Home Foreclosure in California – Can We Do More To Respond To This Continuing Impediment to Economic Recovery, Homeownership, Strong Communities, and Jobs?

Joint Oversight Hearing of the Assembly Banking, Housing and Judiciary Committees

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-- *Briefing Paper Prepared by the Staffs of the Assembly Banking and Finance, Housing and Judiciary Committees*

Introduction

In early 2007 it became clear that the U.S. housing market was in deep trouble as several major mortgage lenders filed for bankruptcy, while others teetered on the brink of collapse. At first this downturn was limited to the housing sector of the economy, but over time it became evident that the entire economy was at risk due to the complex and interdependent nature of housing finance. Today, California faces the second-highest unemployment rate in the nation, as well as one of the highest foreclosure rates.

Of course, the pain of the foreclosure crisis has been widely shared by homeowners, the financial markets, investors, and others. Foreclosures blight neighborhoods, put financial pressure on families and drive down local real estate values. And consumers, made more cautious by a crippled housing market, spend less freely, curbing the economy's growth. Distressed borrowers are certainly among the hardest hit. But as communities across the country know all too well, families that lose their homes are not the only victims of foreclosures. Even homeowners who have never missed a payment on their loans have suffered as "spillover" costs extend throughout the neighborhood and the larger community. By some estimates the foreclosure crisis will strip neighboring homeowners of $1.9 trillion in equity as foreclosures drain value from homes located near foreclosed properties by 2012. As a result of depressed home values, nearly one out of every four borrowers is "underwater," owing more than the home is worth. Meanwhile, state and local governments continue to be hit hard by declining tax revenues coupled with increased demand for social services. In fact, the Urban Institute estimates that a single foreclosure costs $79,443 after aggregating the costs borne by financial institutions, investors, the homeowner, their neighbors, and local governments. However, even this number may understate the true cost, since it does not reflect the impact of the foreclosure epidemic on the nation's economy or the disparate impact on lower-income and minority communities.

This past year, new and unseen difficulties have added to the already troubling foreclosure crisis. Across the country media stories have raised concern regarding the legal rights and remedies available to borrowers in the foreclosure process, as well as, various complications involving the assignment of mortgage notes and actual holders of title. The issue of who holds the mortgage note and who may exercise the power of sale has been a growing conundrum across the nation. This issue and the perspectives involved will be discussed further in this briefing paper.

Policy makers continue to debate how best to stem the foreclosure crisis. When the Bush Administration first stepped in to shore up the economy in 2008, it chose to buttress Wall Street and the banking system with hundreds of billions of dollars in taxpayer bailouts while largely leaving homeowners on their own. Recent federal, state and industry programs have sought to promote permanent and sustainable loan modifications that homeowners can manage.

I. Current State of the California Real Estate Market, Mortgage Defaults and Foreclosure Activity

Current Conditions. Nationwide, over two and half million homes are in some stage of foreclosure. A total of more than 3.8 million foreclosure filings -- default notices, scheduled auctions and bank repossessions -- were reported on a record 2.87 million U.S. properties in 2010, according to a January 2011 report by RealtyTrac, Inc**.** The number of filings was an increase of nearly 2 percent from 2009 and an increase of 23 percent from 2008.

According to RealtyTrac, a total of 546,669 California properties received a foreclosure filing in 2010, a decrease of nearly 14 percent from 2009 but still the largest state total. After hitting a two-year low in November, California foreclosure activity rebounded nearly 15 percent higher in December but was still down 18 percent from December 2009. (The charts attached in the Appendix to this paper provide more detail on 2010 California data.)

Observers have noted that the numbers would have been much higher were it not for the decision of several major banks to slow foreclosures dramatically late last year amid scrutiny from lawmakers, regulators and law enforcement officials over their foreclosure practices, including allegations of faulty documentation.

Forecasts For The Coming Year. The Federal Reserve estimates there will be two and one-quarter million foreclosures this year, and about two million more in 2012. The Center for Responsible Lending released a foreclosure forecast estimating an additional 9 million foreclosures between 2009 and 2012. Regardless of the discrepancy between these estimates, the enormity of the continuing tragedy is clear.

A large number of adjustable-rate mortgages are reportedly scheduled to reset to higher rates in coming months. That could lead to another uptick in foreclosures if the borrowers cannot make the higher payments, or decide that they are throwing good money after bad. With high unemployment, a weak economy and problem loans, many believe that California foreclosures in 2011 could surpass last year, and possibly the peak year of 2009.

According to published reports, lenders are poised to take back more homes this year than any other since the U.S. housing meltdown began in 2006. About 5 million borrowers are at least two months behind on their mortgages and industry experts say more people will miss payments because of job losses and also loans that exceed the value of the homes they are living in. "2011 is going to be the peak," said Rick Sharga, a senior vice president at foreclosure tracker RealtyTrac Inc. The firm predicts 1.2 million homes will be repossessed this year. The blistering pace of foreclosures this year will top 2010, when a record 1 million homes were lost, RealtyTrac said." ("2011 to Top 2010 Record of 1 Million Foreclosures," Associated Press, Jan. 13, 2011.)

At the same time, new mortgage originations are trending down. Freddie Mac estimates that mortgage originations will total $1.05 trillion this year, down from a projected $1.2 trillion last month and $1.8 trillion in January 2010. In a forecast last October, the Mortgage Bankers Assn.

predicted that 2011 originations would fall below $1 trillion because of the drop in refinancings and a weak economic recovery.

II. Federal, State and Industry Responses to Homeowner Defaults and Foreclosures

A. Federal Efforts.

The federal "Making Home Affordable Program" was developed by the U.S. Department of the Treasury, at the urging of President Obama, in order to help borrowers avoid foreclosure.

Home Affordable Modification Program. In 2008, the president signed and enacted the Emergency Economic Stabilization Act. This legislation granted Treasury the opportunity to create the Troubled Asset Relief Program (TARP). In 2009, Treasury allocated $50 billion in TARP funds to implement the Home Affordable Modification Program (HAMP).

HAMP relies on financial incentives to servicers to modify mortgages for homeowners as well as beneficiaries of these modifications to stay current on their mortgage payments going forward. When a servicer qualifies for HAMP, the lender must first reduce monthly payments until they are no more than 38% of the borrower's gross monthly income and then the Treasury will match, dollar for dollar, further reductions required to bring the monthly payments down to 31% of the borrower's income.

Borrowers may be eligible for HAMP if:

1) the home is owner-occupied, not vacant and not condemned;

2) the remaining balance on the home does not exceed $729,750;

3) the borrower is delinquent or in default;

4) the borrower demonstrates financial hardship; and

5) the borrower has a monthly debt-to-income ratio of more than 31% (meaning the monthly mortgage payment must be greater than 31% of the borrower's grossly monthly income.)

If a borrower is eligible for HAMP, the borrower must successfully complete a three month trial period. A borrower who remains current through the trial period becomes eligible for a permanent modification. As of October 3, 2010, 105 servicers enrolled in HAMP covering nearly 90% of all non-GSE mortgage loans.

HAMP will only continue to make trial modifications until the end of 2012. In addition, the Treasury as of October 3, 2010 can no longer make programmatic changes to HAMP nor will any additional TARP money be allocated to the program.

It is important to note that HAMP modifications are not the only option available to borrowers. First, a large number of loans are not eligible for HAMP based on the type of loan or the borrower's characteristics. Even in those cases where a borrower may not qualify for HAMP, many servicers do offer their proprietary modification programs.

Congressional Oversight Panel Assessment of HAMP. According to a report released by the Congressional Oversight Panel (COP) on December 14, 2010 reviewing Treasury's Foreclosure Prevention Programs, the panel estimates that, if current trends hold, HAMP will prevent only a small fraction of the foreclosure crisis (700,000 to 800,000 foreclosures). The program was originally estimated to stop 3 to 4 million foreclosures. Treasury's authority to restructure HAMP ended on October 3, 3010 so the success of the program is unlikely to improve. To date, HAMP has only permanently modified loans for 519,648 borrowers.

As of October 31, 2010, about 1.4 million trial modifications had been initiated under HAMP. Of these, 20,998 were initiated in October 2010. Between May and October 2010, each month posted, there was an average of 23,000 new trial modifications, down from a high of almost 160,000 in October 2009.

HAMPs initial premise, COP said, was straightforward. Because foreclosures allow the investor only a small recovery, lenders should generally prefer to avoid that step. HAMP was designed to further incentivize lenders to modify the loan rather than foreclose by offering payments to all parties to modify through a reduction in monthly payments. The primary problem, according to the report, is that HAMP did not take into account the complexity of the mortgage relationship. Rather than a one-to-one borrower/lender situation, most mortgages involve a servicer whose interests may collide with that of both of the other parties. These issues are explored in greater detail in other sections of this paper. HAMPs attempt to correct this market distortion by offering payments to servicers, the report finds, appear to have fallen short, in part because servicers were not required to participate in the program. (*See* "Report Charges Conflicts Of Interest In Treasury Program," National Law Journal, December 14, 2010; "Congressional Oversight Panel Blasts HAMP," Mortgage News Daily, Dec. 14, 2010.)

Obstacles to HAMP Success. The recent COP report discusses a number of obstacles to HAMP which are summarized below.

- Fees. It could be in the best interest of a servicer to foreclose on a property. Although lenders suffer significant losses on a foreclosure, the servicer collects fees in a foreclosure. According to the Congressional Oversight Panel, it is in the servicer's interest to keep a mortgage for as long as it is producing an income stream, and once it goes into default, to ensure that the mortgage goes through foreclosure.

- Re-default. As of October 2010, approximately 35,815 borrowers with permanent modifications had re-defaulted out of the 519,648. This equals a redefault rate of 6.9%.

- Voluntary. HAMP is a voluntary program. While there are incentives for lenders and servicers to participate it is completely on a voluntary basis. The Treasury does not have the ability to pressure servicers to actually make modifications.

- Second liens. HAMP does not take into consideration second mortgages. It may not be in the best interest of a second lien holder to modify a loan. HAMP also does not consider credit card debt and car debt. More than 40% of homes and approximately 50% of HAMP participants have second liens.

- No data. Up to this point, Treasury has not collected any data that would explain the lack of success.

- No accountability. Treasury has not held servicers accountable for losing paperwork and not performing permanent loan modifications.

- Outsourcing. Treasury has outsourced the responsibility for overseeing servicers to Freddie Mac and Fannie Mae who have close business relationships with the servicers.

- Borrower debt. HAMP is designed to get borrowers to a payment that is 31% of their monthly income. This calculation does not take into account all of the borrowers debt such as credit cards, second liens and car debts. Due to this front end concentration, borrowers post-modification are still left with back-end DTI ratios on the average of 63%. This factor may explain re-defaults even when the front end DTI is 31%.

- Negative equity. Of all active modifications 95% have an unpaid principal balance that is higher than it was before modification, with 76 of mortgages in permanent modifications carrying a negative loan-to-value ratio.

