and Financial Markets Association (SIFMA). The panel discussed servicing fee alternatives, the secondary market for servicing rights, the state of the secondary markets for non-conforming mortgage products and other issues that could impact servicing in the future.

Panel III: Consumer Perspectives

This panel included Mike Calhoun, President of the Center for Responsible Lending, Patrice Ficklin, consumer advocate and Counsel for Reiman, Dane & Colfax, and David Berenbaum, Chief Program Officer for the National Community Reinvestment Coalition. The panel provided a glimpse of the borrower's views on how servicers performed during the current crisis.

Panel IV: Legal Perspectives

This panel included Laurence Platt, Partner of K&L Gates and Adam Levitin, Associate Professor, Georgetown University Law Center. This panel discussed various legal issues associated with the foreclosure process, including chain of title issues, "robo-signing," and the use of MERS.

Economics of Mortgage Servicing

In this session, Jay Brinkmann, Ph.D., MBA's Chief Economist, and Marina Walsh, MBA's Associate Vice President of Industry Analysis, presented a summary of the trends in economics for servicers during the recent crisis.

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The following are summaries of secondary marketing perspectives, regulators' perspectives, legal perspectives and consumer perspectives based upon the Summit's panel discussions and various articles. Following those summaries is the servicer's perspective meant to be both a summary of the servicer's experience during the credit crisis and a counterpoint to some of the "urban myths" about servicers' roles and responsibilities.

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IV. Secondary Market Perspective

Several days before the Summit, FHFA announced that it was conducting a study jointly with Ginnie Mae, Fannie Mae and Freddie Mac for a new fee structure that would better align servicer incentives and investor interests when it comes to servicing loans in default. This became a primary focus for the secondary marketing panel during the Summit.

One of the primary drivers for the initiative to change servicing fee structures relates to a pending change in capital rules for banks. On July 26, 2010, the oversight body of the Basel Committee[1] on Banking Supervision (Basel Committee) approved an annex to the Basel accord which is an international agreement that establishes capital standards for financial institutions. The annex specifically guides respective member countries' bank regulators to adopt rules for the treatment of specific assets in determining Tier I capital for regulatory reporting purposes. Under the annex, the following assets may receive only limited recognition when calculating the common equity component of Tier I capital, with recognition for each class of assets capped at ten percent of the common equity component of Tier I capital:

- Significant investments in the common shares of unconsolidated financial institutions (banks, insurance and other financial entities),
- Mortgage servicing rights (MSRs), and
- Deferred tax assets (DTAs) that arise from timing differences.

In addition, under the annex a bank must deduct the amount by which the aggregate of the three items above exceeds 15 percent of its common equity component of Tier I.

1. The Basel Committee is a group of bank regulators from various countries including the United States. It recommends capital guidelines for banks in order to level the playing field for all banks competing world-wide. It recommends policies and principles, but each participating country must develop their own respective rules using Basel as a guideline.

This treatment would be much more onerous than treatment under existing capital rules whereby MSRs are measured at 90 percent of fair market value (FMV) (for capital purposes) and a bank may hold up to 100 percent of capital in MSRs before any reduction from Tier I capital.

The second primary driver for the proposed changes in fee structure is the perception that the present servicing fee structure misaligns the servicer's interest with that of investors. Proponents of this view believe that servicers are overpaid for servicing performing loans and underpaid for servicing non-performing loans. Servicers disagree with this notion. See the Servicer's Perspective section below whereby servicers dispel this "urban myth."

The general themes emerging from the secondary market panel discussion related to the need to increase predictability and flexibility while decreasing volatility and concentration risk. For example, some participants voiced the opinion that an alternative to the existing I/O strip method for calculating servicing fees should be created in order to decrease volatility. A related question arose with respect to who would absorb the volatility in servicing fees in a downturn (i.e. the investor or guarantor). Panelists also said that since the "TBA" market thrives on predictability, care should be taken to be compatible with the TBA guidelines.

In terms of flexibility, the panelists said that servicing rights should incorporate factors that reflect market conditions so that the fee varies accordingly. For example, they mentioned the benefit of having one arrangement for the "low-touch, high-tech" business platform for primary servicers, and another arrangement to accommodate the "high-touch" platform for default servicers. However, care should be taken because the transition from "high-tech" to "high-touch" is very complicated and disruptive. This is a double-edged sword, however, because the market's desire for certainty/predictability runs counter to a flexible approach to calculating servicing rights.

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Ideally, the calculation method also should be designed to improve the ability of firms of all sizes / structures to hold servicing rights. Such an improvement will open up the market for servicing rights and address the existing concentration risk associated with a relatively small number of existing firms that are interested in holding servicing rights. Panelists also mentioned the lack of excess capacity in the servicing industry to absorb dramatic changes in volumes of defaulted loans, loan modifications and other transactions. The financial condition of a servicer is a critical factor because moving servicing is not done easily.

Shortly after the Summit, FHFA released a document that illustrated four servicing fee structures that FHFA, Ginnie Mae, Fannie Mae and Freddie Mac were exploring. In the following table, the first column is an example of today's fee structure whereby the minimum servicing fee is 25 basis points, the guarantee fee is assumed to be 20 basis points, and there is five basis points of excess servicing fee to capitalize as part of the MSR or to monetize. The next column presents what the industry has dubbed the "Alternative Minimum Servicing Fee" or "AMSF." Rather than take a fee based upon an interest strip, the servicer would take an unguaranteed interest in both the principal and the interest cash flows. In the table below, that is assumed to be a one percent interest in principal and interest cash flows. The third through fifth columns are various permutations of the existing fee structure. The third column assumes a minimum servicing fee of 12.5 basis points, the fourth column assumes a minimum of three basis points, and the final column assumes no minimum servicing fee. In each of the proposed alternatives, the compensation relates to the servicing of performing loans. The guarantor would pay the servicer or, a special servicer, additional fees for each non-performing loan on the basis of a flat dollar amount per loan per month based upon stage of delinquency.

			Fee for Service Models		
Mortgage Rate Composition (Note A)	**Today's 25 basis points**	**AMSF 1% of P&I**	**12.5 basis points (MSR)**	**3.0 basis points (MSR)**	**0 basis points (MSR)**
Treasury	4.20%	4.20%	4.20%	4.20%	4.20%
MBS spread to Treasury	1.30%	1.30%	1.30%	1.30%	1.30%
MBS Current Coupon	5.50%	5.50%	5.50%	5.50%	5.50%
Guarantor revenue					
G Fee	0.20%	0.20%	0.20%	0.20%	0.20%
Mortgage Bank Revenue					
Minimum servicing fee required to be held	0.25%	0.00%	0.125%	0.03%	0.00%
Additional spread to hold or monetize (Note B)	0.05%	0.30%	0.175%	0.27%	0.30%
Total primary / secondary spread	0.50%	0.50%	0.50%	0.50%	0.50%
Borrower rate	6.00%	6.00%	6.00%	6.00%	6.00%

Note A: Source Servicing Compensation Initiative Pursuant to FHFA Directive in Coordination with HUD, Background and Issues for Consideration, February 2011, page 14.

Note B: Under the 1% P&I illustration, the excess servicing would be for the 99% of the loans not held by the servicer.

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V. Regulators' Perspectives

During the Summit, the Council hosted three keynote speakers from different government agencies:

- The Honorable Sheila Bair, Chairman, Federal Deposit Insurance Commission (FDIC)
- The Honorable David H. Stevens, Assistant Secretary for Housing and Commissioner of the Federal Housing Administration, U.S. Department of Housing and Urban Development
- Richard Neiman, Superintendant of Banks, State of New York

These regulators offered insight on the government's perspectives on servicer performance during the recent crisis and their recommended changes for the industry. Together they addressed the idea of setting a common standard for the residential mortgage servicing industry, including modifications, the foreclosure process, technology, human resources and adequate supervisory regulation.

- **Standards:** There was a call for the development of a national servicing standard especially as relates to foreclosure and default administration. One model would establish a national servicing standard to be developed in conjunction with the rulemaking process under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) for implementing risk retention and defining the Qualified Residential Mortgage (QRM). Another approach calls for the development of a comprehensive servicing process in a joint federal and state effort one speaker dubbed a "Cooperative Federalism." Representatives from the industry at a later portion of the Summit pointed out that mortgage servicing does have standards through Fannie Mae, Freddie Mac, FHA and VA servicer guidelines.
- **Human Resources:** The regulators stated that servicers need to have adequate staffing to deal with the large volume of borrowers in default. The importance of a single point of contact was emphasized, particularly for borrowers with loans in default or in the process of loan modification. Later at the Summit, it was recognized that improving staffing levels and their skills was key and that the industry had increased staff, though defining what a single-point of contact meant varied.
- **Technology:** The regulators contrasted the industry with itself from several years ago when it used more technology to reduce costs and human resources, while under a less structured environment. The regulators believe that today's challenges require more human contacts than technology.
- **Foreclosure Process:** There were concerns expressed about document irregularities, servicing processes and legal issues, about rights to foreclose and missing documentation, among other matters. This will be discussed further in the legal issues portion of this paper.
- **Regulation:** Generally, there was a sense that mortgage servicers have not been sufficiently regulated. The new Consumer Financial Protection Bureau (CFPB) has the potential to fill that perceived void.

Outside of the subjects discussed at the Summit, other government policymakers have shared their own approaches for improving residential mortgage servicing to more effectively deal with borrowers in default.

- U.S. Senator Jeff Merkley (D-OR) proposed a "short refinance" program that would enable homeowners who are facing foreclosure to refinance their mortgages based upon current interest rates and home values. The proposal aims to allow a family to stay in their home while a full appraisal, new underwriting and current lender payoff negotiations are concluded. The refinanced loan would have an FHA guarantee and also establish a third-party review prior to foreclosure in order to enforce existing law. The bill would also: stop "dual tracking" that continues interim foreclosure steps (but not foreclosure sale) while modifications are being evaluated; require that homeowners be provided

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with a single- point of access when they pursue a modification; and implement a "lifetime bankruptcy option."[1] However, there are many specific details about this proposal that are unclear to MBA and the Council. In addition, filing for bankruptcy can already place a pause to a foreclosure proceeding, so it is unclear how the lifetime option serves a new purpose. It also appears such an option would not be in investors' interests and would limit the availability of credit in the future.

- On October 27, 2010, Joseph H. Evers, Deputy Comptroller for Large Bank Supervision, Office of the Comptroller of the Currency (OCC), in testimony before the Congressional Oversight Panel, reported some favorable trends in home retention actions taken by banks during the second quarter of 2010. During that quarter, servicers implemented 504,292 home retention actions, which included loan modifications, trial performance plans and payment plans. During the same timeframe, servicers implemented 273,419 permanent loan modifications, including modifications under HAMP and other proprietary modification programs. Among the permanent modifications completed during the quarter, term extensions were used in 51 percent of the modifications, principal deferrals were used in 11 percent, and principal reductions were used in two percent of the modifications. The testimony stated that servicers must determine the appropriate mix of actions to take, striking an appropriate balance between the needs of borrowers for affordable and sustainable payments with the rights and interests of investors in those loans. Cumulatively, 46 percent of these modifications remain current or were paid off, another 10 percent were 30 to 59 days delinquent, more than 25 percent were seriously delinquent, and 13 percent were in the process of foreclosure or had completed foreclosure. Further, the testimony reports that more recent modifications appear to be performing better than the earlier modifications. The testimony also points out modifications that reduced the monthly payment by 10 percent or more performed significantly better than modifications that reduced payments by less than 10 percent.

- On December 1, 2010 in a Senate hearing, Federal Reserve Board Governor Daniel Tarullo indicated that it might be wholly appropriate to establish a national servicing standard.[2] This is similar to the ideas from Chairman Bair and Superintendant Neiman presented during the Summit. The Council recognizes that the Seller / Servicer Guides from Fannie Mae and Freddie Mac are national standards and that anything greater than that should be the subject of robust policy discussions.

- Iowa Attorney General Tom Miller told a Senate panel recently that robo-signing is only a symptom of a much larger problem with the mortgage servicing system. He noted the robo-signing investigation by the 50 Attorneys General is also looking at various servicing fees, force-placed insurance, as well as the problems servicers and investors are having showing a proper chain of title and ownership of securitized mortgages. He also expressed concern that modifications are not proceeding at an appropriate pace.[3]

1. Senator Jeff Merkley, *Paving the Way to a Healthy Housing Market.*

2. Cheyenne Hopkins, *American Banker*, "Louder Outcry for U.S. Standard in Loan Servicing," December 15, 2010.

3. Brian Collins, *National Mortgage News*, "It's Hard Out There for a Mortgage Servicer...," December 6, 2010.

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VI. Legal Perspectives

The mortgage servicing industry has been under intense legal scrutiny recently, particularly with respect to policies and procedures related to the servicing of nonperforming loans. Although most of the legal challenges have been raised about the nature of securitization, more recently, a ruling by the Massachusetts Supreme Judicial Court voided two foreclosures on legal grounds. The Summit addressed these matters during the Legal Issues panel, which was formatted as a point / counterpoint session between Adam J. Levitin, Associate Professor of Law at Georgetown University in Washington, DC, representing the consumer viewpoint, and Laurence E. Platt, an attorney at the firm of K&L Gates specializing in mortgage banking and consumer financial products, representing the mortgage industry position. Four major legal issues relating to residential mortgage servicing were examined:

1. The sufficiency of foreclosure documentation and attestation policies and procedures;
2. Chain of title issues;
3. Fees and lender-placed insurance; and
4. The MERS mortgage registry system for recording transfers of servicing rights.

