Problems in Mortgage Servicing From Modification to Foreclosure

Written Testimony

of

Diane E. Thompson
National Consumer Law Center

also on behalf of
National Association of Consumer Advocates

Before the United States Senate Committee on
Banking, Housing, & Urban Affairs

November 16, 2010

I. Introduction

Chairman Dodd, Ranking Member Shelby, and members of the Committee, thank you for inviting me to testify today regarding the problems occasioned by mortgage servicer abuse run rampant.

I testify here today on behalf of the National Consumer Law Center's low-income clients. On a daily basis, NCLC 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.[1]

I am an attorney, currently of counsel to the National Consumer Law Center (NCLC).[2] 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

[1] 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.

[2] 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.

with the various abuses committed by servicers, ranging from the excessive fees that force homeowners into foreclosure to the failure to negotiate a loan modification in good faith to preparation of false affidavits. Lamentably, nothing about the current crisis is new.

What robo-signing reveals is the contempt that servicers have long exhibited for rules, whether the rules of court procedure flouted in the robo-signing scandal or the contract rules breached in the common misapplication of payments or the rules for HAMP modifications, honored more often in the breach than in reality. 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 robo-signing scandal, the failure of HAMP, and the wrongful foreclosure of countless American families.

The falsification of judicial foreclosure documents is closely and directly tied to widespread errors and maladministration of HAMP and non-HAMP modification programs, and the forced-placed insurance and escrow issues. 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

[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).

juggernaut that at best prolongs and deepens the current foreclosure crisis and at worst threatens our global economic security.

The current robo-signing scandal is a symptom of the flagrant disregard adopted by servicers as to the basic legal and business conventions that govern most transactions. This flagrant disregard has been carried through every aspect of servicer's business model. 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. Solutions must include but go beyond addressing the affidavit and ownership issues raised most recently. Those issues are merely symptoms of the core problem: servicers' failure to service loans, account for payments, limit fees to reasonable and necessary ones, and provide loan modifications where appropriate and necessary to restore loans to performing status.

In testimony before this 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. HAMP failed to realign servicer incentives with the interests of homeowners, investors, and the American public.

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. We are living through a period of historic levels of foreclosures. 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]

---

[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

Servicers, however, do not lose when they foreclose. Servicers make money from force placed insurance and other excessive fees that push homeowners into default. Servicers are able to minimize staffing and other costs when they fail to modify, without imperiling their income. Servicers save money by engaging in robo-signing, and may even have been able to use robo-signing allegations to reduce their obligation to make advances—thus saving them even more money and shifting more of the risk of failure to the top-rated tranches held by pension funds and other large institutional investors.[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. Indeed, in 2009, foreclosures actually increased as a percentage of the outcomes for loans in default.[9]

---

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] 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 robo-signing 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] Diane Pendley et al., Fitch Ratings, U.S. RMBS Servicers' Loss Mitigation and Modification Efforts Update II at 1 (June 2010).

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, 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.
- 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 in HAMP and provided for 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.

- Federal regulators should conduct random sample reviews of the servicing and payment history of all servicers, with special attention to the history of borrower contacts, the application of payments, and the legality of imposed fees.
- Where investor restrictions actually restrict modifications, they must be eased.
  - Servicers must be required to seek waivers.
  - Regulatory agencies should encourage investors to grant such waivers freely.
  - 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.
- HAMP must be improved.
  - Enforcement and compliance mechanisms under HAMP must be adopted, including the enactment of the Franken Amendment that gives homeowners the ability to appeal HAMP servicer decisions.
  - Principal forgiveness under HAMP must be mandated.
  - Coordination with the second lien program must be strengthened.
  - Homeowners suffering an involuntary drop in income should be eligible for a second HAMP loan modification.
  - For some homeowners, payments at 31% of family income are not affordable. For those homeowners, monthly payments below 31% should be offered.
  - Conversion from trial modifications to permanent modifications should be made automatic and self-executing.
  - The period of time for unemployment forbearance should be extended, no further trial modification period should be required after the unemployment forbearance

II. 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. As the robo-signing scandal illustrates, servicers hold themselves above the law in ways large and small.

Bank of America recently refused to process a Chicago-area homeowner for a loan modification, saying that the investors forbid modification, but refused to provide the name of the holder of the loan—despite the fact that federal law[10] requires servicers to provide the name of the holder upon request. In communicating with a California attorney, Bank of America representatives similarly represented that a pooling and servicing agreement forbade all modifications, when, in fact, the Pooling and Servicing Agreement specifically provided for modifications in the event of the borrower's default. The Bank of America representative in that case went so far as to provide the homeowner's attorney with an electronic copy of the relevant sections of the PSA from which the clause permitting modifications in default had been excised, and a comma replaced with a period. Tens of thousands of homeowners have languished in trial modifications—facing growing loan principals and increasingly damaged credit—although they have met all requirements to obtain a permanent deal. The errors by servicers are systematic and widespread. In the aggregate, they cannot be explained as good faith mistakes.

[10] Truth in Lending Act, 15 U.S.C. § 1641(f)(2).

A. Servicers deny and delay loan modification requests improperly.

Examples abound of servicers refusing to evaluate homeowners for loan modification or delaying loan modifications until a loan modification is no longer feasible. A ProPublica survey found that the average length of time homeowners spend seeking a HAMP loan modification is 14 months.[11] Delay and deny is many servicers' standard response to loan modification requests, as recent examples from advocates around the country illustrate:

- SunTrust took over a year to process an Illinois homeowner for a loan modification. When the homeowner requested that she be reviewed for a HAMP modification, she was told she was not eligible for any modification and the offer of the non-HAMP modification was rescinded.

- A Brooklyn homeowner placed into a HAMP trial modification in June 2009 received, after making his timely trial modification payments, a verbal denial of the HAMP modification in December 2009, followed by the offers of three non-HAMP compliant modifications, which were less sustainable by their terms than a HAMP modification would have been.