B. Other Federal Foreclosure Mitigation Programs.

Home Price Decline Protection (HPDP). Effective on July 31, 2009, designed to address the issue of investor objections to modifications due to the fear of declining home values. Investors receive incentive payments that accrue over a 24-month period to mitigate potential losses and encourage consent to proposed modifications.

Principal Reduction Alternative (PRA). Effective October 1, 2010, this program provides principal forgiveness. Servicers are required to evaluate a loan that is eligible for HAMP and has a market-to-market loan-to-value ratio greater than 115%. Final decision on whether to grant a reduction is the servicers. Investors receive incentive payments as well as a percentage of each dollar forgiven.

Home Affordable Unemployment Program (UP). Effective July 1, 2010, this program assists unemployed homeowners by granting a temporary forbearance of a portion of their monthly mortgage payment for a minimum, the lesser of three months or until employment is regained. During the forbearance period, payments are reduced to no more than 31% of the borrower's gross monthly income, including unemployment benefits.

Home Affordable Foreclosure Alternatives (HAFA). Effective on April 5, 2010, this program was created to encourage the use of short sales and deeds-in-lieu of foreclosure for HAMP-eligible borrowers unable to qualify for modifications of currently underwater mortgages. Servicers agree to forfeit the ability to seek a deficiency judgment in exchange for borrowers engaging in short sales or issuing deed-in-lieu of foreclosures. All parties receive financial incentives in the form of relocation assistance, one-time completion, and reimbursement to release subordinate liens.

Second Lien Modification Program (2MP). Effective August 14, 2010, this program allows borrowers to apply for a modification on their second loan if their first loan has been modified.

ALL 2MP modifications must consist of: an interest rate reduction, an extension of term years matching the first loan modification, and principal forbearance or reduction matching the percentage of any principal forbearance or reduction on the first loan.

FHA Short Refinance Program. Effective on September 7, 2010, this program allows borrowers to refinance non-FHA insured underwater mortgages into above-water, FHA insured mortgages. Eligible borrowers are not guaranteed a refinance and program participation is voluntary for servicers on a case-by-case basis.

<u>C. State Laws In Response to the Foreclosure and Lending Crisis.</u>

SB 1137. California's principal legislative response to the foreclosure crisis has been SB 1137 (Perata) of 2008. Until January 2013, this measure requires every lender or servicer to endeavor to contact borrowers for certain mortgages (first loans on a principal residence recorded between January 1, 2003 and January 1, 2008) in person or by telephone in order to assess the borrower's financial situation and explore options for the borrower to avoid foreclosure. During the initial contact, the lender or servicer is to advise the borrower that he or she had a right to request a meeting and that the meeting, if requested, would have to occur within 14 days of the request. Failure to comply with these requirements prevents filing a notice of default (NOD) until 30 days after the lender or servicer complies.

SB 1137 requires the lender or servicer to make a "diligent" effort to contact covered borrowers, without expressly stating what that might entail. The law does not require the lender or servicer to actually offer the borrower a loan modification, only to contact the borrower to discuss the borrower's options. If the lender or servicer did not have a loan modification program, or if the borrower did not meet the requirements for a modification, the lender or servicer had no obligation to negotiate with the borrower, much less reach an agreement on a modification.

It is not known whether these requirements have been effective. The law does not specify what should occur at the meeting or provide any clear enforcement mechanism if the holder or servicer does not offer any meaningful workout options or negotiate in good faith. The law does not add any process for court or some third-party review to the dominant non-judicial foreclosure process in California if the borrower is dissatisfied with the outcome.

In September of 2010, the Attorney General issued a letter to all lenders and servicers operating in California asking them to suspend foreclosures until they could confirm that they comply with California's contact requirements under SB 1137. While some lenders did temporarily suspend foreclosure actions at about this time, these lenders have since resumed foreclosures, and it is unclear whether or how any lenders and servicers responded to the Attorney General's request to provide evidence of compliance with the requirements of SB 1137.

ABX2 7 (Lieu) of 2009. This bill also sought to encourage loan modification by requiring the lender or servicer to wait 90 days after a default before filing a notice of sale on a foreclosed property; however, an exemption to this additional 90-day delay could be obtained for lenders and servicers who had implemented a "comprehensive loan modification program." The purpose of this legislation was to either encourage lenders or servicers to develop loan modification programs (and thereby be exempted from the additional 90-day delay) or, where no programs had been developed, to give the borrower additional time to cure the default or negotiate a modification.

Other State Legislation. The Legislature has enacted a handful of other measures related to the lending and foreclosure crisis since 2007 regarding both lending, loan modification, foreclosure, tenant protections, foreclosure consultants and related issues. A table listing these measures is attached at Table 1. The Legislature has also considered many additional measures that either failed passage or were vetoed by Governor Schwarzenegger. Perhaps most prominent among these was last year's SB 1275 (Leno and Steinberg) and AB 1639 (Nava, Lieu, Bass) which attempted to strengthen loan modification obligations. A table listing these bills along with other unsuccessful measures is attached at Table 2.

D. Banking Industry Programs.

Banking industry mortgage servicers through the HOPE NOW Alliance offer loan modifications for borrowers who either don't qualify for HAMP, or for loans that are not covered. HOPE NOW is a private sector voluntary alliance of mortgage servicers, investors, mortgage insurers and non-profit counselors that began in October of 2007 as the initial coordinated industry response to the foreclosure crisis. Based on metrics released by the Alliance for November, 2010, the pace of proprietary modifications has outpaced HAMP modifications over the previous year, and over a month-to-month average.

At first, HOPE NOW was off to a shaky start. Servicers were overwhelmed with borrower inquiries, and it was unclear what type of modification would lead to sustainability for the borrower. These obstacles, among others, were demonstrated in a report from the Congressional Oversight Panel, March Oversight report "Foreclosure Crisis: Working Toward a Solution" (March 6, 2009) that found that 49% of HOPE NOW workouts had reduced borrower's monthly payments, while 34% had actually resulted in higher monthly payments. However, recently HOPE NOW reported on October 2, 2010 that 91% of the 150,000 modifications completed in August 2010 involved payments reductions. Proprietary loan modifications have outpaced HAMP modifications, however, on average HAMP modifications offer greater payment reductions and have a lower risk of re-default. While some comparisons can be made on the pace of loan modifications for HAMP versus proprietary modifications, the Congressional Oversight Panel reports, "the lack of comprehensive, reliable data makes it difficult to make an apples-to-apples comparison of HAMP and non-HAMP programs."

The nature of proprietary loan modifications offered by servicers vary by servicer and by loan characteristics so proprietary loan modifications are not standardized across the industry, as opposed to the standardization of HAMP. Servicers that participate in HAMP must first determine if a borrower is eligible for HAMP before considering them for a proprietary loan modification. Often lost in the discussion of loan modifications is that the ability to get a modification, or the type of modification offered, may reach beyond simple borrower qualifications. Investors may be required to give approval for certain modification approaches, and some loans by their nature are more apt for specific modification actions. For example, the growth of prime loan defaults has reportedly been problematic to address because prime loans may have less modification flexibility because they lack the features of non-prime loans, such as adjustable payments, that would allow quick changes to monthly payments.

III. California's Customary Non-Judicial Foreclosure Process is Expeditious And Generally Appropriate To Traditional Mortgage Default Problems, But Provides Few Procedural Safeguards When The Right To Foreclose Is Contested, As In Many Recent Controversies Regarding The Foreclosures Initiated By Mortgage Servicing Companies

Existing Procedure for Non-Judicial Foreclosure in California. Although California law provides a judicial foreclosure process, discussed below, the vast majority of foreclosures in the state are "non-judicial," meaning that they are authorized through the "power of sale" clause in the mortgage or deed of trust. This power-of-sale authorization permits the initiation of the foreclosure and the final sale without any review by the courts or any other neutral party. As discussed below, this process differs markedly from the 23 states that require judicial foreclosure – that is, where the party seeking to foreclose must bring a foreclosure action in the courts.

California Civil Code Section 2924 sets out the following steps for bringing a non-judicial foreclosure:

1. Where there is a "power of sale" clause in the mortgage or deed of trust, the mortgagee, trustee, or agent, in order to foreclose, must first record a Notice of Default (NOD) with the county recorder. The NOD must include the following:

   a) A statement identifying the mortgage or deed, giving the book and page number where the mortgage or deed is recorded.

   b) A statement that there has been a breach of the obligation under the mortgage or deed.

   c) A statement setting forth the nature of each breach actually known to the beneficiary. (CC Section 2924 (A) (1)-(3).) The statute does not say how detailed this statement needs to be or what, if anything, is required if the beneficiary does not have actual knowledge of the nature of the breach.

2. If the default is not cured within 30 days of the NOD filing, the mortgagee or trustee must mail a notice to the borrower stating that the borrower is in default and warning the borrower that unless action is taken "to protect your property" it may be sold at public sale. (CC Section 2924f (c) (3).)

3. After three months have elapsed from the NOD filing, the mortgagee or trustee may file a Notice of Sale (NOS) with the county recorder. The NOS must contain a statement of the total amount of the unpaid balance. In addition, at least 20 day prior to date of the sale the mortgagee or trustee must publish notice of the sale (usually in a newspaper). A copy of the notice of sale must also be mailed to the borrower and a copy posted on the front door of a residential property 20 days prior to the date of sale. (CC Sections 2924 (a) (3) and 2924f.)

4. The borrower may prevent the foreclosure sale by paying all of the debt up to five days before the sale.

5. Until January 1, 2013, requires pursuant to SB 1137 of 2008, that a lender or loan servicer must make a "diligent" effort to contact the borrower to discuss any loan

> modification options at least 30 days before filing the NOD. The lender or servicer is not required to actually offer a loan modification; only to attempt to contact the borrower and discuss any available alternatives to foreclosure. [1]

Thus, little is required by way of documentation or attestations on the part of the mortgagee or trustee, other than an unverified statement in the notices that the underlying obligation has been breached. California case law has expressly held, for example, that possession of a promissory note is not required to bring a foreclosure action, since the promissory note is only evidence of the debt, whereas the right to foreclose upon and sell the property is guaranteed not by the note but by the "power of sale" clause in the recorded mortgage or deed. (*Chilton v. Federal Nat. Mortg. Ass'n*, 2009 U.S. Dist. LEXIS 129577, and cases cited therein.)[2]

Alternative Judicial Foreclosure Process. In judicial foreclosure states, the mortgagee or other beneficiary must sue in court in order to secure a decree for foreclosure and order of sale; the borrower may raise any relevant defenses. Because judicial foreclosure requires bringing the action in court – as opposed to simply recording a notice with a county recorder – it also requires the mortgagee or trustee to provide more documentation. That documentation may be scrutinized by the court, and the borrower has an opportunity to rebut the documents and/or challenge the foreclosure by raising defenses. Although procedures vary in the 23 states with

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[1] A federal district court has held that the "contact" requirement under 2923.5 is preempted by the federal Home Owners Loan Act (HOLA), as least as to HOLA-regulated federal banks and thrifts. The HOLA governs the terms of loan origination; its application to the foreclosure process may be disputed. (*Nguyen v. Wells Fargo,* N.D. Cal. (Oct. 2010).

