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The CFPB Should End Dual Track and Mandate Sensible Loan Modifications

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The Consumer Financial Protection Bureau should use its authority under the Truth in Lending Act to protect homeowners and investors from unnecessary and expensive foreclosures.

The CFPB should take the following steps:

- declare that it is an unfair and deceptive practice to initiate or continue a foreclosure when a homeowner has submitted a substantially complete loan modification application;
- declare it an unfair and deceptive practice to deny an affordable loan modification to a homeowner facing hardship when the modification would produce more income for the owner of the loan than a foreclosure; and
- declare that noncompliance with existing modification requirements is an unfair and deceptive practice.

The rule should apply to all servicers. To the extent there are procedural limitations on initially promulgating a universal rule, the rule initially should apply to all large servicers and also should hold larger entities responsible for the actions of their agents. Subsequent SBREFA rulemaking should be pursued to cover smaller servicers directly.

The Problem

Servicers often pursue foreclosure instead of loan modification because it is more profitable to the servicer, at the expense of both investors (for whom they generally work as agents) and homeowners. As a result, homeowners who qualify for loan modifications lose their homes even when the modification would also benefit the investor more than foreclosure. Homeowners and investors also face inflated default servicing fees as servicers extend the foreclosure timeline and pile on fees in the interest of increasing profits. If the loan ends in foreclosure, the servicer's fees may be paid out of the foreclosure sale proceeds before investors are paid, leaving investors shortchanged.

Servicers' profit motives encourage them to continue foreclosures during modification reviews, to delay decision-making, and, often, to wrongly deny modifications. Because of the agency problems inherent in the servicer-investor relationship, a mandatory rule is necessary to correct the market's failure to provide for loan modifications when beneficial to both homeowners and investors.

Processing loan modifications and foreclosures at the same time results in foreclosures while homeowners are seeking, or have been approved for, loan modifications. These are foreclosures that could have been avoided, saving homes for families, preventing losses for investors, and limiting the devaluation of neighborhoods. Foreclosures and loan modifications are handled by different departments at most servicers, with only imperfect communication between departments. Homeowners are often confused by the dual track process and believe that they need not appear in court if they are negotiating with their servicer. This confusion is often amplified when servicer representatives tell homeowners that "everything has been taken care of." Continuing the foreclosure process for a homeowner seeking a modification also inflates the fees charged on the account, hurting both homeowners and investors and further limiting loss mitigation options. *Mandating a pause to the foreclosure process during the loan modification review will stop unnecessary foreclosures, reduce abusive fees, and stimulate faster modification decisions.*

Many qualified homeowners are wrongfully denied loan modifications for which they qualify. This result harms both homeowners and investors, who would benefit from NPV-positive loan modifications. This occurs for many reasons, including servicers' financial incentives that often promote foreclosure over modification. *Requiring that servicers provide NPV-positive loan modifications to qualified homeowners facing hardship would optimize outcomes for investors and homeowners and align the incentives of the servicers with the rest of the market.*

The Solution

The Bureau should declare that initiating or continuing a foreclosure against a homeowner who has submitted a substantially complete loan modification application before the application has been fully and finally reviewed is an unfair and deceptive practice in violation of the Truth in Lending Act, 15 U.S.C. § 1639(p)(2)(A). The "substantially complete application" standard is already used by FHFA; it is a known rule with existing compliance mechanisms in place. Adopting this standard would result in consistent rules across the market.

The rule should depart from existing protocols by requiring the cessation of any existing judicial or non-judicial foreclosure, as well as barring the initiation of any new foreclosures. While the FHFA and AG standards move in this direction, they are complex and provide reduced protection to borrowers seeking modifications after the initiation of a foreclosure.

Pausing a foreclosure is not expensive and will not result in significant delay where the servicer completes the review in a timely manner. The additional advertising costs in nonjudicial foreclosure states generally are not substantial. In states with judicial foreclosure, the filed foreclosure can be temporarily stopped while the review and negotiation occur—a common practice that generally does not require refiling or a restarting of the foreclosure timeline.

The Bureau should also declare that denying an NPV-positive, affordable loan modification to a qualified homeowner facing a hardship is an unfair and deceptive practice under the same TILA provision. An enforceable rule would increase access to sensible loss mitigation, which would benefit investors as well as homeowners. Terms such as "hardship" and "NPV-positive" are established standards that can be further determined outside the context of the rule itself.

In addition, the Bureau should declare that failing to offer a modification required by existing federal, state and contractual requirements, including HAMP, FHFA guidelines, the Attorney General settlement and applicable pooling and servicing agreements (PSAs) is an unfair and deceptive practice. Many of these rules are routinely violated. For example, violations of existing dual track and investor requirements are well-documented. Denying a modification based on investor restrictions when the PSA allows or even requires it is deceptive as well as unfair. Similarly, when program rules require a halt to a foreclosure during a loan modification review, violation of such rule is deceptive and unfair. The CFPB should promote compliance with existing modification requirements.