- An Illinois homeowner has faxed her documents, and confirmed receipt dozens of times since 2008, and never yet received a complete loan modification application from her servicer, Chase - although she did once receive three pages of a ten page modification agreement, which she, in desperation, returned with a payment. Her payment was returned to her, and she was denied that modification, in part, for failure to make the required initial payment.

- In one all-too typical case from Ohio, getting to a permanent HAMP modification for a low-income and elderly woman took a skilled and determined attorney seventeen months. The attorney first submitted a completed HAMP application to Countrywide in April 2009 and resubmitted the complete application to Bank of America in June 2009. The attorney spent the next several months resending the same application and income documents, which Bank of America repeatedly claimed it had not received. In January 2010, the homeowner received a notice that she had completed a forbearance plan—not the trial modification she thought she was under. Four months elapsed between when Bank of America first acknowledged the homeowner was entitled to a permanent loan modification, in April 2010, and the final permanent HAMP modification sent to the homeowner in August 2010.

---

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

- ❖ A Colorado advocate reports that at least twice Bank of America refused to process HAMP application requests submitted on the standard Request for Modification Agreement (RMA) forms. In one case, the borrower received back a non-compliant "special forbearance" offer. In another case, Bank of America replied to the RMA with a promise to send out a HAMP application form. (A California advocate reports similar experiences with Bank of America refusing to process modification applications submitted on the standard RMA).

- ❖ When an elderly Illinois man realized in January 2010 he would miss a mortgage payment due to an unexpected furnace repair, after 10 years of regular mortgage payments, he called his servicer, PNC, to see if he could make some payment arrangements. PNC suggested a loan modification, but told the homeowner to wait to apply and not to make his February payment because that would interfere with his ability to get a modification. After he submitted a modification application, PNC placed the homeowner into foreclosure and rejected his offer to sell his woodworking equipment to raise the cash to pay off the entire arrearage.

- ❖ In early 2010, Chase canceled, without explanation, the trial modification of an Illinois couple and then offered a non-HAMP modification that would have required an unaffordable payment at a 41% debt-to-income ratio. The homeowners requested that they be evaluated again for a HAMP modification, and Chase made assurances that the non-HAMP modification offer would remain outstanding while the HAMP evaluation was completed. But, several months later, Chase denied the HAMP modification because the homeowners had failed to accept the non-HAMP compliant modification.

- ❖ One New York couple initially requested a loan modification in 2009, and is still waiting for a response from Bank of America, despite having submitted a completed application packet at least twice. Worse, Bank of America placed them into foreclosure while they were awaiting evaluation of their HAMP request, and returned their payments. The day after a Bank of America employee told the homeowners that their payments were being rejected because they had been placed in foreclosure, they received a letter instructing them to continue making payments.

- ❖ One Indiana couple dealing with Bank of America discovered that they are no longer eligible for a loan modification because of the extent of their default—default that occurred, in part, due to reliance on Bank of America's representations that they could not be considered for a loan modification until they were further in default.

- ❖ A Brooklyn homeowner, who applied for a loan modification from Washington Mutual in 2009, was told to cease making payments for three months before getting the loan modification only to have Chase rescind the permanent modification because he was in default.

- ❖ An Illinois homeowner has spent the past two years attempting to get a loan modification from Chase, faxing her documents dozens of times and having numerous payments

- ❖ Bank of America cancelled another Illinois homeowner's trial modification because he had allegedly withdrawn from the program. But the homeowner had never requested to be removed from the program and was in fact traveling away from home when Bank of America claimed to have received his opt-out notice.

As discussed more below, delay serves servicers' interests. During delay, fees and interest accrue. For example, a Brooklyn homeowner was placed into foreclosure by Ocwen after attempting to pay off her loan in August 2007. In the intervening three years, the amount Ocwen claims is due and owing to pay off the loan has more than tripled, due largely to the imposition of 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, the servicer's monthly servicing fee will increase since it is calculated as a percentage of the outstanding principal, and the homeowner's principal balance will increase due to the capitalization of fees and back interest. For example, in the seven months it took First Franklin to process a Brooklyn woman's loan modification request, her principal balance increased by $30,000.

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.

To counteract these incentives to delay the process of evaluating homeowners for loan modifications, many advocates report taking extraordinary steps to document the delivery of complete document packages and monitor the timeline. One advocate in Indiana reports that she submitted the same documents three times, without change, as Bank of America employees first claimed that the documents were not signed, and then that they were not notarized. Fortunately, she had not only ensured that the original submission was complete, but retained copies. Not all homeowners attempting to navigate the loan modification maze are able to be as meticulous or as persistent, and many give up in confusion and frustration after they are asked for the same document four or five times or told that they did not submit documents they did submit.

Advocates have received little help from Treasury in enforcing the applicable timelines for processing loan modification requests under HAMP. One Florida attorney was told by the HAMP escalations center, the organization tasked by Treasury with fielding disputes regarding servicer compliance with HAMP, that a failure to evaluate the loan modification request within 30 days, as required under the HAMP handbook, was not a compliance issue.

Particularly offensive are servicers' failures to accept documentation of the death of a co-owner. One California advocate reports that his client submitted his wife's death certificate to Bank of America no fewer than six times. Bank of America sent a deceased Indiana homeowner a letter denying a loan modification because they had received no documents from her (unsurprising, since she had been dead for over two years at that point), although the co-owner had submitted a complete loan modification packet and a death certificate numerous times. Worse, a representative of Bank of America appeared at the home one day and demanded repeatedly to talk with the deceased homeowner and refused to talk to the remaining co-owner, despite her repeated explanation that she was the surviving joint tenant and a signatory to the note. A South Brooklyn woman whose husband died in 1999 has been attempting to negotiate a loan modification with Wells Fargo since 2008, but Wells refuses to modify the mortgage until and unless she brings the loan current, since only her husband was on the original note.

Other documentation requests may violate the terms of HAMP or federal anti-discrimination statutes. For example, Bank of America discounted a 65 year old woman's employment income, and then denied her for insufficient income, because they judged that at her age she was unlikely to continue working. When her attorneys challenged this denial, Bank of America asserted she had failed to provide necessary documentation of her income and continued employment.