[2] A recent decision by the Massachusetts Supreme Judicial Court may call into question the holding of the *Chilton* court that proof of possession of a note is not required. Like California, Massachusetts in a non-judicial foreclosure state. In *U.S. Bank Nat'l. Assn. v. Ibanez* (Jan. 7, 2011), the Massachusetts high court upheld a lower court ruling invalidating two foreclosure sales because the plaintiff banks failed to show that they were the holders of the mortgages at the time of the foreclosure. California courts, however, have held that Civil Code Section 2924 is a "comprehensive" statute setting forth all of the requirements for non-judicial foreclosure, and does not require the production of a note. Because of differences between the relevant statutes, it is not clear what impact the *Ibanez* reasoning holds for the rule in *Chilton* that, in California, the person foreclosing does not need to be in possession of the original promissory note. Neither state requires production of a note or any other document showing a right to foreclose or an ownership interest in the mortgage. However, both statutes assume that the party bringing the foreclosure has the right to do so. Under Massachusetts law, that must be "the mortgagee or his executors, administrators, successors, or assigns." In California, it must be the "trustee, mortgagee or beneficiary or any of their authorized agents." California courts apparently recognize a technical distinction between the "deed of trust" (which gives one the right to foreclose) and the "note" which gives one the right to receive payment of the underlying obligation. Traditionally, this was the same entity – the lender held the deed of trust and the note. With securitization, ownership can become separated. According to *Chilton,* however, the one in possession of the deed of trust can proceed with the foreclosure so long as it either has "some interest" in the note or has permission to act as the agent of the note-holder.

judicial foreclosure, typically the lender must prove the facts justifying foreclosure by filing a complaint with supporting documents and a sworn affidavit – the latter of which is usually signed by a bank employee who (supposedly) has some knowledge that the facts are true. (The recent "robo-signing" controversy, which occurred in judicial foreclosure states, involved bank employees allegedly signing such documents without even reading them, let alone having any knowledge as to whether the facts asserted therein were true.)

Special Protections for Members of the Military. Federal law, the Servicemembers Civil Relief Act, protects service members on active duty from being foreclosed upon. Under the law, only a judge can authorize a foreclosure on a protected service member's home, even in states where court orders are not required for civilian foreclosures, and the judge can act only after a hearing where the military homeowner is represented. The law also caps a protected service member's mortgage rate at 6 percent. Despite these protections, however, there have been continuing reports of violations across the country, some involving prominent banks. ("A Reservist in a New War, Against Foreclosure," New York Times, Jan.26, 2011.)

California Judicial Foreclosure Process And Borrower Liability For Deficiency Judgment. About half of the states in the U.S. *require* judicial foreclosure. California, like other non-judicial foreclosure states, *permits* judicial foreclosure, but it is estimated that more than 90 % -- and perhaps as many as 99% -- of foreclosures in California are non-judicial. The only time a lender is required to use judicial foreclosure in California is where the mortgage or deed of trust does not contain a "power of sale" clause. Since California adopted non-judicial foreclosure in 1917, virtually all mortgages and deeds of trust contain these clauses.

Where there is a power of sale, a lender *may* nevertheless elect to use a judicial foreclosure if it wishes to obtain a deficiency judgment – making the borrower personally responsible for any amount by which the debt exceeds the foreclosure sale price – but this has traditionally been rare. California's non-judicial foreclosure process adopts the so-called "one action" rule. Once the lender has sold the property, the borrower is completely relieved of the debt and the lender cannot subsequently try to obtain a deficiency judgment if the amount obtained at sale is less than the amount owed on the mortgage. However, this bar on seeking deficiency judgments applies only to the original "purchase-money" loan; it does not apply to any of the popular second mortgages that have been taken out on many properties, nor does it apply to the common refinancing of purchase-money loans. Under judicial foreclosure, the lender may pursue a deficiency judgment making the borrower personally liable on both the original and any subsequent mortgages.

Pros and Cons of Judicial and Non-Judicial Foreclosure Processes. The judicial foreclosure process provides a venue for a borrower to challenge the foreclosure and raise defenses. In a judicial foreclosure process, the court provides a structured opportunity for the borrower to dispute the underlying facts (*e.g.*, the payments are not in arrears or the person seeking to foreclose does not have standing, and the borrower may raise specified defenses – *e.g.*, the terms of the mortgage were unconscionable; the lender misrepresented the terms of the loan; the foreclosing party did not follow foreclosure procedure; the foreclosing party cannot prove that it owns the mortgage; the mortgage servicer made a mistake in crediting payments, imposed excessive fees, or substantially overstated the amount needed to reinstate the mortgage.) (*See e.g.*, Katherine Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims*, Texas Law Review (2008).)

In a non-judicial foreclosure process, the only way that the borrower can challenge a foreclosure is by initiating a separate action for wrongful foreclosure. The allegations raised in a wrongful foreclosure action essentially parallel the defenses that a borrower raises in judicial foreclosure states: mistake, misrepresentation, unconscionability, lack of standing, failure to follow procedure, and so on. The remedies available to the borrower vary depending upon the stage at which the action is brought: if the action is brought before the sale, the borrower can generally only obtain declaratory relief and an injunction preventing the sale; if the action is brought after the sale, the property cannot be recovered, but the borrower can obtain damages from the mortgagee.

However, the lack of documentation required in non-judicial foreclosure makes it much more difficult for the borrower to bring a cause of action. Most notably, there is no sworn legal claim to contest, and the borrower does not know the facts that the foreclosing entity relied upon to support the claim of breach of obligation. Indeed, California and federal courts have even held that there is no requirement for the foreclosing party to produce the note underlying the mortgage. The only thing that the foreclosing party must produce at the time of filing the NOD is a simple statement claiming that the obligation has been breached and a general description of the nature of the breach, but only if the beneficiary or trustee has knowledge of the nature of the breach. In fact, under California law the designated trustee that conducts the sale (often the title insurance company) is entitled to rely upon the statements of the mortgagee or beneficiary and is expressly immune from liability if those statements are false.

In short, not only does the non-judicial foreclosure process fail to provide a neutral forum to raise defenses – thereby forcing the borrower to initiate a lawsuit, usually requiring the borrower to hire an attorney who specializes in this area, which most borrowers are unable to afford – but unlike the judicial foreclosure process it does not require the mortgage holder to submit any documentation to substantiate the breach or prove that the foreclosing party is the owner of the mortgage. The lack of required documentation may be more important in light of current controversies regarding the role of mortgage servicing companies, potential mistakes because of the high volume of foreclosures and possible conflicts of interest in the foreclosure process, as discussed below.

While the borrower is free to bring a cause of action alleging wrongful foreclosure, he or she cannot counter the bank's asserted basis for initiating a foreclosure if he or she does not have any information describing that basis – *e.g.,* does the bank allege that the borrower missed a payment? Did the bank misapply a payment? Did payments that the borrower thought were reducing the debt in fact go to cover a "forced" insurance payment or a late fee imposed by a mortgage servicer? Without access to the facts and reasoning underlying the lender's action, the borrower has little to proceed upon and may have trouble convincing a lawyer to take his or her case, even if the borrower had the financial means to do so.

Whatever advantages in fairness and accuracy there may be in the judicial foreclosure process, however, it must be noted that judicial foreclosure adds to court case loads. Assuming that most foreclosures are justified because the foreclosing entity has the right and standing to foreclose, borrower is in fact legitimately in default, non-judicial foreclosure may be most economical and efficient for both the lender and the defaulting borrower. If the loan was lawful (as is most often the case) and there is no dispute that the borrower is in arrears on a lawful obligation to the note-holder, there is very little if anything for the courts to resolve. Moreover, judicial foreclosure exposes the defaulting borrower to liability for deficiency judgments regarding purchase-money loans for which they would have no liability in a non-judicial foreclosure. This factor may be less important than it has been traditionally in light of the large number of refinanced loans, second mortgages and home equity loans because non-judicial foreclosure does not protect borrowers from deficiency judgments for these obligations.

It should also be considered that even where judicial foreclosure is used many borrowers in financial trouble face the challenge of having limited resources to retain an attorney to represent them in order to exercise their legal rights. In states where judicial foreclosure is predominant, many homeowners are unrepresented in court against the legal professional retained by banks, leaving them to rely on court self-help services, judges and other court personnel to insure that the law is followed.

<u>Brief Primer on Mortgage Loan Servicing And Securitization.</u> Mortgage loan servicing became widespread with the advent of securitization – mortgages bundled together into investment vehicles that are sold to investors on the secondary market. A good explanation of securitization can be found in the introduction of written testimony offered by Adam Levitin, Associate Professor of Law, Georgetown University Law Center, before the House Financial Services Committee, November 18, 2010.

> Securitization is a financing method involving the issuance of securities against dedicated cash flow stream, such as mortgage payments, that are isolated from other creditors' claims. Securitization links consumer borrowers with capital market financing, potentially lowering the cost of mortgage capital. It also allows financing institutions to avoid the credit risk, interest rate risk, and liquidity risk associated with holding the mortgages on their books.

How does this system work? First, a financial institution assembles a pool of mortgage loans. The loans were made by the financial institution, an affiliate of the institution, or purchased from unaffiliated third party originators. This package of loans is first sold to a subsidiary set up for the sole purpose of conducting the first step in the securitization process. This special purpose entity is known as the depositor. Next the deposit sells the loans to a specially created single purpose vehicle (SPV). The SPV issues certificates to raise money to pay the depository for the loans and either sells the securities directly to investors or are issued to the depositor as payment for the loans. The depository then resells the securities. These securities are collateralized by residential mortgage loans owned by the trust (SPV) hence the creation of residential mortgage-backed securities (RMBS).

Securitized pools of mortgages are governed by complex contractual obligations between investors and servicers. These pooling and servicing agreements (PSAs) vary but generally provide that the servicer is obligated to maximize the interest of the investors or certificate holders. The Government Sponsored Entities (GSEs), such as Fannie Mae, provide in their PSA specific directions on how to deal with delinquent loans, while private label residential mortgage-backed securities (RMBSs) may only give general guidance, leaving it up to the servicer to interpret the best course of action. The ability to modify securitized loans may be complex and complicated by contractual agreements and often counter incentives to modify loan in a pool. Furthermore, modifying a loan in a securitized pool requires a withdrawal of the loan from that pool, which is not a simple task considering the leveraged nature of these RMBSs and which may require an immediate value write down of the assets on the books.