A fundamental issue discussed was the role of the trustee. From the consumer viewpoint, the servicer is an indirect agent of the investor through a trustee. However, the servicer can be an agent or contractor, depending on the structure of the agreement. The servicer's legal rights and obligations are controlled by various legal documents.

Chain of Title Issues

The discussion at the Summit summarized the applicable laws related to the perfection of ownership in the mortgage and note. In the midst of this housing crisis, some have questioned the lender's reliance on long-standing case law and the Uniform Commercial Code to transfer notes and mortgages. The two core legal documents in most residential mortgage loan transactions are the promissory note and the mortgage (or deed of trust). In most residential mortgage-backed securities transactions (MBS) the mortgages and notes are sold or transferred to a trust. The principal law governing this transfer of notes is the Uniform Commercial Code (UCC) as adopted in all 50 states and the District of Columbia.[1]

Article 3 of the UCC applies to the transfer of a mortgage note that is deemed to be a negotiable instrument under the UCC. However, Article 9 of the UCC also applies to the sale and assignment of promissory notes.

Moreover, a security interest in the note also results in a security interest in the mortgage.[2]

Under Article 3, negotiable mortgage notes may be transferred to a securitization trust by endorsement and transfer of possession to a trustee. Under Article 9 of the UCC, a security interest may be transferred by an outright sale and assignment to the trust. Most notes are negotiable and are either bearer paper (meaning they are payable to whomever holds the note) or specific paper (the note names the owner of the paper). Most private label MBS provide for both the negotiation by endorsement and transfer of possession under Article 3 and for an outright sale and assignment under Article 9.[3]

Under Article 3 of the UCC, the transfer of a negotiable instrument is commonly accomplished by endorsing the note "in blank," whereby the endorsement does not identify a specific party to whom the mortgage note is payable.[4]

The UCC contains a rule that stems from hundreds of years of common law. The rule is that "the mortgage

1. American Securitization Forum, *Transfer and Assignment of Residential Mortgage Loans in the Secondary Mortgage Market*, November 16, 2010, page 2.
2. UCC § 9-203(g)
3. Ibid, American Securitization Forum, page 3.
4. Ibid, page 3.

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follows the note."[5] They are not separate in mortgage practice or application. For example, if someone legally transferred the note, then the rights under the mortgage effectively transfer to the transferee as well, even without the execution of an assignment.

In addition to Article 3, however, a note can be transferred by assignment under Article 9.

Under Article 9, the sale of a mortgage note is deemed to be a secured transaction and the transferee's "security interest" is automatically perfected when it attaches (See UCC § 9-309(4). While security interests are most commonly thought of as the liens obtained by lenders, the UCC defines the term "security interest" to also include "any interest of a ... buyer of ... a promissory note in a transaction that is subject to Article 9." UCC § 1-201(b)(35).

Before a buyer's "security interest" in a mortgage note can be perfected under Article 9, the security interest must "attach." A security interest attaches when (1) value has been given for the sale, (2) the seller has rights in the mortgage note or the power to transfer rights in the mortgage note to the buyer and (3) either (a) the mortgage note is in the possession of the buyer pursuant to a security agreement of the seller or (b) the seller has signed a written or electronic security agreement that describes the mortgage note. See UCC § 9-203(b).

Consumer advocates assert that the UCC applies to sales between two parties, but since one of the parties in an MBS transaction is a trust then trust law of the state governs the transaction. By this approach, a note would not legally transfer to the trust if the trust required a specific endorsement, but the endorsement was executed in blank, despite possession transferred to the trustee's document custodian. While such a transfer would be valid under the UCC, it was argued that the transfer would be invalid because of the failure to follow specific endorsement pursuant to the trust documents. It was further argued that MBS trust powers are limited to those in the document that create the trust and the Pooling and Servicing Agreement (PSA). Most PSAs are governed by New York law, which provides that a transaction beyond the authority of the trust documents is void.[6] Typically PSAs have two relevant transfer provisions, a recital stating that the notes and mortgages are "hereby" transferred to the trust and a provision that states that, in connection with the transfer, the original notes each containing a chain of endorsements that show the ownership history with the final endorsement in blank will be delivered to the trust.[7]

5. Ibid, page 4.

6. Adam Levitin, *The Big Fail — Securitization Never Occurred*, January 31, 2011, page 2.

7. Ibid, Adam Levitin, pages 2 and 3.

During the point/counterpoint discussion at the Summit, the consumer approach to trust law was illustrated where the notes are assigned in blank with no evidence of intervening endorsements. If the PSA requires all intervening endorsements, trust law would supersede the UCC and, therefore, would invalidate the transfer. This argument is countered because a number of federal and state courts have held that the UCC governs both the transfer of notes to securitization trusts and whether the servicers, as agents for the trustee, have the authority to enforce the notes (and mortgages). In contrast, the consumer argument relies upon a 1928 case *Vincent v. Putnam* that pre-dates the codification of the UCC and the creation of mortgage securitization trusts.[8]

Use of MERS

According to its Web site, "MERS is an innovative process that simplifies the way mortgage ownership and servicing rights are originated, sold and tracked. Created by the real estate finance industry, MERS eliminates the need to prepare and record assignments when trading residential and commercial mortgage loans."

The right to enforce a mortgage loan registered in MERS has been the subject of litigation in recent years. During the point/counterpoint discussion at the Summit, a concern about MERS' legal standing in the context of a securitization was addressed.

Robo-Signing

A conflict arose in late 2010 over whether employees of mortgage servicers who signed affidavits had "personal knowledge" and properly notarized legal paperwork for foreclosures of residential mortgages. In some cases, servicing employees, with authority over significant portions of the servicing operation, signed the documents based on business records and other staff entrusted with performing due diligence as to the accuracy of the information contained in the motion for summary judgment. Legal questions and concerns surfaced about this practice. The question this panel briefly contemplated was whether the process to support such a practice can be compliant with the legal requirements.

8. Laurence E. Platt, Phoebe Winder and Andrew Glass, "Trust But Verify: Claim That New York Trust Law Voids Mortgage Transfers Does Not Survive Legal Scrutiny," *Newsstand*, December 22, 2010.

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Ancillary Fees and Servicer Authority

Lender-Placed Insurance

Residential mortgage servicers may collect late fees and ancillary fees from the borrower where applicable. Consumer advocates are concerned that fees applied to loans in default and that are also subject to lender-placed insurance are unfair to the borrower. Lender-placed insurance is an insurance policy taken out by a lender or creditor when a customer breaches the mortgage contract by failing to carry appropriate insurance on the home that is collateral for the mortgage. The charges for this insurance are passed on to the customer. The requirement for lender-placed insurance is in the mortgage contract, and is permitted by the GSEs and FHA and is provided for in some PSAs for private label MBS. The controversy arises when the lender-placed insurance is entered into with a related party of the servicer or the insurance affiliate of the servicer receives a commission from the insurer. Servicers clarified that lender-placed insurance is necessary to avoid uninsured damage to the property that not only harms the investor, but the borrower and community if properties cannot be repaired. The benefits of lender-placed insurance were made evident with Hurricanes Katrina and Rita and other similar natural disasters. Moreover, it is important to know that servicers invest significant financial resources in ensuring that they renew voluntary insurance whenever possible. However, in many cases, voluntary insurers cancel or do not renew policies on high risk properties, including vacant homes and those owned by delinquent borrowers. If borrowers are unable to obtain substitute insurance in the voluntary market, the servicer will often lender-place the insurance.

Late Charges

Late charges are stipulated in the mortgage note itself and, therefore, are a contractual right of the creditor. Generally, most servicing agreements allow the servicer to keep late charges collected as compensation for the added cost to the servicer for collection procedures and for advancing principal and interest not collected from the borrower to the MBS investor. (See Servicer Perspectives for a more thorough conversation.)

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VII. Consumer Perspectives

The Consumer Perspectives panelists included Mike Calhoun, President of the Center for Responsible Lending, Patrice Ficklin, consumer advocate and Counsel for Reiman, Dane & Colfax, and David Berenbaum, Chief Program Officer for the National Community Reinvestment Coalition. The panel was moderated by Jordan Dorchuck, EVP and Chief Legal Officer of American Home Mortgage Servicing Inc. This panel gave perspectives about servicing practices from the borrower's point of view, especially as it relates to default servicing. In general, the consumer group panelists expressed the sentiment that servicers have lost the trust of consumers.

One suggested solution by members of this panel was to look back to the Savings and Loan collapse in the early 1990s and establish a contemporary version of the Resolution Trust Corporation (RTC) to acquire troubled mortgages. According to their perspective, establishing such an entity would put these loans in the hands of a party other than the current investor and servicer, who they claim do not have the same priorities as the borrower. Of course the RTC was intended to address the liquidation of failed thrifts, not assets of going concerns.

In addition to this proposed solution, during this panel several key issues were addressed:

- **Incentives:** Consumer advocates believe there is an under-incentive to modify mortgages in spite of the various fees under the Home Affordable Modification Program (HAMP). However, because the mortgage servicing business accumulates small fees through a high number of transactions, some consumer advocates believe the existing servicing fee structure fails to help the borrower.
- **Standards:** Consumer advocates favor a minimum national standard while granting the authority to states to set higher standards.
- **Transparency:** The point was raised that servicing standards need to be more transparent. The consumer advocates would support such transparency as a requirement in a national servicing standard.
- **Modifications:** The discussion addressed several issues and misconceptions about modifications. HAMP modifications are not being executed at the rate the Obama Administration had hoped. However, proprietary (non-HAMP) modifications are being executed at a very successful pace. Panelists highlighted the fact that certain loan products, namely Option ARMs, increased principal that contributed to higher defaults. Second mortgages complicate the modification process especially where home values are declining. It is also notable that some panelists perceive that there is no economic difference to the investor between principal reduction modifications and short sales; despite the fact that short sales divest the borrower of his or her home, creating a built in deterrent to strategic default.
- **Foreclosure Process:** Dual tracking, whereby the foreclosure process runs parallel with the loan modification process, was also discussed as a problem area for residential mortgage servicers. The rules from Fannie Mae, Freddie Mac and Ginnie Mae set a schedule for when the steps of foreclosure take place and when foreclosure actions can be paused or terminated upon loss mitigation. While in the past, some agencies prevented solicitation of borrowers for loss mitigation after foreclosure was initiated, this policy was changed because of the positive effects ensuring loss mitigation during the foreclosure process. Allowing loss mitigation conversations and outreach during foreclosure, however, has lead to the dual tracking concerns. It was suggested that those rules should change.
- **Borrower Contact:** The panel discussed homeowners' complaints of getting to a "real person" when they call their mortgage servicer, and even if they reach a live person, often that person had little if any knowledge of their unique situation or any efforts already in progress. The consumer advocates emphasized the need for a "single point of contact" for borrowers in the loan modification process.

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VIII: Servicer's Perspectives

Three of the recommendations that panelists echoed throughout the Summit were 1) servicer compensation is not properly designed to incent the servicer to perform loan modifications, 2) servicers need to eliminate dual tracking of loan modifications simultaneously with the foreclosure process, and 3) servicers need to establish a single point of contact between the borrower and the servicer. The following is the servicers' perspective related to these three issues.

Basic Economics of Servicing Delinquent Loans

There have been numerous studies on the servicer's incentives: Sigtarp Study;[1] Federal Reserve of Philadelphia,[2] and the National Consumer Law Center.[3] These studies provide hypothetical cost-benefit analyses for both borrowers and servicers. These studies will be cited in the discussion below.

In each study, however, the assumptions used do not accurately reflect current servicing practices or fail to accurately state the costs and revenues inuring to the servicer with regard to a delinquent loan. Also, during MBA's Summit, it became evident that the servicer's costs and recovery of costs are not well understood. This chapter provides greater explanation of the servicer's financial responsibilities and recovery opportunities and limitations. We outline the key components of the major revenue and costs associated with:

1. Bringing the loan current through HAMP
2. Bringing the loan current through a proprietary modification
3. Foreclosure

Reinstatement of Servicing Fee Income

Most importantly, a modification reinstates the servicing fee income. The single greatest financial incentive supporting modifications over foreclosures for servicers is the reinstatement of servicing income. Assuming a borrower remains current under the modified terms, the servicer will continue to receive the servicing fee income monthly over the life of the loan. In contrast, such income ceases during the period of delinquency. In the case of private label securitizations (PLS), the servicing fee would ultimately be reimbursed to the servicer when the REO property is sold, but without interest. In summary, foreclosures result in an early termination and, in the case of PLS, deferment of servicing fee income, while modifications result in the reinstatement and continuation of same. In the case of GSE and FHA servicing, the servicer loses the servicing fee income during the period of delinquency and permanently when the loan is foreclosed. A continuation of the servicing fee income, under a loan modification, provides retention of value of the servicing asset that is otherwise written off upon foreclosure.

Advances

The Sigtarp study, as well as the Federal Reserve of Philadelphia study, recognizes the cost of advancing principal, interest, taxes and insurance with respect to delinquent loans held in securitizations.

In the case of PLS, servicers generally must advance principal and interest to bondholders from the due date of the first unpaid installment until the property is liquidated through the sale of REO. Likewise, servicers may be required to advance tax, insurance and other costs. According to Lender Processing Service's (LPS's)

1. Special Inspector General, Troubled Asset Relief Program, Quarterly Report to Congress, October, 26, 2010.
2. Federal Reserve Board, Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang, & Eileen Mauskopf, The Incentives of Mortgage Servicers: Myths and Realities, Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, 46 (2008).
3. National Consumer Law Center, Inc., Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicing Behavior: Servicing Compensation and Its Consequences (2009).