B. 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[12] or where a servicer misapplication of payments leads to default.[13] Servicer errors can and do lead to foreclosure.

As discussed below, servicers have substantial incentives to impose significant fees on homeowners because they are usually permitted under the pooling and servicing agreements to

[12] *See, e.g.,* Maxwell v. Fairbanks Capital Corp. (*In re* Maxwell), 281 B.R. 101 (Bankr. D. Mass. 2002).
[13] *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).

retain all of those fees. Forceplaced insurance in particular is often a locus of abuse.[14] The result of the abusive placement of forceplaced insurance frequently leads to default and foreclosure. For example, a servicer billed a Maine homeowner twice for force-placed insurance at $8,500 per year, when the homeowner had in place coverage at $550 per year. The resulting increase in his monthly payments eventually forced the homeowner into default and foreclosure, and the lender dropped the foreclosure only after several years of active litigation. Similar examples have been reported around the country.[15] Mortgage insurance may also be a source of profit for a servicer or its affiliates and hence a frequent locus for improper placement and upcharging of fees. One New York advocate reports that her client—who had never before paid mortgage insurance and for whom there was no apparent contract authority to require mortgage insurance—was suddenly required to make a monthly payment to support mortgage insurance, increasing the cost of her loan and providing her no benefit.

Other "technical" errors can push homeowners into foreclosure. An Illinois homeowner ended up deeply in default and on the verge of foreclosure when there was a problem processing an on-line payment because his servicer, American Home Mortgage Servicing, Inc. (AHMSI), changed his loan number—without notice to him. It took three months of repeated calling before AHMSI located his loan and provided the home owner with the new loan number, but, by then, his loan had been referred to foreclosure as 90 days delinquent. The desperate homeowner agreed to make payments of twice his monthly payment for several months until he paid off the claimed arrearage (twice what he in fact owed), but AHMSI nonetheless instituted foreclosure payments

---

[14] *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.
[15] *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)

and returned his check. Only the intervention of a legal services attorney saved this homeowner from losing his home—despite the fact that the initial arrearage was entirely due to a "technical" error by AHMSI.

In a more extreme case, Countrywide sold a North Carolina woman's home at a foreclosure sale, even though she was making the timely payments required under a consent order entered in bankruptcy court, perhaps because the bankruptcy consent order permitting the modified payments was not entered into the servicer's computer system.

Not infrequently, servicers return borrowers' payments for obscure reasons and then proceed to foreclose on the basis of the default. For example, after an Illinois couple sent in a triple payment to catch up two missing payments on their mortgage (and after consulting with their servicer), Bank of America returned the payment and initiated foreclosure proceedings. A North Carolina woman made payments under a trial modification agreement with Chase for 15 months, and then, on the advice of a Chase representative, sent in a partial payment in the 16th month of her trial modification. Chase promptly returned the partial payment and initiated foreclosure proceedings, without ever processing her for a permanent modification.

Servicers have yet, more than three years into the crisis, to figure out staffing, with sometimes disastrous results for homeowners. One Illinois advocate was told by an employee at Chase's Homeownership Preservation office, after she called to determine why her client had been denied a modification she never applied for, that when the loss mitigation department gets too busy, the collections department answers the phone. Once collections takes that call, the employee reported, the homeowner's file with loss mitigation is transferred to collections and no further loan modification work goes on. Neither the homeowner nor her counsel had requested that transfer or even been informed of it.

When I was representing clients, I more than once arrived at an agreement in principle in a foreclosure defense case only to be told by opposing counsel that his client no longer owned the loan, that they were unsure who owned the loan, but that they were still willing to settle with my client. Not infrequently, servicers will bring foreclosure actions in the name of the wrong trust. In one recent case involving a homeowner in Long Island, after protracted litigation, including denial of a motion to dismiss a foreclosure complaint filed in the name of Deutsche Bank for Deutsche Bank's failure to prove ownership, and multiple transfers of ownership, the attorney for the holder acknowledged that Deutsche Bank had never had an interest in the loan. This uncertainty about ownership complicates settlement, frustrates loan modification, and can, occasionally, expose homeowners to double jeopardy on their mortgage loans.

The problems establishing ownership and chain of title demonstrated in the robo-signing 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. [16]

C. All safety fuses limiting servicer abuses have been blown.

Most of the major servicers have acknowledged their failure to follow standard legal procedures for documenting transfer of the note and mortgage and failure to document correctly the amount and extent of the borrowers' default. While servicers claim to have remedied or be in the process of remedying these defects, no existing external mechanism will reliably prevent a recurrence. Indeed, 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

[16] *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).

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. 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, as most do. In many courtrooms, the foreclosure process resembles a factory assembly line far more than our images of a court of law.

During the years I represented homeowners—from 1994 through June 2007, before the massive levels of foreclosures we are currently experiencing—the judge hearing foreclosure cases would often dispose of one to two hundred cases in no more than an hour and a half. A few minutes before court opened, paralegals from the two firms representing lenders would wheel trolleys stacked with bankers' boxes into the courtroom. The paralegals would then empty the boxes onto the counsel tables, with the prepared orders paper clipped on top. Stacks of cases would then be handed to the judge, the judge would call out the homeowner's name, and if no one answered, sign the order and hand it to the courtroom clerk for file stamping. Those homeowners who did show up were told to go talk with the bank's lawyer out in the hallway, to see if something could be worked out. By and large, if the homeowner said, as many did, "The bank told me we could work something out," the judge would nonetheless sign the order for foreclosure, relying on the attorney's representation that their client had not communicated any instructions for ceasing the foreclosure but that, if they did work something out, the bank would come back and set the foreclosure aside. I sometimes appeared on as many as ten cases, but only one or two other homeowners were typically represented on those Thursday morning foreclosure docket calls, leaving often a hundred or more unrepresented.