Due to bankruptcy and tax laws, the SPV is a passive entity and creates the need for a third party to actively manage the loans. Mortgage servicers are the link between borrowers and SPV and RMBS investors. Every mortgage loan is serviced, regardless of whether it is securitized or held in portfolio by the originating institution. Servicing historically has had low overhead costs because the business model is simply the processing of payments and collecting of fees for mortgage payments. However, loss mitigation activities are more labor intensive where a servicer may have to determine if a borrower has suffered hardship and process loan modification paperwork. This expense is on the top of existing expenses arising from the day-to-day servicing activities. This expense was among the difficulties confronting the foreclosure crisis because servicers have not had the resources or expertise to engage in loss mitigation. However, over the last year and half most of the major servicers have reportedly increased resources devoted to the loss mitigation side of servicing. The main servicing revenue is a fixed fee expressed as a percent of the outstanding balance of the loan and is subtracted by the servicer from the monthly principle and interest payments collected by the servicer. This fee ranges from 25 basis points for prime loans, up to 50 basis points from subprime loans.

Private label RMBS pools are carved into tranches from AAA ratings down through B. Holders of different varieties of RMBS tranches can have different and conflicting interest that can make loan modifications difficult or even impossible. A servicer's obligation under a PSA is to maximize the returns to investors as a whole and not just particular tranches, certain modifications or outcomes may only benefit one tranche. For example, the biggest conflicting interest is the investor in a subordinate tranche could benefit from a loan modification where otherwise foreclosure would eliminate their equity because higher tranches would receive the proceeds first out of a foreclosure sale. So those investors at the top have an incentive not to approve loan modifications, because the structure of the pools means they will get whatever proceeds are realized from the foreclosure at the expense of the lower tranches. With the high recidivism rates of modified loans, senior tranches may prefer foreclosure as an option in order to take advantage of losses now versus further losses later.

Servicers also service second lien mortgage loans, further complicating the loan modification process. Second lien mortgage loans, or "piggy back" mortgages, gained popularity in the subprime boom as a workaround for borrowers who could not make a down payment on the property. Most of these mortgages were split into a loan of 80 percent of the property's value and junior lien for the remaining 20 percent. Attempted loan modifications where a second lien exists become difficult because the second lien holder must agree to the modification and possible extinguishment of their lien holder rights when they stand to make no benefit. Junior lien holders have been slow and reluctant to agree to re-subordinate in this episode and have held up refinancing, modifications, and short sales.

Given the uncertainties surrounding modifications, senior lien holders generally require the junior lien holder to affirmatively agree to subordinate their claim to the modified senior lien before agreeing to the modification. In today’s depressed housing market, when a mortgage is being modified it is likely that the junior lien holder has essentially no equity; thus, a big part of the value of the lien is the ability to extract a payment from the senior lien holder in a workout. As mentioned previously, Treasury has acknowledged this difficulty and has attempted to set up incentives for second-lien holder cooperation under the Making Home Affordable 2nd Lien Modification Program, however little data is available to determine the success of that program.

An additional issue complicating loss mitigation efforts is the issue of Net Present Value (NPV). NPV is a complex formula designed for servicers to calculate the value of loss mitigation versus foreclosure. For private label RMBSs the NPV calculation can vary, but for Fannie Mae and Freddie Mac loan pools the NPV is dictated with specific actions servicers must follow at different points in the delinquency process. Those servicers that participate in HAMP must use Treasury's NPV model in making a determination on a potential HAMP eligible loan. As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act, servicers will have to inform borrowers of NPV calculations in loan modification denial letters.

Securitization of Mortgages Has Raised Concerns Regarding Whether Financial Paperwork Is Sufficient To Establish The Right To Foreclose. As residential mortgages were packaged into securities over the past decade, it has been reported that the appropriate paperwork was not always completed and transferred among the parties, leading to concerns about whether an entity that initiates a foreclosure has the legal right to do so.

As noted above, a recent decision by the Massachusetts Supreme Judicial Court may unsettle the existing California case law holding that possession of a note is not required to foreclosure. In *U.S. Bank Nat'l. Assn. v. Ibanez* (Jan. 7, 2011), the Massachusetts high court upheld a lower court ruling invalidating two foreclosure sales because the plaintiff banks failed to show that they were the holders of the mortgages at the time of the foreclosure. California courts, however, have held that Civil Code Section 2924 is a "comprehensive" statute setting forth all of the requirements for non-judicial foreclosure, and does not require the production of a note. Like California, Massachusetts is a non-judicial foreclosure state.

It is not known how widespread this problem may be. However, a recent case involving Bank of America, the nation's largest mortgage bank, suggests that the problem may be extensive. A team leader in the company's mortgage-litigation management division said during a U.S. Bankruptcy Court hearing in New Jersey last year that it was routine for the lender to keep mortgage promissory notes even after loans were bundled by the thousands into bonds and sold to investors, according to a transcript. Contracts for such securitizations usually require the documents to be transferred to the trustee for mortgage bondholders. As a result, the court rejected a claim on the home of John T. Kemp, ruling that Bank of America had failed to deliver the note to the trustee. That could leave the trustee with no standing to take the property, and raises the question of whether other foreclosures could similarly be blocked.

The potential impact may depend on the outcome of a broader dispute between homeowner and industry lawyers about whether missing or incomplete paperwork subsequently can be fixed. The chief judge of the U.S. Bankruptcy Court for the District of New Jersey said during hearings that the Countrywide securitization contract covering Kemp's loan called for a trustee to take possession of the promissory notes, which represent the borrowers' obligation to repay their loans. The securitization contracts related to the Kemp loan, and at least two other Countrywide mortgage-bond transactions, didn't assign the company the additional role of document custodian for the trust. Countrywide, as the servicer, can take back the notes from the trustee when needed to manage foreclosure actions and mortgage payoffs, according to the contracts.

Giving notes to the trustees after the fact isn't a solution because the rules governing trusts, enforced by New York trust law, require that assets are in place by a specified closing date, according to quoted experts, because the notes also can't be transferred to the trust without first being conveyed through a chain of interim entities. ("BofA Mortgage Morass Deepens After Employee Says Notes Not Sent," Bloomberg News, Nov. 30, 2010.)

Related Concerns Regarding the Legal Status of the Mortgage Electronic Registration System (MERS). A private company established by the mortgage banking industry in 1997 to promote the sale of mortgages and to avoid the need to record each transfer now holds nominal title to more than 60 percent of the country's residential mortgages. According to a Washington Post analysis, the Mortgage Electronic Registration System (MERS) was modeled on the clearinghouse for stocks called the Depository Trust Co. which not only kept track of the stock ownership but kept the physical certificates in a vault in order to avoid the need to physically transfer the certificates each time they were sold.

Doing away with the time-consuming and costly chore of recording and re-recording ownership of the individual mortgages was also intended to promote securitization of loans. When a home loan is securitized, many parties are typically involved. The loan might be originated by a mortgage finance firm, sold to a company that aggregates them into a pool and then sells them to an investor such as a pension fund. A different "servicer" such as Bank of America is usually responsible for collecting payments. Most loans are bought and sold several times, and the servicer can change, too.

But somewhere along the way MERS became a stripped down version of the original idea, according to The Post report. The first thing to go was the vault for keeping documents. MERS instead became a giant electronic card catalogue that tracked who was managing a particular loan as it was sold and resold, but it left the companies themselves responsible for guarding the mortgage (or deed of trust) and the promissory note (or IOU) - the two critical pieces of paper that prove who owns a loan.

Next to go was transparency, critics allege. The mortgage bankers decided that to simplify record-keeping, MERS would be listed as a "nominee" for the mortgage holder in local land records offices. When the loans changed hands, the new owner or servicer would register the transaction electronically in the MERS system without having to re-record the transaction across the country. However, as millions of homes fell into foreclosure, MERS found itself in a tricky legal position because its name was listed as the mortgage holder in local land records. Because the law allows only the mortgagee to foreclose, MERS had to either file court papers in its own name or transfer the mortgage back to the real owner. Both scenarios require huge amounts of paperwork.

But with only a handful of employees, most of them computer technicians, MERS was in no position to do so. So MERS authorized employees at mortgage servicers, debt collectors and foreclosure law firms – 22,000 at most recent count – to identify themselves in records or court papers as "vice president" or "assistant secretary" of MERS Inc.

A key bone of contention is whether MERS can be listed as the mortgage holder without actually owning the loan. The Missouri court of appeals said in June 2009 that MERS lacked the authority to assign a mortgage from one service company to another. Because the transfer by MERS "had no force," the court ruled, the owner of the loan "lacks a legally cognizable interest" and could not pursue the delinquent borrower. The Kansas Supreme Court ruled in August 2009 that MERS did not have any interest in the underlying property of a bankrupt borrower whose home was auctioned - even though MERS was listed as the mortgagee. Moreover, the court said that the MERS transfer of the mortgage was invalid because the owner, Sovereign, had never recorded its interest in Ford County, Kan. In October, a federal judge in Oregon issued an injunction preventing Bank of America from foreclosing on a home, because of the use of MERS.

Clerks from counties across the country are suing MERS to collect unpaid filing fees. Several state courts have rejected attempts by MERS to act on behalf of banks seeking to foreclose on delinquent mortgages. And Congress is weighing legislation that would bar home loan giant Fannie Mae from buying any mortgage listed in MERS, potentially a death knell for the registry. (*See* "How A Mortgage Clearinghouse Became A Villain In The Foreclosure Mess," Washington Post, December 30, 2010.)

<u>New Concerns About Faulty Procedures In Non-Judicial Foreclosure States Such As California.</u> This month American Banker noted a new issue regarding allegedly faulty process in non-judicial foreclosure states, such as California. According to the report:

> Last year's robo-signing scandals delayed tens of thousands of foreclosures in the 23 states where the process is handled in court. A new controversy could complicate foreclosures in the other 27 states.
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> At issue is the notice of default, the first letter that a mortgage lender or servicer sends to a homeowner who has fallen behind on payments. The notice typically starts the formal foreclosure process in nonjudicial states such as California, Arizona and Nevada.
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> Every notice of default has a signature on it. But just like the infamously rubber-stamped affidavits in the robo-signing cases, default notices, in at least some instances, have been signed by employees who did not verify the information in them, court papers show. In several lawsuits filed in nonjudicial states, borrower attorneys are arguing that this is grounds to stop a foreclosure.
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> "Whoever signs the NOD needs to have knowledge that there is in fact a default," said Christopher Peterson, an associate dean and law professor at the University of Utah.
>
> The suits also argue that the default notices are invalid because the employees who signed them worked for companies that did not have standing to foreclose.
>
> In a lawsuit against Wells Fargo & Co. in Nevada, an employee for a title company who signed default notices admitted in a deposition this month that he did not review any documents or know who had the right to foreclose.
>
> "They are starting foreclosures on behalf of companies with no authority to foreclose," said Robert Hager, an attorney with the Reno, Nev., law firm Hager & Hearne, representing the borrower in the case. "The policy of these companies is to just have a

> signer execute a notice of default starting foreclosure without any documentation to determine whether they are starting an illegal foreclosure."
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> Walter Hackett, a lawyer with Inland Counties Legal Services, in San Bernardino, Calif., and a former banker with Bank of America Corp. and Union Bank, has filed several cases contesting notices of default, on the grounds that the employees signing such notices were working for companies that are not the noteholders — or even their appointed agents.
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> "A huge percentage of notices of default and notices of trustee sales are legally questionable and probably void," Hackett said. "Nobody with the authority to trigger the nonjudicial foreclosure process is triggering it — only third parties who claim they have the right to do so are triggering it."
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> Peterson, the law professor, said one difference between the notice of default cases and the widely publicized robo-signing incidents is that in the latter, affidavits are given to judges whereas the notice of default is not strictly a legal document.
>
> But consumer lawyers said homeowners face a bigger legal burden in nonjudicial sates because they have to file a lawsuit against the holder of the note to bring any action in court.
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> "Because there's no court reviewing anything in nonjudicial states," abuses are "probably even more rampant," Gardner said. "This is just another example of robo-signing in a different context."