A servicer's representations to the homeowner should be binding and subject to the unfairness and deception tests. Where a servicer represents, orally or in writing, that a homeowner's foreclosure or sale will be halted during the loan modification review, action to the contrary should be deemed deceptive and unfair. A similar rule should apply where a servicer represents that the homeowner qualifies for a loan modification and then subsequently withdraws that offer.

The servicing UDAP rule must apply to actions taken by agents of covered servicers. Otherwise, servicers will be encouraged to evade the rule by contracting out default management to small, inexperienced entities without adequate oversight or management. Whether a homeowner receives a modification should depend on whether it makes economic sense to modify the loan, not on the size of the servicer the loan was transferred to after the borrower defaulted. Neither investors nor homeowners have any control over such transfers; servicers should not be encouraged to evade their responsibilities to modify loans appropriately by inappropriate servicing transfers.

Use of the Bureau's TILA authority would provide homeowners, for the first time, with a directly enforceable, federal right to appropriate loss mitigation. Those few homeowners able to access counsel would benefit from the opportunity to enforce their rights in real time, but far more homeowners and investors would benefit as servicers responded to the rule with appropriate management changes. Such a rule would be the first time since the beginning of the foreclosure crisis in 2007 that servicers had a meaningful incentive to avoid unnecessary foreclosures.

The Authority

The Truth in Lending Act provides that the Bureau "shall prohibit acts or practices in connection with mortgage loans that the Bureau finds to be unfair [or] deceptive . . . ." The legal standard for deception is well established under both the FTC Act and state UDAP statutes. Generally, a practice is deceptive if it is likely to deceive even a minority of consumers. The standard does not require intent to deceive (or knowledge that the act is deceptive). A practice can be deceptive even where it is industry-wide.

The Dodd-Frank Act provides that a practice is unfair where "(A) the act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers; and (B) such substantial injury is not outweighed by countervailing benefits to consumers or to competition." The Bureau may consider established public policies as evidence to be considered, although not as the primary basis for determining unfairness.

Proceeding with foreclosure during a loan modification review is both unfair and deceptive. Pursuing foreclosure during loss mitigation is deceptive because homeowners may be led to believe either that loss of the home is inevitable, and that they should therefore abandon the loss mitigation process, or that they need not continue to defend the foreclosure and can instead rely on the loss mitigation process. This confusion is often compounded by oral reassurances by servicer staff that everything is being taken care of in the loss mitigation process. Disclosure cannot cure the deceptive nature of the dual track process. The relationship between the legal proceedings to deprive homeowners of their property and the loan modification process conducted off the record, by staff not involved in the foreclosure proceeding, is complex and ambiguous even to experienced attorneys representing lenders as well as to unsophisticated homeowners who are facing the loss of their home. Indeed, disclosure is likely to exacerbate the harm: if homeowners know that foreclosure will proceed even though they complete a loan modification application, many of them will conclude that modification efforts are hopeless—and in many cases they will be correct, because of the inexorable schedule of the foreclosure process and the fees it adds.

The dual track of loss mitigation and foreclosure also is unfair. It regularly causes (and therefore is also likely to cause) substantial injury. Homes often are wrongly sold at a foreclosure sale while an outstanding loss mitigation review is underway or even after a permanent loan modification agreement has been finalized In some cases, these sales occur months or years after the initial notice of foreclosure is served on the homeowner, during which time the homeowner is making payments under a modified agreement and believes that the foreclosure process has been stopped due to the modification. Reversing a foreclosure is nearly impossible and the loss of household stability is devastating. The confusion caused by pursuing foreclosure during loss mitigation can steer unrepresented homeowners away from following through on loss mitigation requests; even more frequently, it causes unrepresented homeowners to waive their rights in the foreclosure proceeding in reliance on the loss mitigation process, resulting in unnecessary foreclosures.

Moreover, the costs of foreclosure, including property valuations, preservation and attorneys' fees, and title charges, substantially increase a homeowner's principal balance. Those fees, made necessary only by the continuation of the foreclosure during the pendency of loan modification negotiations, can push loans away from eligibility for a modification that has a positive net present value, strip equity, and inevitably increase arrearages, which must be paid either out of increased loan payments, through an extended amortization period, or with a large balloon payment at the culmination of the mortgage. Thus, continuing foreclosure proceedings during loan modification efforts becomes a self-fulfilling prophecy, making a loan modification that would save the home unaffordable.

This injury is not reasonably avoidable by consumers, nor is it outweighed by countervailing benefits to consumers or competition. A homeowner generally cannot prevent the wrongful sale of a foreclosure during a loss mitigation review. Most homeowners are not able to obtain counsel and even those who do face enormous hurdles in light of the limited communication between servicers and the servicer's own foreclosure attorneys. Homeowners cannot avoid the additional fees charged during the foreclosure by the servicer; the servicer exercises complete and unfettered discretion in the imposition of such fees. Any confusion about the dual track process is caused by the construct of pursuing two contradictory processes simultaneously and is inevitable.