That experience was not atypical, and the numbers have only gotten worse. The numbers of foreclosures have overwhelmed the already limited judicial resources. We cannot count on activist judges to find the time to independently review the filings in the hundreds of cases presented to them on each foreclosure docket. Fundamentally, our legal system relies on an adversarial model. Currently, that adversarial model is lacking in the vast majority of cases: lenders are represented by attorneys while homeowners go unrepresented. Only when homeowners are represented by competent and engaged attorneys are judges likely to confront the gross inadequacies found in many foreclosure filings. Homeowners facing foreclosure need increased access to attorneys.

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 reports 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.

III. Servicers' Incentives Incline Them Towards Increased Fees and Foreclosures over 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.

After a refinancing, which is always the path of least resistance for a servicer facing a homeowner in default, foreclosure is the best option from the servicer's point of view. The servicer's expenses, other than the financing costs associated with advances, will be paid first out of the proceeds of a foreclosure. Thus, the servicer will recover all sunk expenditures upon completion of the foreclosure, including the cost of services provided by affiliated entities, like title and property inspection.

Whether and when costs are recovered in a modification is more uncertain. While the credit rating agencies have made steps to improve clarity on the treatment of advances in a modification, there are still ambiguities. Existing PSAs provide at best spotty coverage of how a servicer should be paid for doing a modification and what kinds of modifications are preferred, offering the vague "usual and customary practices" as guidance to skittish servicers. Worse, recovery of costs is delayed in a modification, with some costs, particularly the sunk costs of staffing and time, not recovered at all.

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.[17] 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.

How long a delay in the foreclosure will be profitable depends on the interplay of the servicers' ability to charge additional fees during the foreclosure, on the one hand, and the servicer's financing costs for advances and the time limits for proceeding through foreclosure imposed by the PSA and credit rating agencies, on the other hand. If the servicer can juggle the time limits—perhaps by offering short term workout agreements—the prospect of increased fees may outweigh interim interest costs. Once the servicer's financing costs outweigh the incremental fees that can be extracted by maintaining a borrower in delinquency, the servicer will choose the

[17] *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.

faster option, either a foreclosure or a modification, all other things being equal.[18] Unfortunately for homeowners and investors, the faster option is usually a foreclosure.

Effect of Components of Servicer Compensation on Likelihood and Speed of Foreclosure

	Favors Foreclosure?	Likely Effect on Speed of Foreclosure?
Structural Factors		
PSAs	Neutral	Speeds Up
Repurchase Agreements	Neutral	Slows Down
REMIC rules	Neutral	Neutral
FAS 140	Slightly Favors Foreclosure	Neutral
TDR Rules	Slightly Favors Foreclosure	Neutral
Credit rating agency	Slightly Favors Foreclosure	Speeds Up
Bond insurers	Slightly Favors Foreclosure	Speeds Up
Servicer Compensation		
Fees	Strongly Favors Foreclosure	Slows Down
Float Interest Income	Slightly Favors Foreclosure	Neutral
Monthly Servicing Fee	Strongly Favors Modification (but not principal reductions)	Slows Down
Residual Interests	Slightly Favors Modification (but not interest reductions)	Slows Down
Servicer Assets		
Mortgage Servicing Rights	Neutral	Slows Down
Servicer Expenses		
Advances	Strongly Favors Foreclosures	Speeds Up
Fee Advances to Third Parties	Slightly Favors Foreclosure	Speeds Up
Staff Costs	Strongly Favors Foreclosures	Speeds Up

A. 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.

[18] Tomasz Piskorski, Amit Seru & Vikrant Vig, Securitization and Distressed Loan Renegotiation: Evidence from the Subprime Mortgage Crisis 5 (Dec. 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1321646 (finding increased numbers of modifications when the foreclosure process is delayed).

Financing these costs is one of servicers' biggest expenses.[19] 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.[20]

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.[21] Unpaid principal may or may not be advanced, depending on the PSA.[22] 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.[23] In a small number of cases, servicers may be exempted from continuing to make advances once the loan is in foreclosure or more than five months delinquent.[24] A servicer's failure to make advances, even "nonrecoverable" advances, can lead to the servicer's removal.[25]

---

19 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).

20 *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).

21 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).

22 *See, e.g.,* Ocwen Fin. Corp., *supra* note 17, 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).

23 Keane, *supra* note 22, at 3.

24 Servicers may also escape the requirement for advances if a borrower files for bankruptcy. Brian Rosenlund, Metropolitan West Asset Management RMBS Research 3 (Winter 2009).

25 Rosenlund, *supra* note 24.

Servicers' advances are taken off the top, in full, at the post-foreclosure sale, before investors receive anything. [26] 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).[27]

In contrast, when there is a modification, servicers are usually limited to recovering their advances from the modified loan alone, after required payments to the trust, or, if the advances are deemed nonrecoverable, from only the principal payments on the other loans in the pool, not the interest payments.[28] As a result, servicers can face a delay of months to years in recouping their advances on a modification. Modifications involving principal reductions compound the problem: they lengthen the time to recover advances on any individual modified loan as well as on other modified loans, by reducing the amount of principal payments available for application to recovery of advances.[29]

---

[26] Cordell et al., *supra* note 21, at 11; Ocwen Fin. Corp., *supra* note 17, 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)..

[27] *See, e.g.,* Ocwen Fin. Corp. *supra* note 17 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 26, 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).

[28] Monica Perelmuter & Jeremy Schneider, Standard & Poor's, Criteria: Structured Finance: RMBS: Methodology for Loan Modifications That Include Forbearance Plans for U.S. RMBS 3 (July 23, 2009).

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

Although the cost of the advances themselves may be recovered, the significant financing costs associated with making advances cannot be.[30] This incentive can encourage servicers to sell the investors out at a post-foreclosure fire sale, as the servicers seek to recoup their costs quickly once the possibility of additional fees is exhausted.[31]

The combined force of the limitations on the recovery of advances to the loan level and the non-recoverability of the cost of financing advances drives servicers to seek upfront payments from homeowners prior to modification. Few borrowers, having once defaulted, are in a position to make the large payments required to bring their loan current and then continue making regular payments; many redefault. But, of course, if the loan ends in foreclosure after a modification, the advances will again have super-priority status. Thus, servicers face no real risk by insisting on the payment of large upfront fees, even if the result is redefault.