("New Point of Foreclosure Contention: Default Notice," American Banker (January 21, 2011.)

<u>Controversy Regarding The Role of Mortgage Servicer Fees In The Foreclosure Process.</u> A primary reason for the poor performance of the federal HAMP program according to the December report of the Congressional Oversight Panel (COP) is that mortgage servicers often profit from foreclosure proceedings and have little incentive to participate in the program. According to COP, this is true even if the lender and borrower would have benefited financially from a modification that reduced the mortgage principal and kept the borrower in the home. The lender and investor may be interested in modifying a mortgage, the report states, but the servicer is opposed because it can "turn a substantial profit from foreclosure-related fees." In other situations, borrowers have second mortgages owned by banks that also act as the servicer on the first loan that they do not own, causing the bank to block a modification of the first loan to increase their own profits, the report states. More than 40 percent of homes reportedly have second loans. ("Report Charges Conflicts Of Interest In Treasury Program," National Law Journal, December 14, 2010; "Congressional Oversight Panel Blasts HAMP," Mortgage News Daily, Dec. 14, 2010.) These contentions are presumably disputed by the banking industry, but research by committee staff did not produce a counterpoint.

A recent scholarly paper explores the role of servicers in greater detail, contending that the foreclosure system is fundamentally flawed because of the principal-agent conflict between investors and servicers.

> A traditional mortgage lender decides whether to foreclose or restructure a defaulted loan based on its evaluation of the comparative net present value of those options. Most residential mortgage loans, however, are securitized. Securitized mortgage loans are managed by third-party mortgage servicers as agents for mortgage-backed securities (MBS) investors.
>
> Servicers' compensation structures create a principal-agent conflict between them and MBS investors. Servicers have no stake in the performance of mortgage loans, so they do not share investors' interest in maximizing the net present value of the loan. Instead, servicers' decision of whether to foreclose or modify a loan is based on their own cost and income structure, which is skewed toward foreclosure.

(A. Levitin and T. Twomey, *Mortgage Servicing*, Yale J. on Regulation, Vol. 28.1 (2011).)

This analysis contends that servicers' incentives diverge from investors on two levels. First, in reference to individual loans, servicers do not have a meaningful stake in the loan‘s performance because their compensation is not keyed to the return to investors. Second, the servicing industry‘s combination of two distinct business lines — transaction processing and default management — encourage servicers to underinvest in default management capabilities, leaving them with limited ability to mitigate losses.

Servicer Compensation Allegedly Creates Incentives To Put Loans In Default and Keep Them There, Paying Servicer Fees, For A Substantial Period Without Foreclosing Or Modifying Loan Principal. Servicers' incentives in the management of individual loans creates three interrelated problems, this analysis asserts. First, servicers are incentivized to pad the costs of handling defaulted loans at the expense of investors and borrowers. Second, servicers are not incentivized to maximize the net present value of a loan, but are instead incentivized to drag out defaults until the point that the cost of advances exceeds the servicer‘s default income. In other words, servicers are incentivized to keep defaulted homeowners in a fee sweatbox, rather than moving to immediately foreclose on the loan. Third, servicers are incentivized to favor modifications that reduce interest rates rather than reduce principal, even if that raises the likelihood of re-default.

Servicers often compete with investors for loan proceeds. Because servicers get paid out of the proceeds of a loan, they are in conflict with investors when there are insufficient proceeds to pay all parties in full. Servicer compensation structures encourage servicers to inflate the size of their claims. This problem arises because servicers receive cost-plus compensation on defaulted loans without any sort of cost control mechanism. When a loan performs, servicers' compensation is essentially flat-rate. On a performing loan, a servicer receives the fixed-percentage servicing fee and float. When a loan defaults, however, servicers' compensation switches to a cost-plus basis. The potential incentive misalignments from this form of compensation are so severe that it is prohibited for most federal government contracts. Often, servicers cease to be permitted to collect their servicing fee until the mortgage is liquidated or reinstated, although the fee accrues in the meantime. Instead, the servicer receives compensation for all of its costs as well as for any additional fees it collects (typically through foreclosure), such as late fees. The servicer collects these fees, as well as reimbursement (without time value) for its advances, off the top of foreclosure sales. This means that the servicer has an incentive to levy as many fees as it can, as they will be paid off the top of the foreclosure sale proceeds. It also means that servicers have no incentive to keep down costs; indeed, to the extent that servicers in-source default management functions, they have an incentive to inflate costs, as the inflated costs are profit margin for them.

MBS investors have little ability to monitor servicers once they have invested. Investors simply lack sufficient data with which to evaluate servicer performance. MBS investors therefore rely on trustees to protect their interests, the authors argue, but MBS trustees have very limited contractual duties and little incentive to be more diligent. Vigorous monitoring could jeopardize trustees' close business relationships with servicers and ultimately result in costs for the trustee if the servicer had to be replaced and the trustee had to step in as standby servicer. (A. Levitin and T. Twomey, *Mortgage Servicing*, Yale J. on Regulation, Vol. 28.1 (2011).)

California Lawsuits Alleging Improper Conduct in Foreclosures by Mortgage Servicing Companies. Financially strapped homeowners struggling to obtain mortgage modifications are reportedly taking their frustrations to court, accusing banks and loan servicers of misleading them or breaking promises to help them hold on to their homes.

According to published reports, a theme of the lawsuits filed by homeowners is that banks have denied permanent modifications to borrowers who make their temporary loan modification payments on time and otherwise hold up their end of the agreements. Anaheim lawyer Damian Nassiri said his firm had filed about 100 lawsuits against mortgage lenders since 2007. Earlier suits alleged that lenders misrepresented terms of mortgages or engaged in other shady practices to foist abusive loans on borrowers. Most of his firm's suits now accuse lenders of dealing in bad faith with borrowers who have become delinquent on loans. In cases where foreclosure was inevitable, the suits allege, banks misled borrowers into accepting trial loan modifications with the intent "to get some kind of money out of them" while stalling actions to seize the homes. Other suits allege that banks lost or destroyed paperwork, failed to record payments, misapplied some payments and delayed the processing of others, intentionally inflating balances with unjustified penalty fees and additional interest. ("Lawsuits Accuse Lenders Of Sabotaging Mortgage Modifications," Los Angeles Times (Oct. 26, 2010).)

<u>Alleged Servicer Fee Practices That Promote Foreclosure.</u> An October 18, 2010 letter to 50 State Attorneys General from a coalition of consumer advocates, including Americans for Financial Reform, Center for Responsible Lending, Consumer Action, Consumers Union, National Association of Consumer Advocates, National Consumer Law Center, National Legal Aid & Defender Association, PICO National Network and Public Citizen complains of a "documented pattern of fraudulent and abusive practices by mortgage servicers whose staff are trained for collection activities rather than loss mitigation, whose infrastructure cannot handle the volume and intensity of demand, and whose business records are a mess. Servicers falsify court documents not just to save time and money, but because they simply have not kept the accurate records of ownership, payments and escrow accounts that would enable them to proceed legally."

According to the consumer advocates default-causing behaviors by servicers make it increasingly difficult for homeowners to avoid default, rectify real problems, and avoid foreclosure. They state, "There are hundreds of litigated and reported cases from every district in the country detailing sloppy, unethical and illegal loan servicing practices. And these are only the tip of the iceberg – for each reported case, there are hundreds of unreported cases, and for each litigated case, there are tens of thousands of unlitigated cases of homeowners who were unable to find an attorney. These behaviors by servicers have been so egregious and rampant that, on occasion, courts have painstakingly detailed the standard practices of servicers which routinely overcharge homeowners and push them into avoidable foreclosures." These allegations are presumably contested by the servicing industry, but staff research was unable to locate an industry refutation.

Consumer groups are joined in this concern by investors. For example, the Association of Mortgage Investors issued a recent "white paper" stating, "The current servicing model further harms borrowers by dumping excessive fees (ultimately recouped by servicers) on them during the modification process. The underlying mortgage and foreclosure data must be disclosed in a public and transparent manner, including servicing fees, foreclosure expenses, and the actual asset loss breakdown. The borrower and investor need to understand the full menu of additional costs that might be incurred due to a foreclosure. The costs due to servicer error are not to be reimbursed from the RMBS trust; such costs should be borne by the servicer, not the trust. Finally, vulnerable borrowers must be protected from paying egregious fees after falling behind on their mortgage payments." ("The Future of the Housing Market for Consumers after the Crisis: Remedies to Restore and Stabilize American's Mortgage and Housing Markets," Association of Mortgage Investors (January 2011).)

Late Fees – Delay, Misapplication of Borrowers Payments, and "Pyramiding." Consumer advocates have alleged that servicers do not always timely credit borrower payments, or may misapply payments so that late fees are difficult to cure, causing borrowers to be in default despite making the full monthly payments. According to the National Consumer Law Center, late fees alone constitute a significant fraction of many subprime servicers' total income and profit.

The allegation that banks may fail to timely credit payments received is the same as the practice formerly alleged against credit card companies, that when borrowers make timely payments the servicer simply fails to post the payment until after the due date, causing a late fee to be assessed. The allegation of fee "pyramiding," is that when a late fee is assessed, whether justified or not, servicers may apply future payments to the late fee first, such that some portion of the principal and interest due is deemed to be unpaid, making all future payments delinquent even when the borrower has remitted the full payment within the required time period.