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Mortgage Monitor Report, "As of February 2011, the average length of time a loan in foreclosure is delinquent was nearly 537 days." In addition to the foreclosure time line, servicers must advance until the REO is sold, adding about another 116–176 days.

Alex Villacorta, Ph.D. and Director of Research and Analytics at Clear Capital explains, "The most recent data as of April 2011 indicates that for the distressed segment, marketing times are 56 days-on-market, compared to 65 days-on-market for the same time period in 2007."

Ed Delgado, AMP, and Chief Executive Officer of the Five Star Institute, further adds that, *"It's feasible that an additional 60–120 days may be added to the time frame to ready the property for listing and the time to close the sale."*

A servicer may not be reimbursed for a portion of advances. For example, FHA curtails a portion of interest advanced, and many investors curtail a portion of the foreclosure legal fees advanced by the servicer.

In the case of PLS, these advances are reimbursed at 100 percent, but the servicer incurs the cost to carry these advances (borrowing / capital costs) for the entire delinquency and REO periods. It should be noted that in addition to the obvious financial cost to carry these advances, there is a significant allocation of capital required to carry them as well. This is particularly impactful to smaller servicers

However, if the borrower obtains a modification, the advancing costs would cease upon the execution of the permanent modification. The borrower is brought current by capitalizing the principal, interest, taxes and insurance (PITI) arrearages (meaning the arrearages are added to the balance of the loan). The servicer recovers any PITI advance incurred up to the date of modification at 100 percent. Reimbursement from the pool occurs usually within 60 days of modification. The quicker the modification can be completed, the less the advance cost to the servicer. As a result, the servicer is incented to modify the loan to reduce the interest costs and capital allocation associated with carrying advances. What appears to be missing in the studies to date is the recognition that modifications typically occur much sooner in the delinquency cycle than a foreclosure.

Incentive Payments

One of the key benefits of government loss mitigation and modification programs is the payment of incentive payments. HAMP provides servicers with a $1,000 incentive payment for completing a HAMP modification and an annual "pay for success" fee for a period of three years if the borrower remains current.

The "pay for success" fee is the lesser of $1,000 or one-half of the reduction in the borrower's annualized monthly payment. HAMP also provides a $500 incentive for modifying an imminent default (current) borrower. The GSEs, FHA and VA also provide incentives for successfully modifying a loan (or performing other loss mitigation actions). Proprietary modifications arranged in PLS generally do not provide for incentive payments to complete loss mitigation. As a result, servicers are incented to offer borrowers HAMP modifications because of the significant servicer incentive fees.

Balance Sheet Impact — Servicing Asset

A key economic factor in favor of loss mitigation and modifications is that the fair market value of the servicing asset is preserved if the loan cures. Servicers are required to write-off the value of the servicing asset upon completion of foreclosure. Servicing is usually purchased for or valued at (thus reflected on the balance sheet) a range of values depending on the characteristics and note rate compared to current market note rates. Typically this could range from a multiple of 2.5–4 times the annual servicing fee. A modification preserves the servicing asset to the extent it remains current.

Late fees

Many of the studies to date do not accurately state servicing practices with regard to late fees. Accordingly, it is important to point out these key servicing practices:

1. Late fees are waived on HAMP modifications.
2. Late fees are often waived in non-HAMP (proprietary) modifications.
3. Late fees are not usually capitalized or added to the principal balance of the loan in a modification.
4. Late fees, if not waived, remain as an assessed fee on the account (not capitalized), meaning they are not added to the loan balance, do not impact the amount of interest accrued and can only be collected when the loan pays off voluntarily in the future.
5. The Federal Trade Commission and Federal Reserve rules, prohibit the pyramiding of late fees, which means a borrower's non-payment of a late fee cannot create a late payment. Borrowers often wait until pay-off (many years in the future) to pay late fees.
6. Interest is not charged on late fees.
7. Late fees are not reimbursed in foreclosure.
8. Some PLS PSAs require pass through of the late fees to the trust.

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Late fees, therefore, do not drive foreclosure or loss mitigation. While there is some minor benefit of reinstating the loan if late fees are assessed on the account, the fact that late fees are not collected for many years and are limited in amount, do not contribute significantly to a servicer's incentive to modify or foreclose.

Third-party fees

Typical third-party fees include foreclosure attorneys fees, bankruptcy attorneys fees, inspections fees, property preservation costs, foreclosure filing fees, sheriff fees, title fees (to identify interested parties per state law) and property valuation fees (to determine bid price).

Fees paid to third parties for the performance of a variety of functions are reimbursed from the trust on PLS in theory at 100 percent. Third-party fees exclude late fees. The timing of reimbursement of third party fees is the same as for reimbursement of PITI advances, meaning if the loan goes to foreclosure, these fees are not reimbursed until the REO property is sold in the case of PLS. The servicer incurs the interest/carry cost of paying for third-party costs for the number of months the loan is delinquent and in REO status. Moreover, the longer the loan remains delinquent the more events occur that require third-parties (e.g. initiation of foreclosure, title abstract, BPO, recurring preservation costs, etc.) and their related costs.

If the loan self cures or cures through modification, these third-party fees cease and the servicer is able to get reimbursed shortly after reinstatement through execution of the modification — rather than waiting until foreclosure and sale of REO. These fees are capitalized into the mortgage balance, and the trust refunds the amounts paid by the servicer. The servicer would like to avoid paying these third-party charges sooner if not altogether. A modification can achieve this objective because a modification can occur, if eligible, before the borrower is even delinquent.

While some servicers use affiliated parties to conduct certain activities (such as appraisals), such a practice is not uniform across the industry. Such activity is permissible and legal.

Loss of Float

The servicer earns the benefit of float on remittance funds held for investors and tax and insurance escrow funds. While that float has diminished over the years as a result of technology and because of a sustained period of relatively low interest rates, servicers do continue to benefit from float. The float period for remittance funds varies. When the loan is delinquent the servicers cannot earn float because the borrower has not remitted any funds on which to earn float. When a loan reinstates through modification and begins paying, float income returns.

Cost to Service

The servicer incurs general costs to service both a current and delinquent loan. Current loans are much easier to service and thus less costly. Today, servicing fees do not increase if the loan becomes delinquent, however most government programs provide for incentive payments for successful loss mitigation. Needless to say, by the time the borrower has reached foreclosure, servicers have made numerous efforts to contact the borrower and provide loss mitigation. As a result, the cost of the foreclosed borrower is far higher in terms of total staffing costs than a borrower who does not reach foreclosure, but self cures or cures through a modification or some other loss mitigation alternative.

For more information see Appendix C, *Myths About Servicer Incentives*.

Dual Tracking

Consumer groups continue to advocate for the elimination of so-called "dual tracking." Dual tracking occurs when the servicer continues intermediate foreclosure processes while discussions regarding loss mitigation are underway. Interim foreclosure processes, such as publications, notices, hearings and the like are required by state law or the courts, and would continue during this evaluation process to avoid unnecessarily delaying foreclosure should the borrower not qualify. It is important to realize, however, that servicers will not go to foreclosure sale (e.g. the borrower will not lose the house) if the borrower has provided a complete application package sufficient to evaluate the borrower for loss mitigation and provided such information is given in a reasonable time before the foreclosure sale date.

Successful loss mitigation, however, requires diligence and priority on the part of the homeowner. Homeowners should submit full application packages as soon as possible and prior to initiation of foreclosure. Moreover, servicers should not be expected to stop foreclosure processes or even a foreclosure sale if the borrower waits until the last minute (such as a week before the foreclosure sale) to request assistance. Some courts do not allow a foreclosure sale to be stopped within 7-10 days of the foreclosure sale date.

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The halting of the foreclosure process is difficult due to investor and state timelines. Fannie Mae, Freddie Mac, FHA and VA all require servicers to meet various foreclosure timelines. Failure to meet these timelines, without a granted waiver, results in penalties to the servicer. For example, FHA requires that servicers initiate foreclosure within six months of the date of default. Failure to meet this strict deadline, without a waiver, means the servicer does not get reimbursed for much of its interest claim.

Moreover, state law often provides that various steps must occur at specific times or costly steps, such as newspaper publication, must be restarted at significant cost to the GSEs, government agencies and ultimately taxpayers in the case of government programs. As stated previously, some courts prevent the servicer from postponing the foreclosure sale date more than once or within 7-10 days of a scheduled foreclosure sale.

Delays have significant monetary impact on investors and servicers. Delays extend the period of necessary advances a servicer must pay, increases costs to government agencies due to additional claim filings for those advances and additional property preservation costs. Moreover, delays in foreclosure can result in the loss of equity in the property if market values are declining. Loss mitigation should be allowed to continue during the foreclosure process. Ironically, once a foreclosure proceeding begins, servicers frequently find a borrower is more likely to respond to correspondence concerning their home. A delay by the borrower in seeking assistance, however, should not be at the expense of the investor or servicer.

Single Point of Contact

Many regulators and consumer advocates are promoting a single point of contact to simplify communications between consumers and servicers during the loss mitigation process. The Council supports clear and helpful communication with the borrower. However, the Council is concerned that a single point of contact may have unintended consequences, potentially leaving consumers more frustrated and with greater delays. There is no unified definition of "single point of contact." A plain English definition would imply that a single person would be assigned to each borrower and that the borrower would communicate only with this person. This is not feasible in the current environment and would create numerous problems as servicer call volumes fluctuate significantly throughout the day, week and month.

First, a single point of contact eliminates the specialty training necessary to deliver accurate and timely assistance to borrowers, given that borrower assistance may range from questions regarding payment history or escrow processes to modifications, forbearances, short sales, deeds in lieu of foreclosure, or foreclosure. A single person cannot be expert in each of these highly complex and regulated areas. The result will be delays, miscommunication and errors.

Second, given the current environment, it will be impossible to have appropriate staff to meet fluctuating demand. By the sheer reality of the situation, borrowers may be subject to significant delays and longer response times if limited to one individual. Even if the borrower is able to talk to other knowledgeable team members, the Council is concerned that the borrower will decline and request a return phone call from the single point of contact. The borrower will suffer delays and frustration with regard to his or her issue.

Third, a single point of contact raises concerns regarding staff departures, work schedules, business travel, vacations, illness, etc.

The reality is a single point of contact can never be truly a single person. In its purest sense a single point of contact disrupts a servicer's efforts to provide the best service in a specific area of expertise. Borrowers must have the ability to communicate with other staff familiar with the borrower's account, and servicers must have the flexibility to structure staff the best way to achieve the principle of superior customer service.

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IX. Issues for Further Study and Development of Principles and Policy

In analyzing the issues that surfaced during the Summit, the Council identified three major areas for further study and development of policy recommendations.

- **National Servicing Standards** — Review of existing servicing standards and practices especially in the area of dealing with large volumes of non-performing loans, foreclosure practices and loss mitigation practices, including loan modifications. The Council formed a working group called the National Servicing Standards Working Group to study and make policy recommendations related to a national servicing standard. This group is focusing on standards related to NPL servicing including loss mitigation, loan modification processes, the feasibility of single point of contact for borrowers in default, and the feasibility of pausing foreclosure during loss mitigation. This working group consists of members of MBA's existing Loan Administration Committee working with representatives from the Council.
- **Legal Issues** — Legal issues related to the foreclosure process, chain of assignments and endorsements and other issues. The Council formed a working group called the Legal Issues Working Group to study and make policy recommendations related to legal issues surfaced during the Summit and any additional statutory or regulatory changes deemed appropriate for servicing in the 21st century. This group consists of industry attorneys on MBA's existing Legal Issues Committee, the Council, and within MBA's policy staff.
- **Economics of Servicing** — Analysis of proposed changes in servicer compensation proposed by the FHFA, Ginnie Mae, Fannie Mae and Freddie Mac. MBA formed a group called the Economics of Servicing Working Group to analyze the proposed compensation structure from the vantage of various stakeholders including large and small servicers, depository and non-depository servicers. This working group consists of volunteers from the Council along with other volunteers serving as experts on standing MBA committees. The work group brings together secondary marketing experts, servicing asset specialists, industry accounting and tax experts, and servicing executives from companies representing small and large servicers, depository companies and non-depository servicers, and specialty servicers.

Each of the working groups intends to publish deliverables that will convey their findings and policy recommendations.

MBA's Council notes that numerous stakeholders have put forth their respective versions of a national servicing standard, and various consumer attorneys have put forth their respective opinions on some of the key legal issues. Further, FHFA, Fannie Mae, Freddie Mac and Ginnie Mae have made public their proposals for servicing fee structure changes. MBA asks that these constituents allow the Council the opportunity and sufficient time to complete its studies of the issues so that these potentially sweeping changes to the servicing industry and landscape are fully vetted.

The Council looks forward to working with consumer groups, regulators, and secondary marketing and servicing market participants to improve the future of the servicing industry so that servicers can continue to fulfill their contractual duties to mortgage and MBS investors while also serving consumers in a responsive and compassionate manner.

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Appendix A: A Primer on Servicing

Introduction

When a borrower gets a mortgage, there might be an assumption that the lender will hold the loan and handle the collection of borrower payments and other administrative matters. In reality, the lender now has two different assets that can be transferred and sold: the loan itself (often sold in the secondary market through the GSEs, Ginnie Mae or private conduits) and the rights to service the loan (mortgage servicing rights or MSRs). In many cases, the entity that owns the loan is not the entity that services the loan.