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.[32] Taxes and insurance costs are also often advanced.[33] Some PSAs impose caps on these fee advances.[34]

---

[30] Joseph R. Mason, Mortgage Loan Modification: Promises and Pitfalls 4 (Oct. 2007). A large subprime servicer noted in its 2007 annual report that although "the collectibility of advances generally is not an issue, we do incur significant costs to finance those advances. We utilize both securitization, (i.e., match funded liabilities) and revolving credit facilities to finance our advances. As a result, increased delinquencies result in increased interest expense." Ocwen Fin. Corp., *supra* note 17, at 18; *see also* Wen Hsu et al., *supra* note 20 ("Servicer advance receivables are typically paid at the top of the cash flow waterfall, and therefore, recovery is fairly certain. However, . . . there is risk in these transactions relating to the timing of the ultimate collection of recoveries.").

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

[32] Cordell et al., *supra* note 21 at 17; *cf.* American Securitization Forum, Operational Guidelines for Reimbursement of Counseling Expenses in Residential Mortgage-Backed Securitizations (May 20, 2008), *available at*

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.[35] 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.[36] 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.[37]

B. Fees Are a Profit Center for Servicers

Most PSAs permit servicers to retain fees charged delinquent homeowners. Examples of these fees include late fees[38] and fees for "default management" such as property inspections.[39] The

---

http://www.americansecuritization.com/uploadedFiles/ASF_Counseling_Funding_Guidelines%20_5%20_20_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).

[33] *See, e.g.,* Ocwen Fin. Corp., *supra* note 17 at 4.

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

[35] *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 [hereinafter Goodman, *Homeowners and Investors May Lose*]; Goodman, *Lucrative Fees, supra* note 31; 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).

[36] *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 35 (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).

[37] *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.

[38] *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

profitability of these fees can be significant.[40] Late fees alone constitute a significant fraction of many subprime servicers' total income and profit.[41]

Servicers can collect these fees post-foreclosure before the investors receive any recovery.[42] This guaranteed recovery of fees strongly favors foreclosures over modifications that waive fees, including HAMP,[43] and encourages servicers to delay foreclosures in order to maximize the

---

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 26at S-11 (late payment fees are payable to a certificate holder in the securitization).

[39] *See, e.g.,* Prospectus Supplement, IndyMac et al., *supra* note 26 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.

[40] *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 35.

[41] *See, e.g.*, Ocwen Fin. Corp., *supra* note 17, at 34 (revenue from late charges reported as $46 million in 2008 and made up almost 18% of Ocwen's 2008 servicing income); Eggert, *supra* note 31, at 758; 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).

[42] *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).

[43] *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 (Publicy 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).

number of fees charged.[44] In a self-perpetuating cycle, the imposition of fees makes a foreclosure more likely, by pricing a modification out of a homeowners' reach.[45]

In addition to pre-foreclosure fees, servicers are usually entitled to recover the costs of selling the home post-foreclosure, before investors are paid.[46] The sometimes substantial fees paid to servicers in foreclosure tend to be invisible to investors.[47]

C. The two-track system increases foreclosures.

Credit rating agencies and investors typically require servicers to process both foreclosures and loan modifications at the same time. Subprime servicers, in particular, are expected to show "strict adherence to explicit timelines," offer and accept workouts from only a predefined and standardized set of options, and not delay foreclosure while loss mitigation is underway.[48] The speed at which loans are moved from default through foreclosure is "a key driver in the servicer rating,"[49] encouraging servicers to compete for the fastest time to foreclosure.

The foreclosure and loan modification will be handled by different departments at the servicer, with only imperfect communication. For years, training for housing counselors and attorneys seeking loan modifications for their clients has stressed the importance of speaking to loss mitigation, not collections or foreclosure. The continued vitality of that chestnut is borne out by

---

[44] Goodman, *Lucrative Fees, supra* note 31 ("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.").

[45] *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).

[46] *See, e.g.,* Prospectus Supplement, IndyMac et al., *supra* note 26 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).

[47] Goodman, *Lucrative Fees, supra* note 31.

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

[49] Pendley et al., *supra* note 48, at 9.

the recent experience of an Illinois homeowner whose case was, unbeknownst to her, transferred from loss mitigation to collections when she called on an especially busy day. The transfer resulted in denial of a loan modification, in part because, a helpful Chase employee told the homeowner's attorney, once a case is transferred from loss mitigation to collections, it cannot be transferred back.

Servicers rely heavily on the mechanized production of form documents in processing both foreclosures and loan modifications. Any variation from the cookie cutter norm imposed by the form documents causes delay and consternation, as an Illinois housing counselor learned when she asked that a waiver clause be stricken from a proferred loan modification. *See* Attachment A. The servicer informed the counselor that the form was generated by the computer and could not be changed.

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.

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,[50] and the homeowner suffers the financial, credit, and emotional toll of defending a foreclosure. The two-

---

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

track system allows servicers to increase their profit from fees, through the imposition of foreclosure related fees. These fees are lucrative to the servicer, but can price a modification out of a homeowner's reach. Moreover, where there is little or no equity left in the home, reimbursement for these fees will come out of the investor's pockets at any foreclosure sale or from future payments on the loan.

The two-track system was instituted to encourage servicers to minimize delay, 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. The result is unnecessary foreclosures. .

D. The Problem of Principal Reductions

In an era when one in four homeowners is underwater, principal reductions are key to stabilizing the housing market.[51] The double whammy of declining home values and job losses helps fuel the current foreclosure crisis.[52] 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.[53] Existing data on loan modifications shows that loan modifications with principal reductions tend to perform better.[54] In order to bring down the

[51] 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.

[52] *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).

[53] 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).