The issue of pyramiding fees was addressed by the Federal Reserve in 2008 by regulations under the Truth in Lending Act (TILA). Section 226.36(c) requires payments to be posted to the account in a timely fashion; Section 226.36(c)(1)(ii) requires that if a consumer sends a timely payment sufficient to cover the currently scheduled payment, the creditor cannot assess late fees. Consumer advocates complain that this practice has nevertheless continued because the federal regulations cannot be enforced by individual borrowers, only by a state attorney general. There is some evidence to corroborate this contention in bankruptcy proceedings, one of the few occasions where a California court oversees the fee claims of servicers. (*E.g., In re Herrera,* 422 B.R. 698, 713 (9th Cir. Bnkrtcy App. Panel 2010); *Santos v. U.S. Bank, N.A.*, 716 F. Supp. 2d 970, 980 (E.D. Cal. 2010).

These cases appear to be part of a larger trend. According to the U.S. Trustee Program, the arm of the Justice Department that polices the integrity and efficiency of the bankruptcy system, "One of the Program's top priorities is to identify and remedy violations of the Bankruptcy Code by national mortgage servicing firms. Increasingly the Program has pursued allegations that mortgage servicers file inaccurate papers claiming that debtors owe more money than is actually due, or add charges that are not permitted under the terms of the loan contract. Improper conduct by mortgage servicers includes but is not limited to recording excessive charges for late fees, unwarranted inspection fees and other fees and charges; chronically misapplying payments, by, for example, applying payments to fees that were disallowed; charging unreasonable and excessive attorney's fees; losing debtors payments." (USTP Annual Report, FY 2009, at 13.) In June 2010, the USTP resolved a two-year investigation of Countrywide that focused on three types of practices: inflating the mortgage claims Countrywide made against homeowners in chapter 13 bankruptcy; failing to properly credit homeowners with payments made; and failing to notify homeowners of extra charges added to the mortgage bill.

Unnecessary and Excessive Fees. Consumer advocates complain that servicers impose fees unnecessarily, duplicatively, and in higher amounts than justified. Among the fees that may be allegedly "padded" are late fees, broker-price opinions, inspection fees, attorney's fees, and others. In addition, consumer groups contend, many of the servicer's fees do not actually represent significant dollars out of pocket. For example, NCLC claims, Wells Fargo reportedly charged a borrower $125 for a broker price opinion when its out-of-pocket expense was less than half that, $50. (*Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior*, National Consumer Law Center (Oct. 2009).)

Force-placed Insurance. Mortgage loan documents allow banks to require homeowner's hazard insurance on the home to protect their investment. If the borrower fails to maintain his or her insurance, the servicer has the right to "force-place" a policy at the homeowner's expense. This may arise for three main reasons: the servicer fails to send the previously paid and escrowed insurance money to the insurance agent; the servicer believes there is a gap in insurance due to miscommunication with the borrower; or the servicer buys the policy due to a perceived risk of lapse.

Consumer advocates complain that improper assessment of force-placed insurance has become a problem, and that these policies are obtained with premiums of many times the cost of standard homeowners' insurance. In some cases these insurance policies are placed with an insurance company affiliate of the servicing company, like the broker-price services noted above, resulting in fees and commissions for both companies. More importantly, the fees for these policies are collected and applied before principal and interest, precipitating default and foreclosure on otherwise up-to-date loans.

A number of states regulate force-placed insurance, including Connecticut, New Mexico, Florida, New York, Hawaii, Tennessee, Maryland, Texas and Mississippi. In addition, the recent federal Dodd-Frank Act regulates the imposition of force-placed insurance. It is not clear how these obligations will be enforced by government regulators or individual consumers.

<u>Other Allegations of Wrongful Foreclosure.</u> As lenders have reviewed tens of thousands of mortgages for errors in recent months, more and more homeowners are stepping forward to say

that they were victims of bank mistakes — and in many cases, demanding legal recourse. In an era when millions of homes have received foreclosure notices nationwide, lawsuits detailing wrongful foreclosure, including bank break-ins, keep surfacing. In the wake of the scandal involving improper foreclosure paperwork that has buffeted the nation's biggest banks in recent months, critics say these situations reinforce their claims that the foreclosure process is fundamentally flawed.

Some homeowners say banks have tried to foreclose on houses that did not even have a mortgage. A Michigan man, for example, states that he paid cash to the Deutsche Bank National Trust Company, and yet the bank tried to foreclose on the property and changed the locks while he was away. Others say they believed they were foreclosed upon while negotiating with the bank in good faith, some alleging that they were duped into missing a payment. For example, a Colorado resident is facing foreclosure after the company handling her mortgage allegedly encouraged her to skip a payment, she says, to compensate here for mistakenly changing the locks on her home even though she was current on a loan she had recently refinanced. When she did so, the bank refused to accept all future payments and began foreclosure proceedings.

Consumer lawyers and housing experts acknowledge that it is relatively rare that a bank initiates foreclosure on a homeowner who is current on the mortgage or has no mortgage at all. More common, they say, are instances where homeowners have applied for mortgage modifications but get foreclosed upon anyway. Some commenters believe that errors are due to sloppy practices related to processing a record volume of foreclosures.

A Truckee, California woman has alleged in a federal lawsuit that Bank of America wrongfully foreclosed on her house and threw out her belongings, without alerting her beforehand, while she was trying to work out a loan modification.

A clause in most mortgages allows banks that service the loan to enter a home and secure it if it is in default, meaning if the mortgage payment is 45 to 60 days late, and if the house has been abandoned, authorities said. Banks do so to protect the property from vandalism or damage for which the bank could be liable.

Some of the cases appear to be mistakes involving homeowners who were up to date on their mortgage — or had paid off their home — but who still became targets of a bank. In Texas, for example, Bank of America had the locks changed and the electricity shut off last year at Alan Schroit's second home in Galveston, according to court papers. In Florida, contractors working for Chase Bank used a screwdriver to enter Debra Fischer's house in Punta Gorda and helped themselves to a laptop, an iPod, a cordless drill, six bottles of wine and a frosty beer, left half-empty on the counter, according to assertions in a lawsuit filed in August. Ms. Fisher was facing foreclosure, but Chase had not yet obtained a court order, her lawyer says.

In Washington, Celeste Butler went to check on her father's house after he spent months in the hospital and ultimately died. "The house was ransacked," Ms. Butler said, adding that it had been neatly maintained beforehand. "They had destroyed furniture, broken into china cabinet. They had looted jewelry." In her lawsuit, Ms. Butler is accusing Safeguard, a contractor for JP MorganChase, of breaking into her father's house. Ms. Butler asserts that Chase failed to properly credit payments made when she switched to an automatic system in June 2009, but that she and the bank worked quickly to rectify the problem.

Banks and their contractors insist that the number of mistakes is minuscule given the hundreds of thousands of new foreclosure cases filed each month. (*See* "Homeowners Facing Foreclosure Demand Recourse," New York Times (Oct. 27, 2010); "In a Sign of Foreclosure Flaws, Suits Claim Break-Ins by Banks," New York Times (Dec. 21, 2010).)

V. State Use of Federal "Hardest Hit" Funds For Distressed Borrowers: How Will California Programs Contribute To Foreclosure Relief?

In February 2010, President Obama announced $1.5 billion in funding for innovative measures to help families in the states hardest hit by the aftermath of the burst of the housing bubble. As one of five states initially targeted for assistance, California was initially awarded close to $700 million under the federal Housing Finance Agencies Innovation Fund for the Hardest-Hit Housing Markets program (Hardest Hit Program). As explained below, that allocation has since been augmented to reach nearly $2 billion.

<u>California Housing Finance Agency Hardest Hit Funds Programs.</u> The California Housing Finance Agency (CalHFA), the state entity receiving the funds, was tasked with developing a program for California that met the basic guidelines outlined by the Obama Administration, including:

> <u>Mortgage Modifications</u>—Programs that provide for modification of loans held by HFAs or other financial institutions or provide incentives for servicers/investors to modify loans.
>
> <u>Mortgage Modifications with Principal Forbearance</u>—Programs that provide for paying down all or a portion of an overleveraged loan and taking back a note from the borrower for that amount in order to facilitate additional modifications.
>
> <u>Short Sales/Deeds-In-Lieu of Foreclosure</u>—Programs that provide for assistance with short sales and deeds-in-lieu of foreclosure in order to prevent avoidable foreclosures.
>
> <u>Principal Reduction Programs for Borrowers with Severe Negative Equity</u>—Programs that provide incentives for financial institutions to write down a portion of unpaid principal balance for homeowners with severe negative equity.
>
> <u>Unemployment Programs</u>—Programs that provide for assistance to unemployed borrowers to help them avoid preventable foreclosures.
>
> <u>Second Lien Reductions</u>—Programs that provide incentives to reduce or modify second liens.

The program guidelines required CalHFA to submit its proposal to the U.S. Treasury Department (U.S. Treasury) for approval by April 16, 2010. To inform the proposal, CalHFA states that it met with loan servicers, loan counseling agencies, Fannie Mae, the general public, and other stakeholders to identify the greatest areas of need among at-risk borrowers. The program CalHFA developed, called Keep Your Home California, includes four separate programs to assist individual homeowners:

Unemployment Mortgage Assistance Program (UMA) – Intended to assist homeowners who have experienced involuntary job loss. UMA provides temporary financial assistance in the form of a mortgage payment subsidy of varying size and term to unemployed homeowners who wish to remain in their homes but are in imminent danger of foreclosure due to short-term financial problems. These funds can provide up to six months of benefits with a monthly benefit of up to $3,000 or 100% of the existing total monthly mortgage, whichever is less.

Mortgage Reinstatement Assistance Program (MRAP) – Intended to assist homeowners who have fallen behind on their mortgage payments due to a temporary change in a household circumstance. MRAP will provide limited financial assistance in the form of funds to reinstate mortgage loans that are in arrears in order to prevent potential foreclosures. These funds can provide benefits of up to $15,000 per household.

Principal Reduction Program (PRP) – Intended to assist homeowners at risk of default because of an economic hardship coupled with a severe decline in the home's value. PRP will provide capital to reduce outstanding principal balances of qualifying borrowers with negative equity. Principal balances will be reduced in an effort to prevent avoidable foreclosures and promote sustainable homeownership. The principal reduction program will most likely be a prelude to loan modification. (In order for homeowners to receive assistance through PRP, their servicer must agree to contribute matching funds.)

Transition Assistance Program (TAP) – Intended to promote community stabilization by providing homeowners with relocation assistance when it is determined that they can no longer afford their home. TAP will be used in conjunction with a servicer-approved short sale or deed-in-lieu of foreclosure program in order to help homeowners transition into stable and affordable housing. Homeowners will be responsible to occupy and maintain the property until the home is sold or returned to the servicer as negotiated. Funds will be available on a one-time-only basis.

In order to qualify for any of the Keep Your Home California programs, a borrower must be low- or moderate-income; the programs can be used in combination, allowing a homeowner to receive up to $50,000 in assistance; borrowers cannot qualify if they have refinanced their home to take cash out.