Mortgage servicers are responsible for the day-to-day management of the loan and administer the loan until it is either paid off or transferred to another servicer. Major duties include collecting and crediting borrower monthly loan payments, operating a call center to answer borrower inquiries, remitting payments to investors, administering escrow accounts, and handling collection and loss mitigation activities in the event of borrower default. Mortgage servicers may hold the MSRs but subcontract out the servicing function or portions of the servicing function to an outsource provider, a "subservicer," or in the case of default, a "special servicer."

Loan servicers are governed by investor guidelines; state, federal and local laws; insurers and guarantor requirements, borrower expectations and their own standards. The loan servicer must be adept at organizing and executing the numerous details involved in the life cycle of a loan. Note that loan servicers may service for many different investors such as Fannie Mae, Freddie Mac, Ginnie Mae, private investors and their own company. The same can be said for different localities and states, and private mortgage insurers.

The Evolution of Loan Servicing

Fifty years ago, loan servicing was a back-office function often performed by the company that originated the loan to the borrower. But with the advent of the secondary mortgage market, the growth of the role of Fannie Mae and Freddie Mac, and the proliferation of different mortgage products particularly in the 1990s and early 2000s, the loan servicing operation became a more complex array of functions.

Accounting rules also changed and mortgage servicing rights, once considered a natural hedge to production operations and required to be capitalized on the balance sheet only when they were acquired from an outside third party, were required to be recorded on the balance sheet at allocated cost or fair value, at the servicer's option. MSRs are likened to an "IO strip with operating risks and expenses." Accordingly, their value fluctuates as interest rates change and prepayment speeds increase or decrease. Due to this MSR volatility, many servicers implemented complex hedging programs over the past 15 years.

Loan servicing further evolved when the biggest credit crisis since the Great Depression hit in 2007 and continues into 2011. During this period, mortgage defaults soared and more demands were placed on servicers by investors, borrowers, consumer groups, agencies, local and state governments, and politicians, among many other stakeholders. Sometimes, these demands conflicted and servicers struggled to balance contractual duties to investors with borrower and policymaker expectations. Servicers also struggled with right-sizing their loss mitigation and other default functions to accommodate the deluge of defaults. Servicers continue to struggle with meeting these unprecedented challenges today, and have experienced reputational, legal and other risks as they work with stakeholders to clearly define their responsibilities.

The Major Functions of Loan Administration

The issue of specific national standards for servicing is currently being debated. Nonetheless, there are major functional areas of servicing that are relevant to most pooling and servicing agreements as well as current agency guidelines. The major functions that together contribute to the "direct cost to service" are outlined below.

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Customer Service — Includes activities associated with customer inquiry — whether verbal (via customer call center), written or web-generated. Other duties include year-end processing, customer statements, updating customer records, ARM recalibration research and handling assumption or non-default related modification requests.

Escrow — Includes activities associated with escrow analysis and payments associated with real estate taxes and insurance. Escrow analysis includes analyzing the borrower's escrow account to ensure that the payment is sufficient to pay all escrow items and handling escrow refunds. The tax function includes tax payments from escrow accounts, tax search for non-escrow accounts, tax service maintenance (check tax service reports, reconcile bills, and request payment), special assessments, and research. The insurance function includes insurance payments from escrow accounts, reviews for coverage on non-escrow accounts, force placing insurance when necessary, insurance claim processing, mail processing and research. The types of insurance include hazard insurance, mortgage insurance (FHA, Private Mortgage Insurance, Veterans Administration), optional insurance (life insurance, disability insurance, and other employee related expenses), flood insurance and blanket fire insurance.

Default — Includes collections, loss mitigation, foreclosures, bankruptcy and real estate owned functions required under servicing agreements. Collections involve following investor guidelines and internal guidelines to cure defaults in order to maintain low delinquency rates. The servicer also provides reports to agencies and investors related to delinquent loans. Loss mitigation involves efforts to mitigate losses through a workout program or alternatives to foreclosure (forbearance, modification, deed-in-lieu, short sale) when appropriate. The foreclosure function involves following state law (whether judicial or non-judicial proceedings) and also following procedures dictated by the type of loan (i.e. FHA, VA, conventional). It also includes all claims processing. The bankruptcy function involves protecting the loan asset by monitoring bankruptcy actions, ensuring compliance with federal bankruptcy code, and ensuring property preservation of the property involved in the bankruptcy action. The real estate owned function involves post-foreclosure sale activities, conveyance, property preservation and property management if required as part of the servicing agreement with the investor.

New Loan Set Up and Transfers — Includes boarding new loans on the servicing system and non-payoff-related transfers out, such as transfers of a subservicing portfolio or servicing rights sale.

Payoffs — Include activities associated with payoffs and lien releases. This would include all of the activities relating to discharge, satisfaction and / or reconveyance of the mortgage / deed-of-trust upon payment in full of the mortgage loan.

Investor Reporting — Includes accurately accounting for, reporting and remitting the payments to end investors, including reconciliation of all custodial accounts.

Cashiering — Includes receiving and posting payments (on-site, on-line, ACH and lockbox), ensuring accurate application of the payments to the customers' accounts, the end investors' accounts, and the company's corporate accounts. Cashiering also includes payment processing for payoffs, daily system balancing, custodial accounting and research.

Servicing Technology — Includes personnel and all technology directly related to servicing, such as service bureau, vendor supported or proprietary systems.

Administration — Includes management and administrative staff who oversee the operations of the entire servicing department; record retention and retrieval; bulk sales and acquisitions; MSR risk management; maintaining servicing policies and procedures; servicing compliance; and servicing performance measurement and strategy functions.

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Appendix B: Trends in Servicing Revenues and Expenses

The following provides a "deeper dive" into the trends of servicing revenues and expenses in recent years.

Servicing Revenues. Servicing revenues, averaging 36–43 basis points for large prime servicers and 31–39 basis points for small prime servicers during 2003–2010, are comprised of:

- **Servicing and Subservicing Fees,** include excess servicing and are net of guarantee fees passed-through to Fannie Mae, Freddie Mac, Ginnie Mae and/or a private conduit. In general, servicing fees are about 25 basis points for prime fixed, 37.5 basis points for prime adjustable, 44 basis points for government loans (19 basis points for the Ginnie II program) and 50 basis points for subprime loans. From 2006–2010, net servicing fees have declined. Contributing factors may include longer foreclosure timelines (during which agency servicers do not receive a service fee), and changes in guarantee fees and uncollectable excess servicing (any amounts of interest received by the servicer in excess of "normal" servicing fee). Subservicing fees include those fees, usually in the form of a fixed dollar amount per loan per month, collected by a servicer who handles the servicing operations functions but does not own or manage the servicing asset.
- **Ancillary Income,** the majority of which are late fees, loss mitigation incentive payments, quick pay or speed pay charges and not sufficient funds (NSF) charges. Other types of ancillary income are payoff statement charges, fax charges, insurance commissions, biweekly payment fees, advertising supplement fees and modification fees. During 2003–2010, ancillary fees were generally in the range of 3–6 basis points for prime servicers.
- **Interest Earnings** on principal and interest (P&I) and taxes and insurance (T&I) held in escrow prior to remittances to investors. Also during the period 2003–2010, escrow earnings ranged from less than one basis point to as high as seven basis points.

  From 2007–2010, escrow earnings have continued to decline as the results of low short-term interest rates, higher delinquency rates on borrower payments and declining industry-wide mortgage debt outstanding in recent years. In fact, the decline in interest revenues was the key driver of net interest losses in servicing. Based on MBA data, net escrow earnings (interest revenues less interest expense) were negative during the past three years among the large prime servicers despite declines in interest expense in basis points.

Servicing Costs

Servicing costs include more than simply the direct cost to service. Fully-loaded total servicing costs averaged 12-18 basis points for large prime servicers and 15–21 basis points for small prime servicers during 2003–2010. The key components of the total servicing costs include:

- **Direct Servicing Costs.** These include the personnel, occupancy and equipment, outsourcing and other miscellaneous expenses associated with servicing a loan and include performing the servicing duties stipulated in servicer guides or pooling and servicing agreements (PSAs) and in accordance with federal and state law. The following functional areas of servicing are covered in direct cost to service: customer service, set-ups and transfers, lien releases, servicing systems, default (collection, loss mitigation, bankruptcy and certain foreclosure and REO functions), escrow, investor reporting and accounting, cashiering and servicing administration. During the eight-year period 2003–2010, direct servicing costs generally averaged between 5–8 basis points for large prime servicers and 12–17 basis points for small prime servicers. Higher direct cost to service and lower productivity (loans serviced per servicing employee) from 2007–2010 is a function of higher default rates and evolving servicer responsibilities driven by changing expectations of borrowers, regulators, investors and other stakeholders.

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- **Unreimbursed Foreclosure and REO-related Expenses.** During the foreclosure process, certain default-related types of fees are incurred by the servicer and often are reimbursed by the investor. Generally, reimbursable expenses include attorney fees, foreclosure costs and expenses (eviction costs, posting costs, certified mail, recordation etc), tax and insurance advances, utility payments and property preservation and inspection fees. Servicers submit a request for reimbursement from the investor. For example, Fannie Mae's Cash Disbursement Request (Form 571) outlines the types of reimbursable expenses.

However, depending on the loan type and any perceived servicer errors, such costs might not be reimbursed and would thus affect a servicer's net operating income. The most common issues:

1. **Servicer Error:** Claimable (with third party investor) but unreimbursed expenses due to servicer error, such as interest loss / penalties due to missed investor deadlines or other penalties due to non-compliance with investor requirements.
2. **Property Preservation and Inspection Costs, Add-Ons:** These include unclaimable (and unreimbursed) non-personnel expenses that the servicer deems prudent to perform but that are not reimbursed by investors. Such add-on expenses may include additional third-party inspections or property preservation work beyond the scope of the servicing agreement.
3. **Other:** Other unreimbursed costs that generally are mortgage-product specific, such as one-third of attorney fees, interest advances and other default-related expenses for FHA loans, and losses from VA Buydowns, VA No Bids and Non Conveyance of HUD loans.

Unreimbursed foreclosure and REO-related expenses have ranged from less than half a basis points to 1.5 basis points more recently.

Corporate Allocation

Another expense that needs to be incorporated into total servicing costs is corporate allocation for human resources, legal, company-wide technology support, corporate finance and treasury, and executive management. Corporate costs have historically added 1-2.5 basis points to the total cost of servicing from 2003-2010. The corporate load factor (corporate costs per servicing employee) generally ranges from $20,000 to $30,000 per servicing employee among large prime servicers in the current servicing environment.

Interest Expense

There are five types of non-recoverable interest expense that servicers incur:

1. Interest expense on advances of principal and interest and taxes and insurance.
2. Interest expense on advances related to foreclosure and property preservation.
3. Interest expense on MBS prepayments, also referred as compensating interest. In the event that there is an interest shortfall resulting from a borrowers' prepayment date and the date that security holders are paid, the servicer picks up the cost.
4. Interest expense on assets, which includes interest expense to fund the servicing asset and other fixed assets.
5. Escrow expense or interest paid to borrowers in states that require it.

For the period 2003-2010, interest expense ranged from 4-8 basis points. In recent years, advances related to principal and interest payments as well as other default-related advances has increased but servicers have been helped by low short-term interest rates that kept down the cost of funding such advances.

MSR-Related Gains and Losses

Servicing net operating income is defined as total revenues less total servicing expenses (earlier outlined). From 2003 to 2010, large prime servicers' net operating income ranged from 22-30 basis points, while small prime servicers' net operating income ranged from 16-19 basis points for the same period.

But net operating income only provides half the story. Under the current fair value accounting rules, mortgage companies that own mortgage servicing right assets (MSRs) are required to adjust earnings to account for changes in the value of MSRs. In addition, servicers must report the amortization (or time decay) for these assets. Thus, we introduce the most volatile portion of a servicer's income statement: MSR-Related Net Losses.

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Valuation of MSRs is complex, and has a subjective component due to necessary assumptions used in valuation models and therefore a Level III asset under the accounting rules for fair value. These assumptions may vary by company and valuation firm, but generally speaking, asset valuation incorporates factors such as projected prepayment speeds, default rates, contingent liability for indemnifications, repurchases and / or mortgage insurance rescissions, and customer cross-sell, among others. MSR net losses not only include MSR amortization and the gain / loss on the valuations of MSRs, but the gain / loss on MSR hedging instruments and gain / loss on the bulk sale of MSRs. Overall, MSR *net losses* for 2003–2010 ranged from 9–34 basis points for large prime servicers and 12–26 basis points for small prime servicers. The highest losses were experienced among the largest servicers during the 2003 refinancing boom. Since then, complex hedging instruments were put in place in an attempt to reduce volatility and net losses have not been as severe during the more recent refinancing periods. Once the MSR-related items are taken into account, we arrive at pre-tax net servicing financial income. During 2003–2010, net servicing financial income has ranged from a loss of 9 basis points to a gain of 13 basis points for large prime servicers and a loss of 9 basis points to a gain of 5 basis points for small prime servicers.

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Appendix C: Myths about Servicer Incentives

During MBA's Summit, it became apparent that that regulators and consumer advocates make certain claims regarding the servicing business that the industry views as "myths." The following dispels those myths.