[54] 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*

redefault rate and make loan modifications financially viable for investors, principal reductions must be part of the package.[55]

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.[56] 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 writedowns in refinancing.[57] 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 writedowns 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

---

http://www.ccc.unc.edu/documents/LM_March3_%202009_final.pdf; Pendley, *supra* note 9, at 16 (modifications without principal reductions experience higher redefault rates than those with principal reductions); Pendley *supra* note 48, at 2, 10–11 (modifications with principal reductions greater than 20% perform better than any other category of modifications, but few modifications with principal reductions done and redefault rates, even for loans with a 20% principal reduction, remain at 30%–40% after 12 months).

[55] *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.").

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

[57] *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).

securitization trust. At least some investors would prefer to see more principal reductions through modifications in the absence of refinancing. [58]

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. One low-income Brooklyn homeowner, for example, was offered a HAMP loan modification with a $280,000 balloon payment, due when she would be 86.

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.

[58] *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).

Principal forbearance, unlike interest or principal reductions, stabilizes the monthly servicing fee. 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.[59] Even better, the amount of forborne principal is not reduced by the borrower's monthly payments, leaving the servicer with an inflated income stream for the life of the loan.

Principal forbearance is generally less desirable than principal reduction from a borrower's viewpoint: with principal forbearance, borrowers do not accumulate equity, and they face a balloon payment at the end of the loan. And principal forbearance may result in higher-rated bond holders being shorted on interest payments. But, for a servicer, principal forbearance is preferable to principal reduction: it preserves more monthly servicing fee income for longer.

IV. As a Result of Misaligned Incentives and Servicer Abuses, Both Homeowners and Investors Suffer.

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

[59] *See* American Securitization Forum, Discussion Paper, *supra* note 63, at 8–9.

investors'money. According to some data, investors are now losing nearly 60% of the loan value on each foreclosure, over $145,000 per foreclosure.[60] 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.[61] Recent reporting in the American Banker has illustrated the detrimental impact of force-placed insurance in particular on investor returns.[62]

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.

Servicers, though nominally acting on behalf of investors, have wide discretion in deciding whether to modify a loan—or not.[63] As a result, servicers have chosen to modify loans only

---

[60] *See* Alan M. White, Sept. 26, 2010 Columbia Collateral File Summary Statistics, http://www.valpo.edu/law/faculty/awhite/data/sep10_summary.pdf.
[61] *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).
[62] 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.
[63] *See, e.g.,* American Securitization Forum, Discussion Paper on the Impact of Forborne Principal on RMBS Transactions 1 (June 18, 2009) [hereinafter American Securitization Forum, Discussion Paper], *available at* http://www.americansecuritization.com/uploadedFiles/ASF_Principal_Forbearance_Paper.pdf (noting that servicers are largely left to their own discretion in determining what kinds of modifications to approve); Bernanke, Speech at Federal Reserve, *supra* note 5 ("The rules under which servicers operate do not always provide them with clear guidance or the appropriate incentives to undertake economically sensible modifications.").

when it suited their interests to do so, without much regard to the benefit to investors. Often, it has not suited servicers' interests to modify a loan. Indeed, servicers have seen their profitability per loan rise in the last year as losses to investors from foreclosures have skyrocketed.[64]

Investors have hitherto had very little opportunity to review data on loan modifications, let alone exercise control over a servicer's loan modification decisions. Obtaining information about the nature and extent of loan modifications is not easy, even for investors.[65] Determining how loan modifications impact the return on any one security is even harder.[66] The sometimes substantial fees paid to servicers in foreclosure tend to be invisible to investors.[67] Investors lack the necessary information to make judgments about the cost or benefit of a loan modification. As one commentator observed, "the investor has to completely trust the servicer to act in their behalf, often in substantially unverifiable dimensions."[68] The lack of data often inclines investors to support the certainty of foreclosures over the uncertainty of modifications.

Even once investors recognize there is a problem with the servicer's performance, it is often impossible to get the necessary number (usually a majority)[69] of investors to agree.[70] In large

---

[64] *Servicers Earn More Per Loan,* MortgageDailyNews.com, June 29, 2010.
[65] *See* Complaint at 6, *Carrington Asset Holding*, *supra* note 31 (noting that information on the disposition of foreclosed property was available to junior investor only because of "special rights" bargained for by institutional investor).
[66] *See, e.g.,* Matthew Tomiak & William Berliner, *The Complex New World of RMBS Shortfalls,* Am. Securitization Journal 16 (Winter/Spring 2010).
[67] Goodman, *Lucrative Fees, supra* note 31.
[68] *See, e.g.,* Joseph R. Mason, Servicer Reporting Can Do More for Modification Than Government Subsidies 14 (Mar. 16, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1361331.
[69] *See, e.g.,* Prospectus Supplement, Asset-Backed Pass-Through Certificates, Series 2002-2, Ameriquest Mortgage Securities Inc., Depositor, Ameriquest Mortgage Company, Originator and Master Servicer 44–45 (June 3, 2002) (agreement of 51% of certificate holders required); Complaint at 6, Carrington Asset Holding Co., L.L.C. v. American Home Mortgage Servicing, Inc., No. FST-CV 09-5012095-S (Conn. Super. Ct., Stamford Feb. 9, 2009) (describing "special rights" Carrington allegedly bargained for as holder of the most junior certificates to direct the disposition of property after foreclosure and stating that certificate holders normally have no power to direct the actions of the servicer in property disposition).

subprime pools there may be hundreds of investors, who have differing views of what the appropriate response to a pending foreclosure is.[71] For most subprime securities, different investors own different parts of the security—principal payments, interest payments, or prepayment penalties, for example—and get paid in different orders depending on their assigned priority. Depending on the priority of payment and whether or not a modification reduces interest or principal payments, two investors in the same pool may fare very differently from a modification, with one investor seeing no change in payments and the other investor having its payments wiped out completely.[72]

V. Servicing Reforms Should Be Instituted.

Basic problems in the structure of the servicing industry need to be addressed in order for the homeowner-servicer relationship to be functional. 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. 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

---

[70] *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).

[71] Cordell et al., *supra* note 21, at 22.