During the process of developing its program, CalHFA received numerous suggestions from local governments, counseling agencies, financial advisors, and the general public. As a result of this input, CalHFA requested and received approval from the U.S. Treasury to set aside approximately $20 million for innovative approaches to foreclosure prevention. CalHFA received several proposals, selected the ones that qualified and now must submit them to the U.S. Treasury for final approval.

On June 23, 2010, CalHFA received approval from the U.S. Treasury for the Keep Your Home California programs. On August 11, 2010, the Obama Administration announced that it would be expanding the program from the original five states and giving the existing states more money. California received an additional $799.5 million in Hardest Hit funds. CalHFA also received approval to use $476.3 million in previously allocated foreclosure-prevention assistance for the Keep Your Home programs, increasing the total available for the programs to nearly $2 billion. Since receiving federal approval, CalHFA has been developing its in-house servicing and working with loan servicers to get them signed on to the four programs.

Below is a chart of the servicers that have signed on to at least one of the four programs:

SERVICER	UMAP	MRAP	PRP	TAP
CalHFA	X	X	X	X
Chase Home Finance LLC	X	X		
JP Morgan Chase Bank, NA	X	X		
EMC Corporation	X	X		
CA Department of Veterans Affairs	X	X	X	X
GMAC (Ally)	X	X	X	X
Wells Fargo	X	X		
Bank of America	X			
CitiMortgage	X	X		

Below is a chart of the estimated amount of assistance that CalHFA anticipates offering in each of the four programs and the number of households it estimates could be assisted:

Program	**Allocated Program Funds**	**# of Households**
UMAP	$875 million	60,500
MRAP	$129 million	9,200
PRP	$790 million	23,135
TAP	$32 million	6,470

*Funds may be reallocated based on results

CalHFA began offering the four programs on a pilot basis to its own portfolio of borrowers in the fall of 2010. On January 10, 2011, CalHFA launched the Unemployment Mortgage Assistance Program statewide. On February 7, 2011, CalHFA will launch the other three programs (the Mortgage Reinstatement Assistance Program, the Principal Reduction Program. and the Transitional Assistance Program) statewide.

Implementation Challenges Facing The CalHFA Program**.** Among the challenges implementing the Keeping Your Home California Program have been:

CalHFA developed an in-house servicing department that required hiring and training new staff;

CalHFA needed to develop a secure method of exchanging confidential information about non-CalHFA borrowers with loan servicers; and

The Government Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac, do not participate in principal reduction programs and they own a large percentage of California mortgages, which has been a barrier to getting banks to sign on to the PRP.

Controversy Regarding Principal Reduction Programs. Banks have largely resisted principal reductions. According to published reports "two of the biggest players in the mortgage market –

JP Morgan and Wells Fargo – are open about their dislike of this tactic for modifying mortgages. They said so at an April 2010 hearing before the House Financial Services Committee. The two other big banks, Citigroup and Bank of America were mum on the subject, though Bank of America did start a small program to begin principal reductions in March."

"It's easy to understand why big banks fear principal reductions – they will create big, immediate losses. According to its 2010 first quarter report, JPMorgan lists $247 billion in mortgages and home equity loans on its balance sheet. Of that $79 billion are considered "impaired," bought through its Washington Mutual acquisition. The report indicates that the charge-off rate for non-impaired loans is running at 4.9%, while their delinquency rate is at 7.3%. Meanwhile, its impaired portfolio's delinquency rate is 28.5%. If JPM started writing down a lot of principal from its portfolio to modify loans, then some very large losses would result very quickly, given these ugly statistics." (Congressional Oversight Panel Assails HAMP, The Atlantic Monthly, April 14, 2010.)

Additionally, Fannie Mae and Freddie Mac appear to be resistant to allowing entities that service their loans from doing any principle reduction on their portfolio. The third quarter OCC and OTS Mortgage Metrics Report reveals that on loans where Fannie Mae and Freddie Mac are the investor, principal reduction has not been used as a loan modification option. This is a significant obstacle, considering that they are some 80 percent of the mortgage market

<u>Los Angeles Program Administered by One LA.</u> One LA-IAF, a Los Angeles-based non-profit organization, has initiated a principal reduction program. One LA is a dues-paying membership organization of institutions committed to building power for sustainable social and economic change. One LA-IAF is affiliated with the Industrial Areas Foundation (IAF), a national organizing and leadership development network. The members of One LA-IAF are institutions: congregations, schools (both private and public), labor unions, non-profits and neighborhood organizations that share a concern for families and are rooted in traditions of faith and democracy.

One LA has partnered with Neighborhood Legal Services of LA County to launch a foreclosure prevention plan that has been endorsed by the City of Los Angeles, with $1 million allocated to demonstrate partnering between borrowers, banks, and the public sector designed to prevent foreclosure against 50% of people that would otherwise have lost homes. Neighborhood Legal Services and One LA are negotiating with Bank of America and Chase to utilize their strategy to write down loan principal to achieve a sustainable loan modification.

The Keep Your Home Los Angeles foreclosure program has also been awarded $10 million by CalHFA (with an initial release of $5 million), subject to Treasury Department approval, to help Los Angeles homeowners with severe negative equity modify their home mortgages. Under the program, a small amount of funds is used to pay down "under water" mortgage principal. The payment is in the amount of the Net Present Value, or current value, of the principal. In the alternative, the payment is in the amount consistent with a schedule established by the U.S. Department of Treasury, of .06 to .21 cents per dollar of principal reduction, depending on how delinquent the loan and how far "under water" the mortgage. The program limits total mortgage debt after modification to 125% of a home's current market value. According to One LA the program was vetted by financial analysts within major banks, as well as a volunteer banking expert, the U.S. Treasury and Secretary of HUD, Shawn Donovan and was found to be favorable to both homeowners and investors. It is believed that One LA-IAF has not completed any modifications to date.

Bank of America reportedly committed to a similar $1 million program in April 2010 to assist approximately 50 residents of the Los Angeles City 6th and 7th Council districts, although no modifications are known to have been completed at this time.

VI. Is Further Action Necessary For Loan Modification and Other Loss Mitigation Strategies To Stem The Number of Foreclosures?

When a borrower is in danger of defaulting, a commonsense approach under a traditional mortgage would be for the lender and borrower to mutually agree to modify the terms of the loan, or for the bank to agree to allow the borrower to sell the home in a "short sale" for an amount that equals or approximates the outstanding balance on the loan to save the lender the time and costs of foreclosure. Moreover, in a declining real estate market, the amount obtained by the lender in a foreclosure sale may be less than the amount owed on the loan.

Despite the apparent mutual interest of loan holders and borrowers, many distressed homeowners report obstacles when trying to obtain a loan modification or short-sale approval. (*See e.g.* "Loan Modifications Elude Local Homeowners," *Sacramento Bee*, January 17, 2011.) Part of the answer may be that the mortgage industry has become more complex. Rarely does a modern mortgage involve only two players, a lender and a borrower, with a common interest in avoiding default and the capacity to communicate directly. Instead, the modern mortgage industry typically involves at least four players: (1) the original lender (or originator); (2) a loan servicer (who may or may not be affiliated with the originator) who collects from the borrower and remits to the mortgage holder; (3) an investor who has purchased an interest in the mortgage (or more likely an interest in the stream of income from a pool of mortgages); and (4) a borrower. Under this more complex arrangement, it is the servicer – not the loan originator or the investor holding an interest in the mortgage – who collects payments and has the power to either bring a foreclosure or approve a loan modification or a short sale if the borrower fails to make timely payments.

In some cases, difficulty obtaining investor approval is cited as the primary obstacle. Critics contend, however, that servicers' financial incentives are the true explanation. Whatever the explanation, virtually all observers agree that federal and state programs implemented to promote loan modifications and short sales have, at best, failed to live up to initial promises.

Some analysts and leading economists have cited a failure by banks to provide loan modifications as a signal reason that the foreclosure crisis continues to drag on. Another obstacle to loan modifications arises if borrowers have second liens, like home equity loans, on their properties. These liens are often held by lenders who are also servicers on the first mortgage. They, too, have little interest in seeing any modification because it would harm the value of their holdings and reduce their income from fees. ("A Mortgage Nightmare's Happy Ending," New York Times (Dec. 25, 2010).)

<u>Alleged Conflicts of Interest By Mortgage Servicers.</u> For the same reasons cited above regarding alleged servicer fee abuses, consumer advocates complain that commonsense solutions are negated by a complex set of disincentives on the part of loan servicers in an increasingly

securitized mortgage market. Unlike investors or original lenders, an NCLC report concludes, servicers "do not generally lose money on a foreclosure." The servicer obtains its income not from the borrower's payments, but from a monthly servicing fee paid by the lender or investor and various late charges and management fees assessed on the borrower. Servicers also reap "float income," or the interest earned between the time that servicer receives the payment from the borrower and the time that it advances the payment to the investor or mortgage owner. While a traditional lender would likely suffer a loss in the event of a foreclosure sale, the servicer is guaranteed to collect its fees from the foreclosure proceeds.

In addition, servicers must advance payments to investors even if they do not receive payments from the borrower, and then must recover those advances. A servicer can more easily recover those advances in a foreclosure, but recovery is much less certain in the case of a loan modification. Finally, even where a servicer would benefit from offering a loan modification, the servicer will rarely agree to a modification that involves a principal reduction. Servicer fees are generally calculated as a percentage of the principal, so that any principal reduction will also mean a reduction in fees. Yet, virtually all economists agree that a principal reduction – as opposed to temporary suspension of interest payments, for example – is the most effective form of loan modification. (See, e.g., *Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior,* National Consumer Law Center (October 2009).)

<u>Dual-Track Foreclosures, Temporary Modifications, Delays, Lost Paperwork, and Other Concerns.</u> As noted above, there have been frequent reports of borrowers experiencing long and substantial frustration in their efforts to seek modification of their loans. At the same time as their applications for loan modification are pending, their banks pursue foreclosure against them, a phenomenon known as "dual track." A November 2010 survey by the National Association of Consumer Advocates (NACA) and the National Consumer Law Center (NCLC) found that mortgage servicers often initiate foreclosure proceedings while a homeowner is awaiting a loan modification. It has also been reported that most loan modifications, when they are granted, reduce the interest rate only slightly and tack onto the mortgage all the late fees, legal fees and other questionable costs that have accrued in the foreclosure process — simply adding to the debt that borrowers must repay.

Borrower's complaints about poor servicer response to loan modification efforts are attributed by critics to the reasons noted above – that servicers derive the majority of their income based on a percentage of the outstanding loan principal balance. The higher a servicer can keep the principal balance, whether by capitalizing arrears and unpaid fees or by refusing loan modifications with principal write-downs, critics allege, the larger the servicer's main source of income (the monthly servicing fee) will be. *(Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior,* National Consumer Law Center (Oct. 2009).) A detained response to these contentions from the servicing industry would clearly assist the committees in determining whether there is any legitimate basis for these concerns.