Dispelling the Myths about Servicer Incentives to Foreclose over Performing Loss Mitigation

Myth	Response
Servicers refuse to grant loan modifications	The HOPE NOW Alliance shows that modifications continue at a substantial pace. Below are key data from HOPE NOW's year end 2010 report: • Servicers completed nearly 1.76 million modifications in 2010 versus 1.07 completed foreclosure sales • Since July 2007, servicers have completed just under four and a half million modifications. • Loan modifications with reduced principal and interest payments accounted for approximately 81% (one million) of all proprietary modifications. • Modifications with initial fixed period of five years or more accounted for 84% (609,000) of all proprietary modifications.
Servicers, unlike homeowners and investors, do not generally lose money on a foreclosure.	Servicers lose money due to: • The loss of servicing income. In the event of foreclosure, Fannie Mae (FNMA), Freddie Mac (FHLMC), Federal Housing Administration (FHA) do not reimburse or otherwise pay the servicing fee that is not collected when the loan is delinquent. • The loss of the servicing asset, e.g. future income stream (all investor types). • Cost of advancing principal, interest, tax and insurance (PITI), foreclosure and property preservation costs (all investor types). • Non-recovery of interest advanced (FHA). • Non-recovery of foreclosure attorney fees advanced (FHA only reimburses 2/3 attorney fees). • Risk of principal loss due to investor put-backs or denied MI claims even when loans were underwritten to their standards (FNMA, FHLMC, FHA, PLS). • Unreimbursed property preservations costs or inability to convey properties (FNMA, FHLMC, FHA). • Credit losses (including principal, interest, tax and insurance advances, and loss of fees paid to third parties) exceeding amount of Department of Veterans Affairs (VA) guarantee. • Unrecoverable non-sufficient funds (NSF) or late fees when there is a foreclosure; investors will not pay them. Recovery of such fees is only possible when there is a third-party foreclosure sale and the full debt is paid, including late fees. • Loss of principal due to decline of property value in the case of bank portfolio loans.

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Dispelling the Myths about Servicer Incentives to Foreclose over Performing Loss Mitigation (Continued)

Myth	Response
Servicers have an incentive to foreclosure because principal, interest, tax and insurance advances will be reimbursed immediately, unlike in a modification.	Servicers are reimbursed advances upon completing a modification (within 1-45 days of execution). Modifications always occur earlier than a foreclosure and thus stop servicers from incurring the costs associated with making advances sooner. Reimbursement of PITI comes from the principal and interest cash flow of the trust. The servicer's reimbursement is at the top of the waterfall, meaning the servicer's advances, which may have been from their own funds, get reimbursed first before bond holders receive any interest or principal payments. The modification brings the loan current, clears the advances, and the servicer no longer advances unless the borrower re-defaults on the modified loan. With respect to private label securities, servicers typically make advances throughout the period of delinquency. Reimbursement for such advances normally occurs subsequent to the foreclosure sale and\or liquidation of the property.
Modifications are expensive for servicers and the reason why servicers do not like to perform them. Modifications incur fixed overhead costs, including staffing and physical infrastructure, technology and out-of-pocket expenses (property valuations, credit reports). Whereas, with a foreclosure, servicers lose no money.	Servicers have costs (overhead) associated with performing loss mitigation; however, similar costs are incurred in managing the foreclosure process. In addition, modifications result in a more timely reimbursement of advances (as referenced above) and the reinstatement of servicing fee revenue from the performing modified loan. Moreover, servicers are compensated for the increased costs of loss mitigation through incentives fees. FNMA, FHLMC, FHA, VA and Home Affordable Modification Program (HAMP) provide incentives for successful loss mitigation. As stated above, servicers lose substantially more money on a foreclosure than a modification. Regardless of the overhead costs for performing loss mitigation, servicers have a contractual obligation to perform loss mitigation according to investor contracts and standards or risk having their servicing terminated.
Servicers have an incentive to push borrowers into delinquency, and delay curing the delinquency, in order to collect late payment fees. The servicer profits more if the loan is late then if the loan is brought current.	The cost to advance principal, interest, tax and insurance and, the hard costs and overhead (staffing, notices, and phone calls) to manage delinquent loans often outweigh the late fees. Also servicers have no ability to control the borrower in such a manner. Rather, servicers make efforts to avoid delinquencies by offering a grace period after the due date for borrowers to make their monthly payments. Servicers also employ "effective date" crediting to ensure that a payment received in the lock-box (by the cut-off time) will be credited as of the date of receipt.

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Dispelling the Myths about Servicer Incentives to Foreclose over Performing Loss Mitigation (Continued)

Myth	Response
The servicer may have to waive various fees to achieve a modification, but will always collect them if the loan goes to foreclosure.	Servicers will often waive late fees and NSF fees in order to make a modification or to bring the borrower current. Late fees and NSF fees are generally not collected from the trust or investors upon foreclosure. Servicers, therefore, have no incentive to go to foreclosure in an effort to recover these fees.
Servicers often do not know how to proceed with a modification due to the varying interests of bond holders in different tranches.	Bond holders in different tranches do have different interests. Some would benefit from faster foreclosures. Others would benefit from a longer timeline. Regardless, most contracts with investors provide that servicers must take actions that are expected to yield the greatest net recovery for the trust not individual security holders.
Servicers do not want to reduce principal because they suffer a reduction in servicing income	The decision to reduce principal is at the sole discretion of the investor. To date, FNMA, FHLMC and FHA do not permit principal write downs. It may not be in the interest of investors (using a net present value test) to permanently reduce principal to achieve the same affordability as a reduction in rate, a principal deferral, or extension of term. In the latter cases, affordability is provided without a permanent impairment to the asset. Servicers do not make the decision to offer principal reduction modifications.
Servicers benefit from holding a partial payment in a suspense account because the delinquent payment accrues interest.	Although a borrower is contractually obligated to pay a late fee for being delinquent, *the delinquent payment does not accrue interest*. Rather the interest due remains the same regardless of when it is paid. To illustrate, if a borrower makes one payment after 90 days of delinquency, that payment is applied to the oldest payment outstanding. The amount of interest paid on that payment is the same as if it was paid on time. Proposals to apply partial payments would change the contractual terms of the mortgage and note which is not permitted. The result would cause balloon payments, challenges to acceleration and enforcement of the mortgage, technical defaults under the mortgage contract, and a change in loan type from an amortizing loan to a daily simple interest loan which is not permitted under the mortgage documents.

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PREPARED STATEMENT OF ANTHONY B. SANDERS

PROFESSOR OF FINANCE, GEORGE MASON UNIVERSITY SCHOOL OF MANAGEMENT

MAY 12, 2011

Chairman Menendez, Ranking Member DeMint, and distinguished Members of the Subcommittee, thank you for inviting me to testify today. I have been asked to offer opinions on "The Need for National Mortgage Servicing Standards".

The recent crash of the housing market and the rise of unemployment led to a historic surge in serious delinquencies and requests for loan modifications, short sales, and related transactions. As a result, the residential mortgage servicing industry was overwhelmed. Going forward, it is helpful to recommend changes to both servicing and securitization industries so that they can avoid problems going forward as we attempt to revive the securitization market.

Servicing Standards

During a December 1, 2010, hearing, Federal Reserve Board Governor Daniel Tarullo stated that "it seems reasonable at least to consider whether a national set of standards for mortgage servicers may be warranted." Although the Government Accounting Office (GAO) has released a report to Congress recommending creation of servicing standards,[1] I agree with the sentiment but disagree with the process.

Pooling and Servicing Agreements

There already exists pooling and servicing agreements (PSAs). The PSA is a legal document that contains the responsibilities and rights of the servicer, the trustee, and other parties concerning a pool of securitized mortgage loans. If the securitization is public, the documents must be filed with the Securities and Exchange Commission.

It has been suggested that PSAs be uniform and I would agree that greater uniformity among PSAs would reduce investor uncertainty. However, rather than having it regulated by the Federal Government, uniformity of PSAs would seem to be a natural evolution demanded by investors in the marketplace.

Broader Servicing Guidelines and Standards

In December, Christopher Whalen, Nouriel Roubini and others wrote a letter to U.S. financial regulators regarding national loan servicing standards.[2] I am one of the signers of the letter, but not because I wanted to have national loan servicing standards created by the Federal government. Rather, I wanted to open a discussion for consideration by servicing companies. Many of the items that were discussed were plausible recommendations.

The private sector is able to adopt guidelines and standards for loan servicing. For example, the Mortgage Bankers Association (MBA) created a task force of key MBA members to examine and issue recommendations for the future of residential mortgage servicing. While it is tempting to have the Federal Government regulate loan servicing, it will be more effective to have an industry group such as MBA provide guidance.

One of the items recommended in the Whalen letter to regulators was:

> As part of your duties under Section 941 of the Dodd-Frank Act, your agencies must develop new standards for the secondary market in mortgage loans. These standards must promote a sustainable securitization market and, in particular, maintain additional "skin in the game" for sellers of loans so the excesses and abuses of the past are not repeated. As part of this effort, you will be defining the criteria for the highest quality residential mortgages, those which do not need risk retention. This new definition for what constitutes a qualified residential mortgage should be the gold standard in all areas of mortgage origination, securitization packaging and servicing, and disclosure.[3]

While I agree with the signers that standards could be advantageous to investors and consumers, we need to be careful about the implementation of standards and rules, such as risk retention, which is also an important part of addressing this

[1] Government Accountability Office, "Mortgage Foreclosures: Documentation Problems Reveal Need for Ongoing Regulatory Oversight", GAO-11-433, May 2011.

[2] "Open Letter to U.S. Regulators Regarding National Loan Servicing Standards", Christopher Whalen, *et al.,* December 21, 2010, *http://www.rcwhalen.com/pdf/SecuritizationStandardsLetter__final__122110.pdf.*

[3] *Ibid.*

issue. Ultimately, servicing inadequacies are part of the problem of origination risk, which I address below.

Risk Retention and Servicing

Dodd-Frank requires that securitizers retain at least 5 percent of the risk in all loans that do not qualify as a Qualified Residential Mortgage (QRM)[4] and are sold into the securitization market. In theory, 5 percent risk retention would lead securitizers to be more careful in the loan origination, underwriting, and servicing process.

To be sure, 5 percent risk retention would be the simplest approach to implement in order to encourage improved loan origination, underwriting, and servicing. Unfortunately, risk retention also appears to be the least useful approach.

First, the house price collapse resulted in house price declines that far exceeded 5 percent; for example, Las Vegas fell 56 percent from peak to trough [*see,* Figure 1 for the collapse of housing prices].[5]

Second, risk retention does not directly address origination risk or servicing risk.[6] Representations and warrants (reps and warranties) that are found in Mortgage Loan Purchase Agreements (MLPA) and related documents are supposed to directly address origination risk. The avalanche of loan repurchase requests in the aftermath of the housing collapse makes reps and warranties less viable for nonagency mortgage-backed securities.

Third, the Federal Housing Administration (FHA), Fannie Mae, and Freddie Mac are exempt from risk retention rules. Exempting these players in the mortgage market defeats the spirit of risk retention since a loan originator will be tempted to sell to or be insured by Fannie Mae, Freddie Mac, and the FHA rather than keep the retained risk. All financial entities should be subject to risk retention or none at all.

Fourth, given Reg AB (Dodd-Frank 942) and the anticipated transparency of the asset-backed securities markets, the retention rule implies that Qualified Institutional Buyers (QIBs) are not sophisticated enough to understand origination risks and need to be protected beyond greater transparency. QIBs (or "sophisticated investors") such as Fannie Mae, Freddie Mac, PIMCO and others do not require the additional security of 5 percent risk retention since they perform substantial due diligence and analysis before purchasing securities. Furthermore, they would have been expected to understand the servicing process and PSAs.

Moreover, it is unclear how risk retention will be implemented (*e.g.,* vertical versus horizontal versus "L" cuts) and if it is even effective in reducing origination risk.

There are more effective alternatives to risk retention: transparency and improved reps and warranties via an origination certificate.

Greater Transparency

One solution to origination risk is to provide greater transparency to investors. Greater transparency would permit more accurate pricing. Greater transparency potentially reduces the asymmetric information between securitizers and investors.

There has already been a movement in the industry toward greater transparency. Prospectuses and Prospectus Supplements for both agency and nonagency mortgage-backed securities provide detailed breakdowns of the underlying loans in terms of critical risk measures such as loan-to-value ratio, loan type, credit score, *etc*. In 2006, Freddie Mac took loan transparency to a new level by providing a file of loan level information.[7] The nonagency market (as well as the FHA) could provide similar loan level disclosure.

I would prefer that the securitizers provide transparency themselves rather than be forced through regulation. Some investors may prefer having less information disclosed which should result in a higher expected yield compared to fully disclosed loan information. Investors should retain the right to choose how much information that they want disclosed by securitizers.

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[4] A qualified residential mortgage (QRM) is one with a 80% loan to value, full documentation, and more traditional underwriting standards. Generally includes the 30 year fixed-rate mortgage and excludes exotic mortgages such as interest-only mortgages.

[5] Free exchange, "Recovery Comes to Las Vegas", *The Economist,* January 26, 2010, *http://www.economist.com/blogs/freeexchange/2010/01/recovery_comes_las_vegas.*

[6] Origination risk refers to the risk of breaches of underwriting standards, misrepresentations, fraud, poor data quality, and legal breaches.

[7] See data reports provided by Freddie Mac and available at: ***http://www.freddiemac.com/mbs/html/data_files_5bd.html.***

But additional loan disclosure is just one prong to providing a better alternative to retained risk. The other is to enact an "origination certificate" approach to reducing securitization risk.