[72] *Cf.* Maurna Desmond, *The Next Mortgage Mess: Loan Servicing? Claims of Fraud in the Subprime Mortgage Market Illuminate a Murky World,* Forbes.com, Mar. 20, 2009, http://www.forbes.com/2009/03/20/subprime-mortgages-carrington-capital-business-wall-street-servicers.html (noting that delaying foreclosures and concealing default helps junior investors but hurts senior investors).

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.

1. **Eliminate the two-track system and mandate loan modification before a foreclosure.**

Foreclosures impose high costs on families, neighbors, extended communities, and ultimately our economy at large.[73] Proceeding with a foreclosure before considering a loan modification results in high costs for both investors and homeowners. These costs—which accrue primarily to the benefit of the servicer—can make an affordable loan modification impossible. Moreover, the two track system, of proceeding simultaneously with foreclosures and loan modification negotiations, results in many "accidental" foreclosures, due to bureaucratic bungling by servicers,[74] as one department of the servicer fails to communicate with another, or papers are lost, or instructions are not conveyed to the foreclosure attorney.

If a servicer can escape doing a modification by proceeding through a foreclosure, servicers can choose, and in many instances have chosen, to forgo nominal incentives to modify in favor of the certainty of recovering costs in a foreclosure. Staying all foreclosures during the pendency of a loan modification review would encourage servicers to expedite their reviews, rather than

---

[73] Bernanke, Speech at Federal Reserve, *supra* note 5.

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

delaying them. Congress or the federal regulators should mandate consideration of a loan modification before any foreclosure is started, and should require loan modifications where they are more profitable to investors than foreclosure. Only federal action will ensure that residents of all states obtain this essential protection.

2. **<u>Provide that the failure to offer a loan modification to a qualifying homeowner is an absolute defense to foreclosure, in both judicial and non-judicial foreclosure states.</u>**

While government enforcement is essential to ensuring compliance with legal requirements, it generally is complemented and strengthened by the right of individuals to also seek accountability. One reason why HAMP compliance has been so weak is that homeowners do not explicitly have the right to demand it. Too many unnecessary foreclosures are proceeding as a result. A rule requiring loan modifications to qualified homeowners is intended to save homes. Yet, government enforcement does not have the resources to address each case of noncompliance that may lead to an unnecessary foreclosure. A rule providing a defense to foreclosure where loan modification requirements have not been followed would align the incentives of servicers with the priorities of both homeowners and investors, Moreover, a foreclosure defense can be crafted to protect homeowners while providing bright line rules for servicers and investors.

3. **<u>Increase opportunities for loan modification by providing for quality mediation programs and funding for legal services.</u>**

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. Only depositions and careful document review have revealed the robo-signing debacle. 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 Home Ownership Preservation

Project at the Legal Assistance Foundation of Metropolitan Chicago, for example, expects to lose roughly half its staff to funding cuts by mid-2011, although foreclosure filings in Illinois continue to rise, with Chicago-area filing alone at about 50,000 per year.

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.

4. **Provide for principal reductions in HAMP and via bankruptcy reform.**

The double whammy of declining home values and job losses helps fuel the current foreclosure crisis.[75] 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.[76] Existing data on loan modifications shows that loan modifications with principal reductions tend to perform better.[77] In order to bring down the redefault rate and

[75] *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).

[76] 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* Handbook, *supra* note 53 at 17.

[77] 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; Pendley, *supra* note 9, at 16 (modifications without principal reductions experience higher redefault rates than those with principal reductions); Pendley *supra* note 49, at 2, 10–11 (modifications with principal reductions greater than 20% perform better than any other category of modifications, but few modifications with principal reductions done and redefault rates, even for loans with a 20% principal reduction, remain at 30%–40% after 12 months).

make loan modifications financially viable for investors, principal reductions must be part of the package.[78]

HAMP permits principal reductions, but does not mandate them, even when an investor would be better off with a principal reduction than without. HAMP does require forbearance. 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. The HAMP guidelines should be revised so that they require the reduction of loan balances to at least 125 percent of the home's current market value, as does the Federal Reserve Board's loan modification program.

In addition, Congress should enact legislation to allow bankruptcy judges to modify appropriate mortgages in distress. First-lien home loans are the only loans that a bankruptcy judge can never modify.[79] The exclusion of home mortgages from bankruptcy supervision dates back to the 1978 Bankruptcy Code, when mortgages were generally conservative instruments with a simple structure. The goal was to support mortgage lending and homeownership. Today, support for homeownership demands that homeowners have greater leverage in their effort to avoid foreclosure.

---

[78] *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.").

[79] Second liens can be modified if they are, as many are in the current market, completely unsecured because the amount of the first lien equals or exceeds the market value of the property.

Further reform of the tax code to simplify the exclusion of discharge of indebtedness income would also be of assistance to many homeowners, particularly homeowners with significant refinancing debt whose servicers are persuaded to do sustainable principal reductions.[80]

5. **Regulate default fees.**

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.

Servicers' fees should be treated as nonrecoverable advances, in the event of either a modification or a foreclosure, subject to recovery from the pool, provided that such fees are legal, reasonable and necessary. This treatment would spread the cost of modifications more uniformly across the pool, in line with the loss allocations contemplated at the pool's origin, while creating parity between foreclosures and modifications.

Permitting servicers to recover waived default fees from all the income from a pool in the event of a modification would increase investors' incentive to monitor servicers' use of default fees, perhaps reducing the imposition of bogus fees. It would also reduce servicers' incentives to

[80] *See generally* 2008 Nat'l. Taxpayer Advocate Ann. Rep. at vi – vii (summarizing recommendations regarding changes to the treatment and reporting of cancellation of debt income in the mortgage context).

complete a foreclosure, and increase the availability of affordable modifications. Investors share borrowers' interests in sustainable modifications; investors are in a better position than borrowers to set and enforce prudential standards for the imposition of default fees.

Servicers should be limited to one reasonable appraisal fee before a the 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.

Federal regulators should conduct random sample reviews of the servicing and payment history of all servicers. While abusive servicing fees have been well documented for many years, regulatory examination of these matters has been strikingly limited. Because analyzing the assessment of fees and the application of payments is a complex manner, regulators could adopt a sampling approach that would provide insight into how accounts have been handled.