There are no benefits to consumers or the market in failing to provide NPV-positive loan modifications. While some have argued that speeding up the foreclosure process aids the market, a system that results in denying modifications that benefit investors and homeowners, and raising the costs for providing modifications, only harms the market. Moreover, there is little evidence that dual track results in faster foreclosures: the need to process two sets of paperwork and coordinate communications between different divisions of the servicer complicates an already complex process and may ultimately result in more delays in foreclosure.

Concerns that some homeowners who are able to pay might choose default in order to obtain a modification, and thus increase the cost of credit for all, tend to be overblown. First, of course, defaulting on a mortgage has significant costs to credit as well as emotional security, and is not a risk most families undertake lightly. Entering into loan modification negotiations is an arduous, time-consuming, and uncertain undertaking. In addition, existing requirements that evaluate the objective affordability of the current mortgage payments combined with verification of income and assets prevent homeowners who could reasonably avoid default from taking advantage of loan modification programs.

Stopping dual track will expedite modification reviews and limit the harm to consumers and the market. Such a rule is needed because of current market dysfunction. Outcomes that benefit both investors and homeowners are hard to achieve because servicers have a financial incentive to drag out the foreclosure instead of promptly granting an NPV-positive loan modification where one is available. Homeowners do not choose their servicers and thus cannot avoid these market problems. Investors have so far faced significant challenges in obtaining compliance with loss mitigation requirements. Because homeowners do not enter a loan expecting to default, default remedies such as access to reasonable loan modifications, and fair procedures for obtaining them, are not a subject of negotiation. In fact, they are not on the radar at all when a homeowner initially enters into a loan.

Public policy supports an end to dual track. Several measures at the federal and state level already have acknowledged the damage done by the dual track process. HAMP, FHFA and the AG-Federal settlement all require loan modification reviews to be completed prior to the initiation of a foreclosure. Some of these protocols also protect homeowners to some extent from continuation of an existing foreclosure where loss mitigation is underway. State mediation programs recognize the importance of halting the foreclosure process—whether judicial or non-judicial—in order to first complete the loan modification review.

Denying a qualified homeowner a home-saving modification that also benefits the investor more than foreclosure is both unfair and deceptive. It is deceptive to deny a modification to an eligible homeowner. Denial of that assistance communicates that the homeowner is not eligible, where the contrary is true. Denial also gives the appearance that the investor, for whom the servicer works, benefits from and agrees with the servicer's denial. This show of solidarity is false in the many cases where the investor explicitly permits loan modifications, and there is an NPV-positive loan modification available.

Wrongful denial of a loan modification also is unfair. Failure to provide an affordable loan modification generally leads to home loss, especially in light of recent, very low cure rates. Because servicers generally control the modification review process, a homeowner cannot avoid the injury caused by wrongful modification denial. (Counselors and attorneys nationwide help a small percentage of those needing assistance, and can prevent only a fraction of wrongful modification denials; transparency limitations also make such challenges difficult.) Failure to provide an NPV-positive loan modification to a qualified homeowner does not benefit consumers or competition. While they may provide a profit opportunity to the servicer in some circumstances, wrongful denials harm homeowners, communities, and investors. As described above, loan modifications that benefit investors and homeowners are too hard to get because of market dysfunction; a rule aligning servicer incentives with other market participants would alter that dynamic. Finally, public policy in the last several years has vigorously supported loan modification for eligible homeowners. HAMP, FHFA rules, state laws and private industry developments all favor a loan modification over foreclosure where the numbers add up. The consensus is clear. A rule mandating such outcomes will move incentives in the right direction.

Failure to comply with existing modification requirements also is unfair and deceptive. Where entities fail to comply with existing loss mitigation requirements to which they are bound, such actions are deceptive. For the reasons articulated above, failure to comply with existing modification requirements also is unfair. It causes substantial injury, which is not reasonably avoidable nor outweighed by benefits to consumers or competition. Public policy promotes the rule of law and compliance with existing standards, particularly on loan modifications.

The Federal Reserve Board has previously used TILA UDAP authority to prohibit a broad array of specific practices, including payment of yield spread premiums to mortgage loan originators; steering of consumers into mortgage loans that produce higher compensation to the loan originator unless in the interest of the consumer; exercising inappropriate influence over mortgage loan appraisals; unfair delays in crediting consumers' payments; unfair imposition of late fees; unfair refusal or delay in providing payoff statements; repeat refinancing of high-cost mortgage loans; making higher cost loans without regard to the consumer's ability to repay; and making higher cost loans with onerous prepayment penalties. New rules addressing mortgage servicing issues fit squarely within the historical use of this authority.