Origination Certificate

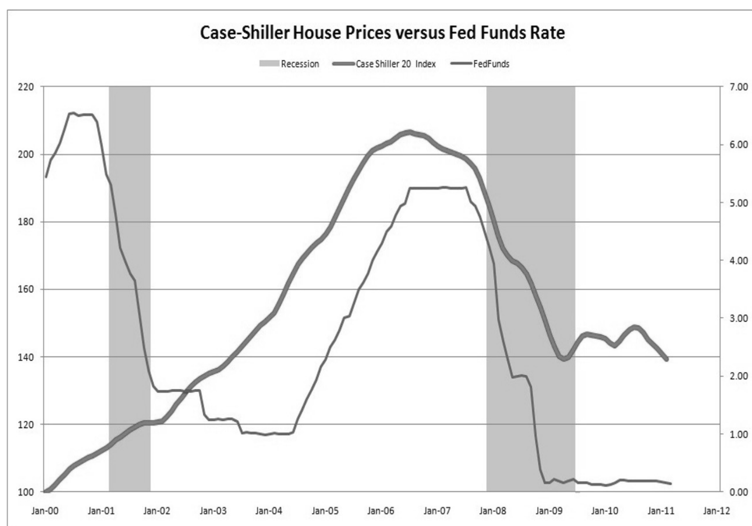
Even though securitizers could release great loan-level information, the market would still be concerned that the information is inaccurate. Furthermore, transparency doesn't address servicing problems. There should be mechanisms to insure that the disclosed information is actually correct and that proper servicing is followed. Andrew Davidson and I proposed a "securitization certificate" in our paper "Securitization After the Fall." [8] In the paper, we write:

> We propose a "securitization certificate" which would travel with the loan and would be accompanied by appropriate assurances of financial responsibility. The certificate would replace representations and warranties, which travel through the chain of buyers and sellers and are often unenforced or weakened by the successive loan transfers. The certificate would also serve to protect borrowers from fraudulent origination practices.

The securitization or origination certificate approach has the potential to be effective because it directly addresses origination risk and contains a fraud penalty. [9] The origination certificate would travel with the loan and would verify that the loan was originated in accordance with law, that the underwriting data was accurate, and that the loan met all required underwriting requirements. This certificate would be backed by a guarantee from the originating firm or other financially responsible firm and would travel with the loan over its life. The seller must provide a means of demonstrating financial responsibility, either via capital or insurance, for the loans to be put into a securitization. There should be a penalty for violations of reps and warrants beyond repurchase obligations and tracking of violations of reps and warrants available to all investors. Furthermore, there could a penalty for violations of the servicing standard adopted by the securitizer.

It is my opinion that risk retention is ineffective at best in solving underwriting and servicing issues. Increased transparency and loan specific origination certification is a more effective way of preventing future problems. And they are best designed and implemented by the private sector and not the Federal Government.

Thank you again for the opportunity to testify. I look forward to your questions.



[8] Andrew Davidson and Anthony B. Sanders, "Securitization After the Fall", Second Annual UCI Mid-Winter Symposium on Urban Research, "Housing After the Fall: Reassessing the Future of the American Dream", February 2009, *http://merage.uci.edu/ResearchAndCenters/CRE/Resources/Documents/Davidson-Sanders.pdf.*

[9] Andrew Davidson and Eknath Belbase, "Origination Risk in the Mortgage Securitization Process: An Analysis of Alternate Policies", *The Pipeline,* Andrew Davidson & Co., 2010.

PREPARED STATEMENT OF RICHARD A. HARPOOTLIAN

ATTORNEY, RICHARD A. HARPOOTLIAN P.A.

MAY 12, 2011

Mr. Chairman and Members of the Committee, I thank you for the invitation to speak on behalf of my clients—Captain Jonathon Rowles of the United States Marine Corps and Sergeant George Holloway of the United States Army Reserve. I represent these fine men and women in uniform along with my cocounsel, William Harvey and Graham Newman.

As the Committee is aware, our law firms have filed a class action complaint against subsidiaries of JPMorgan Chase alleging systematic violations of rights guaranteed to our men and women in uniform under the Servicemembers Civil Relief Act as it pertains to the financing of real estate. I am pleased to report that after intense negotiations we have reached a settlement with JPMorgan Chase and are currently undertaking the process of informing approximately 6,000 men and women in uniform of their entitlement under the settlement. With this case and settlement serving as a backdrop, I would like to discuss three topics: first, the facts and circumstances leading to the JPMorgan Chase litigation and the pending settlement; second, broader problems in the home finance industry revealed by the litigation; and third, suggestions as to how Congress might address these problems.

I. Jonathon Rowles and George Holloway vs. Chase Home Finance, LLC

As I noted earlier, the litigation in which I and my cocounsel are representing Captain Rowles, Sergeant Holloway, and approximately 6,000 military men and women stems from violations of the Servicemembers Civil Relief Act pertaining to home finance. The opening words of the Servicemembers Civil Relief Act establish that the purpose of the law is "to provide for, strengthen, and expedite the national defense through protection extended by this Act to servicemembers of the United States to enable such persons to devote their entire energy to the defense needs of the Nation." The venerable nature of these goals is undeniable. But to truly grasp the importance of the Act to our Nation as a whole, one must examine the history of the legislation through the last two centuries.

a. History of the Servicemembers Civil Relief Act

The roots of the Servicemembers Civil Relief Act lie in the Constitution itself. Article I, Section 8 of the Constitution expressly grants to Congress the authority to build and maintain our Armed Forces in order to guarantee the security of this Nation. With this in mind, as early as the Civil War Congress recognized the need to enact legislation placing certain restrictions on civil actions that would hinder the abilities of an individual soldier or sailor to dedicate all of his efforts to defending this country. In 1917, as the United States became embroiled in World War I, our Government employed the services of Major John Wigmore—then Dean of the Northwestern University Law School and author of the famous treatise Wigmore on Evidence—to draft the first modern version of the SCRA, then known as the "Soldiers' and Sailors' Civil Relief Act." This Act instituted many of the regulations that are central features of the modern law, including a stay of civil actions and a prohibition of foreclosures upon the homes of those on active duty.

Major Wigmore's Soldiers' and Sailors' Civil Relief Act expired 6 months after the end of World War I due to a sunset provision included in the law. Thus, in 1940, as conflicts throughout the globe again escalated into World War, Congress reenacted Major Wigmore's bill with some amendments. At the time, Congressman Overton Brooks of Louisiana reiterated the vital role the Act played in preserving the Nation's defense and recognized the concerns the Act was intended to address.

> This bill springs from the desire of the people of the United States to make sure as far as possible that men in service are not placed at a civil disadvantage during their absence. It springs from the inability of men who are in service to properly manage their normal business affairs while away. It likewise arises from the differences in pay which a soldier receives and what the same man normally earns in civil life.

The Soldiers' and Sailors' Civil Relief Act has been in effect since it was reenacted by Congressman Brooks and others in 1940.

In April of 2003, as Operation Enduring Freedom in Afghanistan progressed, the 108th Congress styled a complete restatement of the Act. The bill received broad bipartisan support in the House Committee on Veterans' Affairs, boasting as its sponsors then-Chairman Christopher Smith of New Jersey and Ranking Member Lane Evans of Illinois. In its Report to the House, the Committee expressly noted the following:

> Congress has long recognized that the men and women of our military services should have civil legal protections so they can "devote their entire energy to the defense needs of the Nation." With hundreds of thousands of servicemembers fighting in the war on terrorism and the war in Iraq, many of them mobilized from the reserve components, the Committee believes the Soldiers' and Sailors' Civil Relief Act (SSCRA) should be restated and strengthened to ensure that its protections meet their needs in the 21st century.

Among the protections recognized as necessary in modern society were three rights directly implicated in the pending litigation involving my clients: (1) a 6 percent cap of interest chargeable on debts incurred prior to military service; (2) a prohibition of derogatory reports to credit agencies due to eligibility of SCRA protection; and (3) limitations upon the ability to foreclose upon servicemembers' homes.

Once favorably reported to the House, the bill gained thirty-nine (39) cosponsors from both parties and was passed by the full House by 425–0. The Senate passed similar legislation with the leadership of Senator Lindsey Graham from my home State of South Carolina and the differences between the two bills were negotiated without need of a conference committee. On December 19, 2003, President George W. Bush signed into law the now-restyled "Servicemembers Civil Relief Act."

b. Experiences of Captain Rowles and Sergeant Holloway

The litigation in which we are involved began after Jonathon Rowles and his wife, Julia, endured several years of frustration regarding their home mortgage with Chase Home Finance, LLC. Our law firms filed this lawsuit on behalf of Captain Rowles in July of 2011. Over the past several months, we have been contacted by numerous military personnel who have experienced similar denials of SCRA protection from Chase's subsidiaries. Last month, we filed an amended complaint, adding allegations on behalf of Sergeant Holloway.

Our research revealed what we believed to be systematic failures in the maintenance of SCRA protections pertaining to three classes of military men and women: (1) those denied the 6 percent maximum interest rate on debts incurred prior to military service; (2) those who received a blighted credit report as the result of their invocation of SCRA protection; and (3) those whose homes were foreclosed upon despite SCRA protection.

A review of the basic facts pertaining to each plaintiff is helpful in explaining how these violations came about.

In February of 2004, the Jonathon and Julia Rowles entered into a purchase money mortgage with BNC Mortgage, Inc. In May of 2004, Chase Manhattan Mortgage Corporation purchased this loan and, from that point in time, the Rowleses made all payments to Chase. After a year of making payments on this mortgage, Jonathon Rowles executed a United States Marine Corps Reserve contract on August 16, 2005, and received Assignment to Active Duty Orders which became effective on January 22, 2006. Shortly thereafter, Rowles requested in writing that Chase reduce the interest rate on the loan to 6 percent pursuant to the SCRA. In this letter, Rowles specified January 22, 2006, as the date he entered active duty and produced two sets of orders to verify his current status. Again on May 2, 2006, Rowles wrote to Chase to request the 6 percent rate protection under the SCRA. This letter also specified Rowles' active duty date and included additional copies of his orders and a copy of his previous letter.

On May 8, 2006, in response to this series of correspondence, Chase requested that Rowles provide "orders and/or an enlistment agreement showing the date of original call to duty." Again Rowles sent faxes to Chase customer service representatives that included handwritten cover sheets explaining his active duty orders as well as copies of his letters of April 14 and May 2. In a letter dated July 27, 2006—seven months after Rowles received his active duty orders—Chase informed Rowles that because he had qualified for the protection of the SCRA, the company had adjusted the interest rate on the loan to 6 percent effective with his May 1, 2006, payment. However, Chase failed to apply the statutory interest rate to the loan until August 17, 2006, which was the date of the first statement received by Rowles that reflected the 6 percent rate.

The July 27 letter also informed Rowles that his "loan is protected against late fees, adverse credit reporting, and default activities. These protections will remain in effect for 90 days following your return from active duty."

Though Rowles' SCRA protection had been in place for less than 4 months, Chase mailed Rowles a letter on December 1, 2007, which it characterized as a "required quarterly verification." The letter included a form which Rowles was instructed to complete and sign in order to continue to receive the protection of the SCRA. Rowles duly completed the form and returned the letter to Chase. Chase sent additional

verification letters on December 17, 2008, March 25, June 22, and December 29 of 2009, and March 22, 2010. In addition to the periodic verification letters, no fewer than four times per year since July of 2006, Rowles has had to call various Chase customer service representatives after being verbally informed or receiving documentation indicating that the interest rate on the loan was going to be adjusted above 6 percent if he failed to do so. In March of 2008, Rowles was forced to request that his commanding officer at Training Squadron Eighty-Six in Pensacola, Florida, write to Chase on his behalf in order to confirm that he was in fact an active duty Marine.

In a letter dated January 16, 2007, Chase again informed Rowles that he had qualified for the protection of the SCRA and that the company had accordingly extended the adjustment on the 6 percent interest rate effective February 1, 2007. On April 2, 2008, Chase informed Rowles in writing that the company was "in receipt" of his "request for relief" under the SCRA and that he should allow three to four weeks for review of the request. A subsequent letter dated April 25, 2008, again informed him that his rate adjustment would be extended effective October 1, 2008.

From the time that Chase applied the 6 percent interest rate to the loan until April 2009, Chase would send loan statements to the Rowles family indicating the interest rate charged on their loan was, in fact, substantially above 6 percent. On information and belief, during this time Chase would use various formulas and accounting methods to reconcile the higher stated interest rates while effectively only charging Rowles at 6 percent.

This pattern of conduct by Chase caused Rowles to spend considerable time communicating with Chase via telephone, e-mail, and written correspondence. This time included leave from his unit which was spent traveling to meet with Chase representatives in an effort to preserve his 6 percent interest rate under the SCRA and to prevent Chase from taking threatened actions which are unlawful under the SCRA. Finally, in June of 2010, Chase denied Rowles electronic access to his account. Thereafter Rowles brought this suit.