6. **The remaining investor restrictions on modifications must be eased and communicated clearly to borrowers.**

Investor restrictions are not the main reason loan modifications are denied.[81] Indeed, investors often would prefer that servicers perform more modifications than they actually do. [82]

---

[81] *See, e.g.,* Congressional Oversight Panel, Foreclosure Crisis: Working Toward a Solution 23 (Mar. 6, 2009) ("the cap is not the major obstacle to successful modifications"). *See generally* Diane E. Thompson, 5-7 Why Servicers Foreclose When They Should Modify (Oct. 2009), *available at* consumerlaw.org.

[82] *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); 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

Nonetheless, a small percentage of loans (probably no more than ten percent of all subprime loans) are in pools that originally prohibited all material modifications.[83] (In some cases, these restrictions have been lifted entirely from the securitization agreements, sometimes after sponsors of the securitization petitioned the trustee).[84]

Congress and the regulators should encourage investors to ease these restrictions in the minority of cases where they remain. Servicers must be encouraged to seek waivers of actual existing restrictions. All too often, purported investor restrictions evaporate when a determined advocate presses for and obtains the actual pooling and servicing agreement. In order to limit servicers hiding behind non-existent servicer restrictions, servicers must be required to document the restriction and their attempts to obtain a waiver, and provide that documentation to the borrower when relying on an investor denial.

Under HAMP, servicers are required to provide NPV positive modifications unless the investor contract prohibits such an agreement, the servicer has sought a change in policy from the investor and the investor has not agreed. The program requirements for documentation are weak, at best. Suggested language to provide transparency and accountability for homeowners is below:

> *When a servicer believes a PSA prevents an NPV-positive modification, the servicer shall contact the trustee and any other parties authorized under the terms*

---

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).

[83] John P. Hunt, Berkeley Ctr. for Law, Business, and the Economy, *What Do Subprime Securitization Contracts Actually Say About Loan Modification: Preliminary Results and Implications* 7 (Mar. 25, 2009), *available at* http://www.law.berkeley.edu/files/bclbe/Subprime_Securitization_Contracts_3.25.09.pdf.

[84] Moody's Investor Service, No Negative Ratings Impact from RFC Loan Modification Limits Increases (May 25, 2008); Morgan Stanley Omnibus Amendment (Aug. 23, 2007) (on file with author). The securitization's sponsor in this case likely held some equity interest in the securitization.

of the PSA to grant a waiver, whether individual investors, credit rating agencies, bond insurers, or otherwise, in order to obtain permission to perform a HAMP modification. The servicer shall provide the borrower or the borrower's representative a copy of the limiting language in the PSA, a copy of all correspondence with the lender and investors attempting to obtain authority to perform a modification, and electronic access to a complete and unaltered copy of the PSA.

7. **HAMP must be improved.**

   a. Enforcement and compliance mechanisms under HAMP must be adopted, including the enactment of the Franken Amendment that gives homeowners the ability to appeal HAMP servicer decisions.

It seems unlikely that all servicers will always accurately evaluate the qualifications of every homeowner who is eligible for HAMP. In fact, evidence to date indicates that errors in HAMP reviews are common. Homeowners who are wrongly denied must be afforded an independent review process to review and challenge the servicer's determination that the borrower does not qualify for HAMP. While the current "escalations" program run by the Treasury Department and staffed by Fannie Mae aims to review and resolve homeowner complaints, outcomes too often do not result in HAMP compliance. Implementation of the "Franken Amendment" provisions to create an Office of the Homeowner Advocate would change this dynamic and provide much greater accountability.

   b. Principal forgiveness under HAMP must be mandated.

As discussed above, principal forgiveness is necessary to make loan modifications affordable for some homeowners. Practically, principal reductions may be key to the success of HAMP. Being "underwater" increases the risk of default, particularly when coupled with unaffordable payments.[85] 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, the HAMP guidelines should be revised so that they mandate principal reductions.

c. Coordination with the second lien program must be strengthened.

Servicers continue to express ignorance of the second lien program and widely refuse to modify second liens, even though certain large servicers have signed contracts to participate in the program. For example, Bank of America representatives recently told a Chicago-area housing counselor that it could not modify second liens.

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

[85] *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.

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.

d. Homeowners suffering an involuntary drop in income should be eligible for an additional HAMP loan modification.

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 HAMP 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, and should include continued eligibility for HAMP modifications rather than only specific servicer or investor programs.

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 recent guidance to FHA servicers, has explicitly recognized that offering a loan modification does not violate the automatic stay or a discharge order.[86]

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 subsidizemodifications below 31% where the homeowner has low residual income or high fixed expenses.

e. Conversion from trial modifications to permanent modifications should be made automatic and self-executing.

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. Sometimes a servicer sends more than one permanent modification offer (including those that are essentially seeking to get the homeowner to opt out of HAMP). Even if the homeowner signs and returns the permanent modification agreement, servicers often delay by weeks or

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

months the countersigning of the document. Automatic conversions will streamline this last step in the HAMP process and decrease incentives for servicers to solicit opt-outs from HAMP.

f. The period of time for unemployment forbearance should be extended, no further trial modification period should be required after the unemployment forbearance period ends, and no fees other than interest should accrue during the period of unemployment forbearance, consistent with the treatment of homeowners in trial modification plans.

Despite the fact that the HAMP program no longer counts unemployment insurance as income, federal and state programs to assist unemployed homeowners are barely off the ground. Adjustments are needed to HAMP's treatment of the unemployed to ensure that these homeowners will still be in their homes when the programs intended to address their needs are fully functioning. Moreover, the trial modification requirement should be removed for homeowners who already have completed a forbearance period. Both trial modifications and forbearance programs result in increasing loan principals and no homeowner should be subjected to two different systems that will substantially raise their principal.

VI. 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 robo-signing scandal, servicers' lawless behavior threatens the integrity of our legal and economic systems. The need to act is great. The HAMP program must be strengthened. 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.

ATTACHMENT A—PNC LOAN MODIFICATION AGREEMENT