<u>State Lawsuits Regarding Servicer Loan Modification Actions.</u> In separate actions, two neighboring states, Nevada and Arizona, both non-judicial foreclosure states like California, recently sued Bank of America for alleged deceptive practices in its handling of loan modification applications. The allegations include claims that the bank promised modifications that were never delivered – leaving borrowers in limbo by failing to make timely decisions, then denying them permanent modification months later, leaving them financially worse off. The

suits likewise allege that Bank of America failed to provide justification for denials, misleading borrowers into believing that missing payments was required in order to qualify for a modification, then pursuing foreclosures against them because of the missed payment, and initiating foreclosures while loans were in successful temporary modifications, intentionally creating a chaotic process with understaffed and undertrained employees and allegedly reprimanded them if they spent more than 5 minutes on the phone trying to help some borrowers. ("Arizona and Nevada Sue Bank of America Over Loan Modifications," Los Angeles Times Dec. 17, 2011.)

<u>Loans Modified By Principal Reduction Are Widely Believe To Be The Key To Sustainable Mortgages, But This Option Faces Many Obstacles.</u> Whatever the impact on investors, servicers suffer a permanent loss of income by agreeing to a principal reduction. Under this scenario, short sales, short payoffs, and realized principal reductions or forbearances as part of loan modifications are costly for both third-party and affiliated servicers, consumer groups allege. In fact, any reduction of principal, even by regular payments, represents a loss to servicers, compared to a result that keeps principal balances high. Delaying payment of principal serves servicers' interests, consumer advocates argue. Principal forbearance, instead of an outright principal reduction, allows servicers to keep their monthly servicing fee high. Principal forbearance is generally less desirable than principal reduction from a borrower's viewpoint: it often leaves the borrower owing more than the house is worth and facing a large balloon payment at the end of the loan. Still, principal forbearance continues to be far more common as a tool in loan modification than principal reduction, whether because of servicer profit incentives, as consumer advocates charge, or due to other factors such as investor parameters, securitization, and the characteristics of the loan.

Negative Equity, Strategic Defaults, and Principal Reduction – When Banks Own The Loans, Principal Reductions Are More Common; When Banks Act Only As The Servicer For An Investor-Owned Mortgage, Principal Reductions Are Rarer. Laurie Goldman, Senior Manager at Amherst Securities, testified to the House Financial Services Committee in December 2009 that principal reduction is the key to successful loan mods based on an analysis of the data because negative equity causes borrowers to default when they experience a change in financial circumstances, such as the loss of a job. A change in financial circumstances, however, is typically not sufficient to cause a default. Rather, it is when a home has substantial negative equity, she argues, that borrowers will opt to default, presumably out of a sense of hopelessness. Because negative equity is the most important predictor of default, she argues that loan modifications in the form of payment reduction plans as provided by HAMP are not likely to be successful. She notes that bank behavior also reflects that principal reduction is the key to successful loan modification, noting that when banks own the loans they service they look to maximize the net present value of the loan and frequently choose to reform the loan by reducing the principal. By contrast, when the servicer does not own the loan, principal reductions are typically not agreed to. In other words, when banks stand in the shoes of investors, their interests and those of the homeowner are aligned and they choose to do principal reduction. Goodman notes that many times servicers also hold second mortgages on the homes for which they are servicing the first mortgage and that this is an impediment to modification because principal reduction requires the second loans to be extinguished.

Incentives To Favor Particular Forms of Modification. Servicers' compensation structures also reportedly encourage them to favor certain forms of modification over others. A modification can reduce monthly payments by reducing the interest rate, reducing the principal, extending the term of the loan, or changing the amortization (to create a balloon at the end). Servicers are not indifferent in choosing these methods, according to one analysis. While any method will reduce monthly payments and thus reduce float income in a given month, servicers are generally disinclined to reduce principal. When the principal balance of a loan is reduced, the servicing fee is also reduced, as it is a percentage of the principal balance outstanding. Moreover, if the borrower has sufficient equity in the property, the borrower may simply refinance the mortgage, and the loan will leave the servicer‘s portfolio. On the other hand, a servicer‘s servicing fee income would actually increase over time if the amortization were adjusted to create a principal balloon at the end of the loan. (*See* A. Levitin and T. Twomey, *Mortgage Servicing*, Yale J. on Regulation, Vol. 28.1, at 79-80 (2011).)

According to one recent analysis, 582,363 mortgage modifications were made by fifteen major servicers during 2009. These servicers cover approximately 65% of the first lien market. First, portfolio loans account for 38% of total modifications, but 92% of principal reductions. In contrast, PLS loans account for 30% of modifications and 8% of principal reductions. There were only 138 principal reductions on agency and GSE loans in this period. The authors of the study note that the low rate of principal reduction modifications on securitized loans is consistent with servicers being disincentivized to reduce principal, although some of the lack of principal reduction modifications may be attributable to PSA restrictions on principal reduction. [*Id*.]

<u>Does Investor Resistance Account For The Lack of Loan Modifications?</u> According to an analysis by the investigative reporting organization ProPublica, loan servicers say their hands are tied by the investors who own the mortgages. However, federal officials, bank officers, housing counselors and investors themselves reportedly say that excuse is cited far more often than is justified. In fact, they say, few mortgage deals include such restrictions. In one case profiled in ProPublica's analysis, Litton Loan Servicing, a subsidiary of Goldman Sachs that services their loan, claimed that its contract with the investor prohibits any modification of a loan in the security it owns. However, Litton's contract with investors has no clear language banning modifications, over 115 other mortgages from the same investment pool have already been modified, and a Bank of New York Mellon representative of the investors stated that only the servicer can decide when to modify loans.

While no one knows the exact extent to which servicers are passing blame on to investors, some housing counselors estimate that 10 percent of the denials they see are attributed to investors; others say they see as many as 40 percent. Either way, tens of thousands of homeowners may be affected, their attempts to modify their mortgage wrongly denied.

The prevalence of such false claims by servicers is a "legitimate concern," according to the Treasury Department. Investors are also dismayed, saying servicers are not acting in their best interests. "This is one of those rare alliances where investors and borrowers are on the same page," according to Laurie Goodman, senior managing director at Amherst Securities, a brokerage firm that specializes in mortgage securities. She says investors have "zero vote" in determining individual loan modifications and, instead of foreclosures, prefer sustainable modifications that lower homeowners' total debt.

Investor-owned mortgages represent more than a third of trial and permanent modifications in the government's program. Under the program, servicers must modify the loans of qualified borrowers unless contracts with investors prohibit the modification, or if calculations determine that the investors won't benefit from a modification. Investors' contracts rarely prohibit modifications, and at times, ProPublica found, they have been blamed for denials even though other mortgages owned by the same investors have been modified.

Even when contracts with investors do have restrictions, servicers do not appear to be following federal requirements that they ask investors for waivers to allow modifications. The Treasury Department states that it is investigating investor denials and considering greater consequences for servicers that wrongfully deny modifications. Servicers' compliance and accountability have been a major problem for the government's program. Treasury has threatened penalties before, but it hasn't yet issued any.

The contracts that servicers often blame are usually not a roadblock according to a report by John Hunt, a law professor at the University of California, Davis, which looked at contracts that covered three-quarters of the subprime loans securitized in 2006 and found that only 8 percent prohibited modifications outright. Almost two-thirds of the contracts explicitly gave servicers the authority to make modifications, particularly for homeowners who had defaulted or would likely default soon. The rest of the contracts did not address modifications. Other explanations might be found in the nature of the relationship between servicer and investor, which may create hesitancy on the part of servicers due to potential liability concerns. Servicers are agents of the investors who ultimately own the loans. While a servicer may have a range of unspecified flexibility to do modifications, they can ultimately run the risk of liability if an investor were to subsequently decided that the servicer's modifications were not in the interest of the investor. In addition, some trusts require approval of modifications by the trustee, who is generally not a servicer and thus not in a position to evaluated a potential workout, requiring that the trustee send the proposal back to the servicer to use the PSA language as guidance. This can become particularly complex and time consuming as many servicers may look for express guidance on vague PSA language, yet when questions arise are told to refer back to the very language that originated the complication.

Homeowners' advocates say that when they successfully disprove a contractual restriction, the servicer just gives another reason for denying the modification. "The investor is cited first until the borrower can prove it otherwise," says Kevin Stein, associate director of the California Reinvestment Coalition, which helps low-income people and minority groups get access to financial services.

Homeowners looking to challenge investor restrictions need information that is not easily accessible, or sometimes even public. "All of the information seems to be in the hands of the servicers," Stein says. "Even the investors don't know what's going on." Tracking down the servicer's contract with investors, or even just the name of the mortgage-backed security that owns a loan, is often a struggle. Many homeowners and advocates report that servicers will not tell them the name of the security.

In 1995, as part of efforts to increase consumer protections in the mortgage industry, Congress passed a law amending the Truth in Lending Act (section F) to require servicers to provide the name and contact information for the owner of a loan when a homeowner submits a written request. The Federal Reserve, which has authority over the Truth in Lending Act, confirmed the law's requirement that the information be provided, but the Mortgage Bankers Association, an industry group, has asserted that onerous requests from homeowners don't require responses. It did not specify what it considered to be onerous.

Treasury has recently begun requiring servicers to provide a list of every potential restriction for every agreement that could impede a government modification. Though the department has not yet decided if it will make the list public, the government's compliance teams will at a minimum have the list to check denials that homeowners or housing counselors bring to their attention. (*See* "When Denying Loan Mods, Servicers Often Wrongly Blame Investors," ProPublica (July 23, 2010) (available at www.propublica.org/article/when-denying-loan-mods-loan-servicers-often-blame-investors-wrongly).)

<u>Similar Concerns Regarding Short Sales.</u> According to consumer advocates, servicers' dependence on fees may also partly explain their reluctance to enter into short sales. In a short sale, the borrower typically bears the cost of arranging the sale, thus depriving the servicer and its affiliates of the fees they could charge for default management, including selling the property. Short sales are an example of a divergence in interests between the servicer and the investor: the investor saves money if the borrower, rather than the servicer, bears the cost of arranging the sale, since the investor must reimburse the servicer, but not the borrower, for the costs of the sale, even if the sale does not generate enough money to cover the outstanding principal balance. The servicer, however, may lose some money and is unlikely to profit at all from the transaction. Only if the servicer's financing costs outweigh the foreclosure fees charged and a short sale is significantly faster than a foreclosure will a servicer profit by agreeing to a short sale over a foreclosure. This disjoint may explain in part investors' willingness to pay servicers greater incentives for short sales than for modifications. As between a short sale and a foreclosure, the servicer's only incentive to favor the short sale are payments by the investor for performing a short sale. Only if those payments are larger than what the servicer expects to squeeze out in fees from the borrower and default management fees from the REO sale proceeds will the servicer's scales tilt towards a short sale. *(Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior,* National Consumer Law Center (Oct. 2009).)