The circumstances giving rise to Sergeant Holloway's allegations are much more brief, but gave rise to an injury perhaps worse than that of Captain Rowles and his family. On March 30, 2000, Holloway purchased a house located in Fountain Inn, South Carolina. At the time of the purchase, Plaintiff Holloway was not on active duty. The purchase was financed by NVR Mortgage Finance, but the loan was thereafter transferred to Chase for servicing. In 2008, Chase initiated foreclosure proceedings against Holloway's home which resulted in a foreclosure sale on May 4, 2009. Holloway was serving on active duty at the time of the sale. Today Sergeant Holloway is serving with the Army Reserve in the Afghanistan theater. His mail is addressed to his parents' home.

c. Details of the Proposed JPMorgan Chase Settlement

After Captain Rowles brought to light the potential systematic failure of internal SCRA procedures at JPMorgan Chase, Chase began an extensive internal review to determine the extent of the mistakes made. That review, combined with the efforts of Captain Rowles and Sergeant Holloway, has resulted in a settlement that was reached after several months of intense negotiations that were supervised by a retired Federal judge.

While this settlement is awaiting final approval of the District Court—the hearing of which has been scheduled for November 15, 2011—the details of the proposal have been made public. In sum, Captain Rowles, Sergeant Holloway, and Chase have agreed to a benefits package amounting to $48 million of relief to the military men and women who were denied SCRA benefits. This figure amounts to an estimated six times the actual damages suffered by the class members, including refunds of overcharges, full remediation of damage to credit, and remediation of all foreclosure actions.

To its credit, JPMorgan Chase has begun instituting many of these reforms even prior to the final approval of the settlement. Chase has also asked Captain Rowles to serve as an informal advisor to several of its senior officers, providing the company with a "boots on the ground" perspective of how its policies affect our men and women in the military.

II. Systematic Problems Revealed by the Rowles Litigation

The immediate effect of SCRA violations on our military men and women are obvious. Unlawful foreclosures force families from their homes. Derogatory reports to credit agencies damage the ability of our soldiers and sailors to enter into future financial agreement. Excessive charges of interest demand monies which are not owed.

Perhaps more damaging than these immediate effects, however, is the financial stress endured by military families while their loved ones serve on active duty. As the stories of Captain Rowles and Sergeant Holloway show, the spouses, parents, and children of our military men and women are those that inevitably bear the brunt of SCRA violations. While her husband was deployed to Korea, Julia Rowles was forced to negotiate with Chase representatives while caring for a small child and pregnant with another. While he was serving in a war zone, George Holloway was powerless to protect his home as foreclosure crept closer.

I began this written testimony by referring to the stated policy of the SCRA: "to enable [servicemembers] to devote their entire energy to the defense needs of the Nation." Violations such as those suffered by our clients directly defeat this purpose. While on active duty, our soldiers have limited time to so much as contact their families. Sadly, it appears that over the past few years several thousand men and women like Captain Rowles and Sergeant Holloway were forced to spend what personal time they did have on the phone with banking officials seeking an explanation why their families were being overcharged interest or why their home was being foreclosed.

Obviously companies like JPMorgan Chase need to do more to ensure that their internal procedures are refined to ensure that all servicemembers entitled to SCRA protection enjoy those rights. As Chase has shown with the settlement terms now pending in Federal court, it has made the affirmative decision to lead the way in the financial industry in crafting more reliable SCRA policies and procedures. But based on my experience in this case over the past year, I believe there are measures that Congress can take to produce an atmosphere in which SCRA violations are greatly reduced. Below are three problem areas that can be addressed.

a. Lack of reliable information regarding servicemember status

As Captain Rowles' situation demonstrates, one of the primary problems with SCRA protection is that it can be difficult for the financial companies to determine when the "active duty" status of servicemen ends. As a result, account managers resort to calling the families of men and women in the military to obtain some sort of verification as to whether the borrower in question is, or is not, still "active duty." This repeated contact, however, violates the very spirit of the SCRA.

b. Lack of JAG manpower sufficient to protect civil rights

Many of the SCRA-protected individuals with whom I have spoken have emphasized two things: first, the staff at their bases or posts do an excellent job of educating them on their SCRA rights; but second, once a problem arose with their home mortgages, insufficient staff existed to help these servicemen negotiate resolutions with the various home finance companies.

Our clients and those servicemen I have spoken to all speak very highly of the JAG services that they receive. However, these attorneys are often heavily burdened with other tasks associated with their duty and do not have the ability to dedicate sufficient time to SCRA problems.

c. Lack of incentives to adjust mortgages that can be saved

After my testimony before the House Veterans' Affairs Committee in February, I received phone calls from hundreds of service men and women about problems they were experiencing with their mortgage. Some of these folks were entitled to SCRA benefits and some were not. But during my many conversations I noticed a disturbing trend of borrowers who had become no more than a handful of months delinquent on their loans only to be threatened with foreclosure.

There appears to be an atmosphere within the home finance market that incentivizes foreclosures and discourages modifications. Numerous servicemen I spoke with offered to increase their payments over a period of 6 months or less to become current on their loans. As a matter of routine, however, the financial institutions replied that these men and women immediately pay the balance of the loan—an option that is impossible for almost every American—or face accelerated collections or even foreclosure.

Within the State of South Carolina, this problem has reached epidemic proportions. In fact, on May 9, 2011, our State Supreme Court Chief Justice entered an administrative order dramatically altering the means by which foreclosures are litigated in this State. Now, before any foreclosure proceedings can proceed, a financial institution must certify:

> (a) that the Mortgagor has been served with a notice of the Mortgagor's right to foreclosure intervention for the purpose of seeking a resolution of the foreclosure action by loan modification or other means of loss mitigation;

(b) that the Mortgagee, or its designated agent, has received and examined all documents and records required to be submitted by the Mortgagor to evaluate eligibility for foreclosure intervention;

(c) that the Mortgagor has been afforded a full and fair opportunity to submit any other information or data pertaining to the Mortgagor's loan or personal circumstances for consideration by the Mortgagee;

(d) that after completion of the foreclosure intervention process, the Mortgagor does not qualify for loan modification or other means of loss mitigation, in accordance with any standards, rules or guidelines applicable to the mortgage loan, and the parties have been unable to reach any other agreement concerning the foreclosure process; and

(e) that notice of the denial of loan modification or other means of loss mitigation has been served on the Mortgagor by mailing such notice to all known addresses of the Mortgagor; provided, that such notice shall also state that the Mortgagor has 30 days from the date of mailing of notice of denial of relief to file and serve an answer or other response to the Mortgagee's summons and complaint.

A copy of this order has been attached to my testimony for your review (*See,* Exhibit A).

III. Suggestions for More Diligent Enforcement of SCRA

The systematic failure of SCRA protections in the Rowles litigation is evidence that the enforcement provisions of the SCRA deserve reconsideration. In our review of the law and its application over the last 6 months, we believe that there are three areas Congress may improve to strengthen the SCRA in hopes of preventing such failures in the future.

a. Cooperation between the Department of Defense and financial institutions

As noted above, much of the strain suffered by Jonathon and Julia Rowles was the result of continuous contact from JPMorgan Chase officials seeking written verification that Captain Rowles was still on active duty and thus entitled to SCRA protection. There is no provision of the SCRA that permits a financial institution to demand such verification and the Rowles believe that Chase was overly aggressive in pursuing it. At the same time, however, JPMorgan Chase and other financial institutions undoubtedly wish to protect themselves from the potential of fraud, namely a servicemember continuing to receive SCRA benefits long after he or she has been deactivated.

A solution for this quandary could be found in the creation of a liaison office within the Department of Defense designed to work with financial institutions to certify when servicemembers are—or are not—on active duty. Such an office would provide the financial institutions with the information needed to determine whether to apply SCRA protections while relieving the servicemembers and their families from the burden of continuously updating their status.

b. Stronger emphasis on legal support for servicemembers

Every single class member with whom I have spoken has noted his or her gratitude for the assistance they have received from JAG officers. However, it appears that JAG is often unable to render remedial SCRA support to servicemen that experience problems with their home loans.

This could be due to several reasons. Obviously lack of manpower hinders any ability to respond to this type of situation. But also, JAG officers may not be licensed to practice in the civilian courts in which their fellow soldiers are experiencing difficulty. For example, a JAG officer assigned to Fort Jackson, South Carolina may receive an SCRA question from a solider about to lose his home to foreclosure in California. It would be highly unusual for that South Carolina-based officer to be licensed to appear on behalf of the soldier in the State of California to contest the foreclosure. Even if the officer was licensed to do so, transporting him or her across the country for this one event may not be practical.

In my opinion, Congress should examine two possibilities that may alleviate this situation. First, determine whether JAG possesses sufficient manpower to adequately address remedial needs of servicemen who need to assert their SCRA protections. Second, examine partnership efforts that can be formulated between JAG and State bar associations who would be, I am sure, willing to offer *pro bono* services to the military in order to help enforce SCRA rights.

c. Incentivize mortgage modification and discourage foreclosure

Congress should reexamine the incentives in place that either encourage, or discourage, loan modifications. As I noted above, many servicemen have offered to ac-

celerate their loan payments over a series of months in order to become current on their obligations to the various financial institutions. Yet they report what seems to be a disturbing trend of preferring foreclosure and/or collections to preserving the terms of a loan.

Federal insurance of mortgages may contribute to this reverse incentive. While the specifics of mortgage finance are not my professional specialty, it appears that the guaranteed payment financial institutions receive from entities such as FHA may be encouraging foreclosure rather than loan modification. While I in no way suggest that such programs be terminated, I do think that considering modifications to these programs that would incentivize loan modification could alleviate many of the problems that servicemembers are now facing with their mortgages. Consideration of several prerequisites to foreclosure as instituted by the South Carolina Chief Justice (*see,* Exhibit A) may serve as a useful starting point.

Conclusion

I would again like to thank the Committee for the opportunity to speak on behalf of our clients and on behalf of the thousands of servicemen and servicewomen who have fallen victim to SCRA violations in the last several years. As the SCRA recognizes, its protections are essential to our national defense. It is my hope that Congress will take all steps necessary to ensure the continuing vitality of this law.

EXHIBIT A

2011-05-02-01

The Supreme Court of South Carolina

Re: Mortgage Foreclosure Actions

ADMINISTRATIVE ORDER

On May 22, 2009, I issued an Administrative Order (Order No. 2009-05-22-01) applicable to mortgage foreclosure actions subject to the Home Affordable Modification Program ("HMP") instituted by the United States Treasury Department ("Treasury"). The program applied to residential loans owned, securitized or guaranteed by the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac).

Subsequently, Treasury issued, by directive, additional guidance to servicers for adoption and implementation of the HMP for residential mortgage loans that are not owned, securitized or guaranteed by Fannie Mae or Freddie Mac. However, the HMP is only applicable to such loans if the lender or servicer has agreed to participate in the HMP. Not all lenders or servicers have so agreed.

Since imposition of my prior order, the number of foreclosure actions filed in this State have continued to increase. The trial courts having jurisdiction over such actions have reported to this Court difficulty in making final disposition of these actions as a result of failed or delayed loss mitigation efforts between lender-servicers and mortgagor-debtors. As a result, the number of unresolved foreclosure actions has increased, with a resulting burden on the resources of the Court before which the action is pending.

The courts have reported that these failures are the result of a breakdown of loss mitigation efforts that all parties find to be in their best interests, if possible. The trial courts report that such breakdowns are largely the result of difficulty in communication between lender-servicers and debtors, and the fact that foreclosure actions are proceeding to conclusion without regard to ongoing loss mitigation efforts by the parties.

I further take judicial notice of the actions of courts in other jurisdictions describing a similar breakdown in the efforts of parties to foreclosure actions to reach a resolution of defaults in payment of mortgage loans.

Therefore, based on the foregoing, and in order to insure that eligible homeowners and lender-servicers have been afforded the benefits of loan modification or other loss mitigation where possible, and to insure that the procedures for handling issues relating to such efforts are handled uniformly throughout the State, so that mortgage foreclosure actions are not unnecessarily dismissed, delayed or inappropriately concluded while loan modification or other loss mitigation efforts are being pursued, it is ordered as follows:

A. Definitions:

For the purposes of this administrative order, the following definitions shall apply:

(1) "Mortgagor" shall include every owner, mortgagor, and debtor under the note and mortgage at issue.

(2) "Mortgagee" shall include the owner and holder of the note and mortgage, any party acting on behalf of the owner and holder of the note and mortgage for the purpose of receiving payments, dealing with the mortgagor, or administering the loan evidenced by the note and mortgage, and any party seeking foreclosure of the subject mortgage, or otherwise acting as the agent of the owner and holder of the note in connection with the loan or the foreclosure of the note and mortgage, except for the mortgagee's attorney.

(3) "Owner-Occupied dwelling" is defined as mortgaged real property that is the principal residence of any mortgagor.

(4) "Court" shall include any judicial officer having jurisdiction over the foreclosure action, including any Circuit Court Judge, Master-In-Equity or Special Referee.

(5) "Foreclosure intervention" shall include any policy, process or procedure employed by a Mortgagee for the purpose of seeking a resolution of a foreclosure action by loan modification or other means of loss mitigation.

B. Procedure in Foreclosure Actions:

The terms and conditions of this order shall apply to all mortgage foreclosure proceedings concerning Owner-Occupied dwellings in this State.

(1) Actions pending on May 9, 2011.

In all mortgage foreclosure actions pending on May 9, 2011, before any merits hearing in the case, or if an order of foreclosure has been entered, before any foreclosure sale, the Mortgagee shall, through its attorney of record, file with the court and serve upon every Mortgagor a notice of the Mortgagor's right to foreclosure intervention. All proceedings in the foreclosure action shall be stayed until completion of such foreclosure intervention.

No foreclosure hearing or foreclosure sale may be held in the foreclosure action until the Mortgagee's attorney certifies the following:

(a) that the Mortgagor has been served with a notice of the Mortgagor's right to foreclosure intervention for the purpose of seeking a resolution of the foreclosure action by loan modification or other means of loss mitigation;

(b) that the Mortgagee, or its designated agent, has received and examined all documents and records required to be submitted by the Mortgagor to evaluate eligibility for foreclosure intervention;

(c) that the Mortgagor has been afforded a full and fair opportunity to submit any other information or data pertaining to the Mortgagor's loan or personal circumstances for consideration by the Mortgagee;

(d) that after completion of the foreclosure intervention process, the Mortgagor does not qualify for loan modification or other means of loss mitigation, in accordance with any standards, rules or guidelines applicable to the mortgage loan, and the parties have been unable to reach any other agreement concerning the foreclosure process; and,

(e) that notice of the denial of loan modification or other means of loss mitigation has been served on the Mortgagor by mailing such notice to all known addresses of the Mortgagor; provided, that such notice shall also state that the Mortgagor has 30 days from the date of mailing of notice of denial of relief to file and serve an answer or other response to the Mortgagee's summons and complaint.

If within thirty days after having been served with notice of the Mortgagor's rights, the Mortgagor has failed, refused, or voluntarily elected not to participate in any foreclosure intervention process, the Mortgagee, through its attorney, shall certify that fact to the Court, and the foreclosure action may proceed.

(2) Actions filed after May 9, 2011.

In all mortgage foreclosure actions filed after May 9, 2011, the Mortgagee's attorney shall serve on the Mortgagor, along with the summons and complaint, a notice of the Mortgagor's right to foreclosure intervention.

No foreclosure hearing may be held in the foreclosure action until the Mortgagee's attorney certifies that the Mortgagee has complied with the requirements of paragraphs B (1) (a) through (e) above.

If within thirty days after having been served with notice of the Mortgagor's rights, the Mortgagor has failed, refused, or voluntarily elected not to participate in any foreclosure intervention process, the Mortgagee, through its attorney, shall certify that fact to the Court, and the foreclosure action may proceed.

C. General Conditions.

Throughout the foreclosure intervention process and the foreclosure action, the Mortgagee shall communicate with and otherwise deal with the Mortgagor through the Mortgagee's attorney, and the Mortgagor shall have the right to deal with the Mortgagee through the Mortgagee's attorney. This includes, without limitation, submission of all required information, negotiations, and consummation of any loan modification or other loss mitigation agreement. If the Mortgagor is represented by an attorney, then the Mortgagee shall communicate with and otherwise deal with the Mortgagor through the Mortgagor's attorney.

No document, statement or evidence of any kind shared, released or exchanged exclusively for purposes of foreclosure intervention pursuant to this order shall be admissible as evidence in any subsequent proceeding. The provisions of Rule 8 of the Court Annexed Alternative Dispute Resolution Rules ("ADR Rules") shall apply to all such documents, statements or evidence, as well as to all discussions, disclosures and negotiations occurring in any foreclosure intervention process.

A Mortgagee's attorney, by proceeding with a foreclosure, represents to the Court that the Mortgagee has fully complied with all provisions of this Order.

In the event that the Mortgagor and Mortgagee agree on any loan modification or other loss mitigation plan ("Agreement"), such Agreement shall be reduced to writing, executed by the Mortgagor and Mortgagee, and served on all parties in the case. Any pending case shall be stayed, and no hearing or foreclosure sale held for 90 days following the entry of any Agreement, unless the Mortgagor shall not comply with the terms of the Agreement.

Upon any failure by Mortgagor to comply with the terms of the Agreement before the expiration of 90 days from the date of the Agreement, the Mortgagee, through its attorney, shall file and serve on all parties a "Notice of Breach of Agreement". Upon filing and service of such notice, the foreclosure action may proceed in the ordinary course.

If the Mortgagor shall be in compliance with the terms of the Agreement after 90 days, the Mortgagee's attorney shall promptly file a notice of dismissal of the action without prejudice, and the case will be dismissed. Such notice of dismissal shall be served on all parties to the action.

The Court having jurisdiction over the foreclosure action shall hear and determine any dispute concerning any party's compliance

with this order, including without limitation, the failure of any party to act in good faith in complying with the terms of this order. In the event the Court determines that any party to the foreclosure action, or their acting agent, has failed to comply with the terms of this order, or has not attempted to reach an agreement for foreclosure intervention in good faith, the Court may, in its discretion, impose such sanctions as it determines to be reasonable and just under the circumstances, including without limitation, the assessment of reasonable attorneys' fees and costs against the culpable party.

The Court having jurisdiction over the action shall have the authority, and may in its discretion, order the parties to submit to mediation. In such event, the mediation shall proceed in accordance with the ADR Rules.

This order remains in effect unless amended or rescinded by the Chief Justice.

IT IS SO ORDERED.

s/Jean H. Toal
Jean H. Toal
Chief Justice of South Carolina

Columbia, South Carolina
May 2, 2011

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN MENENDEZ FROM DIANE E. THOMPSON

Q.1. In your testimony, you provide a stunning array of specific examples of homeowners who have had terrible experiences with mortgage servicers' actions, most of them illegal. In your experience, how widespread are each of the homeowner abuses you describe?

A.1. The abuses I catalogued in my May 12, 2011, testimony are widespread. Every day, I hear examples of similar abuses. Attorneys representing homeowners anywhere in the country have similar experiences to relate.

Last December, in an attempt to quantify the scale of servicer abuses, the National Association of Consumer Advocates, in conjunction with NCLC, conducted a survey of attorneys representing homeowners in foreclosure. That survey found that almost 99 percent of the respondents were representing a homeowner who had been placed into foreclosure while awaiting a loan modification, almost 90 percent of the attorneys surveyed were representing a homeowner who had been placed into foreclosure despite making payments as agreed, 87 percent of the attorneys were representing clients who had been placed into foreclosure due to a servicer's improper failure to accept payments, over 50 percent reported representing homeowners who had been placed into foreclosure as a result of forceplaced insurance alone, with similar figures reported for the impact of illegal fees and the misapplication of payments. These figures suggest that all of these abuses are common.

My testimony provides illustrative examples of several different kinds of abuses: the improper solicitation of a waiver of some or all of a homeowner's legal rights; servicers' failure to honor their agreements with homeowners, whether permanent or temporary modifications or short-term payment plans; the failure to timely convert a loan modification to a permanent modification; foreclosing on homeowners who are either awaiting a loan modification review or are in a temporary or permanent loan modification; misapplication of payments, improper assessment of fees, and abuse of suspense accounts; and a failure to offer homeowners a loan modification that would have benefited the investor. In my experience, all of these abuses are so commonplace as to be unremarkable were they not so appalling.

Q.2. Ms. Goodman, Senior Managing Director of Amherst Securities, stated in her testimony that mortgage servicers should be required to offer borrowers the loan modification that has the highest net present value for the investor, not just any modification that has a higher net present value than foreclosure. Do you agree with that?

A.2. We agree with Ms. Goodman's proposal that servicers be required to offer a loan modification with a principal reduction where a loan modification with a principal reduction offers a greater return to investors than a modification without a principal reduction. The failure to make the HAMP Principal Reduction Alternative mandatory where the principal reduction offers a greater net present value to investors than a conventional HAMP modification is illogical and harms both borrowers and investors.

We would oppose any requirement that the servicer be required to offer borrowers only the loan modification that has the highest net present value for investors in all circumstances. There are many circumstances in which the loan modification that is most responsive to the homeowners' needs may not be the one that returns the highest NPV to investors. Indeed, such a rule might impede settlement of litigation and interfere with judicial oversight of foreclosure mediation.

Moreover, we are not sure that such a rule would in all cases serve the interests of investors. We are unsure the extent to which the NPV test accurately measures the value of an increase in the sustainability of a loan modification. Recent data from the OCC–OTS Mortgage Metrics Report supports our experience that providing deep payment cuts, reducing principal significantly, and otherwise structuring loan modifications to ensure long term affordability results in improved outcomes and lowered redefault rates. Unless the redefault rate used in the NPV test dynamically takes into account the offered terms of the loan modification, the NPV test will likely understate the positive return to investors from a loan modification that provides for greater sustainability.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN MENENDEZ FROM LAURIE F. GOODMAN

Q.1. Can you suggest any methods of doing principal reductions for homeowners that would avoid moral hazard? Please explain how moral hazard would be avoided.

A.1. We have to stop thinking of borrowers making moral choices, and start thinking of borrowers as making economic choices. Once we recognize that they are making an economic choice, we can design an incentive structure where borrowers who need the principal reduction to stay in their home are able to obtain it, while those that don't need the principal reduction are not envious of those who received it.

Here are a few possibilities:

- Make it clear that if the borrower accepts a principal writedown, there is a well established set of costs. These costs could include either (1) a shared appreciation feature, in which the borrower shares any future appreciation with the lender; or (2) a Federal tax levy of 50 percent on any future appreciation on the property. The tax levy is the conceptual equivalent of a shared appreciation mortgage, except the borrower share the upside with the Government. We believe a tax would be easier to implement on a broad scale than a shared appreciation feature.
- If the borrower accepts a modification, there is an appropriate "ding" to one's credit rating.
- To discourage "economic defaulters" who can easily afford their home, lenders will pursue deficiency judgments to the extent possible.

Let's look at the impact of these actions. A borrower at a 150 percent loan-to-value ratio would have been apt to default. By giving the borrower a principal reduction to say, 115 percent LTV, the

borrower is able to stay in his home. A shared appreciation mortgage would be acceptable to the borrower, as that is the only way he can afford to continue to own and live in the home.

A borrower with a 120 percent LTV, who is paying his mortgage, wonders if he, too, should go delinquent in order to obtain a principal reduction. By making the costs of the principal reduction explicit (a shared appreciation mortgage, a ding to a borrower's credit rating), the borrower at 120 LTV would make the rationale decision not too default. He would look at the deal his neighbor received, and decide that he wouldn't take a principal reduction on these terms. That is, in order to receive a principal reduction from 120 LTV to 115 LTV, the borrower would have to share his appreciation with either the lender or the Government—too large a cost for the limited benefit.

Again, the best way to combat the moral hazard issue is to think about a set of economic frictions designed such that the borrower who can afford to pay continues to do so, and the underwater borrower who cannot afford to pay his mortgage is entitled to a principal reduction (assuming the modification is NPV positive).

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN MENENDEZ FROM DAVID H. STEVENS

Q.1. Ms. Goodman, Senior Managing Director of Amherst Securities, stated in her testimony that mortgage servicers should be required to offer borrowers the loan modification that has the highest net present value for the investor, not just any modification that has a higher net present value than foreclosure. Do you agree with that?

A.1. Ms. Goodman indicated in her testimony that servicers should be required to perform principal write-downs on HAMP modifications if they present the highest net present value [NPV]. She suggested this would mandate principal write-downs over other loss mitigation options. MBA does not support mandatory principal write-downs.

- The proposal would require bondholders and lien holders, not merely servicers, to accept principal write-downs. As evidenced by the lack of significant principal reductions by portfolio lenders and Government agencies, there is not a uniform view that principal write-downs are the most economical response for lien holders.
- Rate and term modifications and principal forbearance modifications offer the borrower the same affordability during his or her period of hardship, as a principal reduction, but without the permanent impairment to the mortgage asset for the lien holder. As a result, a borrower who "must" receive a principal reduction to remain in the home in addition to the same affordable payment through other means (such a principal forbearance) is a strategic defaulter. Strategic defaults should be discouraged, not encouraged.
- The NPV does not test whether a policy, such as principal reduction, will result in greater numbers of defaults, thus greater overall losses to lien holders. If there is a high level of debt

forgiveness created by this standard, it is going to increase default frequency associated with high LTV loans. This in turn impacts the NPV assumption, predicting a higher default rate on high LTV loans, thus perpetuating (or self-fulfilling) the appearance that principal reductions are the necessary and best outcome. MBA along with many others believe that principal write-downs will cause more delinquencies and ultimately increase the severity of losses.

- The proposal does not offer indemnification from risk for a servicer who performs a principal reduction on behalf of a trust. HAMP safe harbor may not be sufficient protection to alleviate such risk. A mandate to write down would be a taking and could subject the servicer to litigation risk.
- Some PSAs prohibit principal reduction. We do not believe Ms. Goodman's proposal should or will change the ultimate authority of the transaction documents over HAMP.
- In general, efforts could be made to discourage strategic defaults by reversing the exemption to the discharge of indebtedness tax rules for principal residences created by the Mortgage Forgiveness Debt Relief Act of 2007. Prior to this Act, an individual would be subject to ordinary income taxes on the amount of mortgage debt discharged or written down, unless the person was insolvent. With the current exemption to this rule for principal residences, borrowers benefit even more from a principal reduction than a principal forbearance—despite the forbearance achieving an "affordable payment" for the borrower.

  This greater the incentive of a principal write-down, the greater the impact on default rates—a critical factor that drives the outcome of the NPV calculation. As previously stated, if Congress wishes to discourage strategic defaults, it could reinstate the discharge of indebtedness rules for principal residences. Individuals would be taxed on the amount of discharged debt to the extent he or she was solvent. The change would start to equalize the incentives between principal write-downs and principal forbearances by reducing the strategic default incentive.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN MENENDEZ FROM ANTHONY B. SANDERS

Q.1. Ms. Goodman, Senior Managing Director of Amherst Securities, stated in her testimony that mortgage servicers should be required to offer borrowers the loan modification that has the highest net present value for the investor, not just any modification that has a higher net present value than foreclosure. Do you agree with that?

A.1. No Response provided.