Regulators Target Fair Servicing

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Regulators are now analyzing whether minority borrowers are receiving loan modifications on par with similarly situated non-minority borrowers. Consider the following risk-mitigation strategies for the coming wave of "fair-servicing" examinations and enforcement actions.

Loan servicing has migrated to the forefront of national efforts to resolve the financial crisis. Government agencies and Congress have pressured loan servicers to modify home loans, usually by recasting payments or reducing principal, to aid homeowners whose loan balances exceed their home values. Simultaneously, the media, state attorneys general (AGs) and consumer advocates have spearheaded public scrutiny of loan administration, in the course of which some long-standing servicing industry practices have been challenged. ● Although most homebuyers usually have some personal contact with the individuals involved in originating their mortgage loans, they typically are unfamiliar with the companies that service their loans. Borrowers, moreover, do not choose their loan servicers. ● The loan servicer's traditional role has been as counterparty to an investor, obligated by a servicing agreement to protect the investor's interests. If a borrower is unhappy with the servicer's loan administration practices, he or she cannot simply request a new servicer. ● Loan administration is a complex undertaking requiring compliance with multiple laws, regulations, investors' and agency servicing guidelines, and privately contracted servicing agreements, performed in an environment where business customs and practices have developed over time. Some steps involved in residential loan servicing are not found in statutes or investor guidelines, but are business-process responses to particular needs or technology developments. ● For example, the increasing use of personal fax machines a decade ago led to consumer requests for faxed payoff statements, despite a previous industry tradition of providing payoff statements by mail. Some servicers responded with modest "fax fees" to compensate for the additional work of faxing documents, leading to legal challenges to the propriety of the fees. Several states eventually adopted laws regulating the frequency and amount of fax fees, but others are still silent on the issue.

Today, with e-mail replacing fax machines, borrowers may prefer to have electronic statements, but laws have not yet emerged to regulate servicer use of e-mail for borrower communications. Where laws are silent, servicers adopt internal procedures to guide their operations.

In a robust housing finance economy, servicing procedures are largely invisible to most people, because prompt monthly payments minimize the need for communications between borrowers and lenders. On the other hand, in a souring economy with a rising tide of mortgage foreclosures, more borrowers are receiving escalation letters, demand letters, collection notices and foreclosure notices, and loan servicing practices become the object of more intense regulatory and consumer focus.

A delinquent homeowner's first priority is to avoid foreclosure. As a response to the skyrocketing numbers of foreclosures from 2007 forward, lenders have put renewed emphasis on non-foreclosure alternatives such as short sales, loan modifications and payment-forbearance plans. These specialized loss-mitigation options are usually complex and document-intensive; moreover, borrowers must navigate the particulars of these alternatives at a stressful time in their lives.

Modification programs sprout foreclosure-rescue scams

Responding to a need for foreclosure alternatives in a souring economy, the Obama administration announced the Making Home Affordable program in 2009, claiming that as many as 7 million to 9 million homeowners could remain in their homes through refinanced or modified mortgages. Despite these predictions, the Congressional Oversight Panel, which monitors the state of financial markets and the regulatory system, reported in April 2010 that the Making Home Affordable program will prevent only about 1 million foreclosures, with 10 times as many homes being lost to foreclosure as saved through loan modification. Pent-up demand for debt relief has led to some bogus foreclosure-rescue and loan-modification schemes, leaving enforcement agencies busy attempting to prevent scams and protect the public.

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In April 2009, the Federal Trade Commission (FTC) announced the filing of five new cases against companies offering loan-modification or foreclosure-rescue services, and warned 71 others not to deceptively market mortgage loan-modification and foreclosure-relief services.

Federal agency responses

The FTC presently is considering rulemaking to make the servicing industry's practices more transparent. The FTC announced its intention to regulate servicing in a June 2009 notice of proposed rulemaking on Mortgage Assistance Relief Services (MARS) and Mortgage Acts and Practices (MAP).

Among other things, the FTC is concerned that foreclosure-rescue plans and the collection of advance fees for loan-modification services may be deceptive and misleading to consumers. In its rulemaking, the FTC is likely to be guided by requirements it has already imposed on servicers through consent decrees, notably those with Salt Lake City–based Fairbanks Capital Corporation and Lewisville, Texas–based EMC Mortgage Corporation.

The FTC's 2008 consent decree with EMC and its parent, New York–based Bear Stearns Companies, resolved the agency's claim that EMC acquired and securitized mortgage loans without ensuring the accuracy of consumer loan information, and serviced those loans based on the inaccurate loan data. The faulty data had a domino effect, according to the FTC, resulting in improper collection and default-related practices.

EMC and Bear Stearns agreed to pay $28 million in consumer redress and set up a data-integrity program. EMC also agreed to review customer records and investigate customer disputes before starting foreclosures or charging foreclosure-related fees, and refrain from adding modification fees to loan balances without disclosing the fees to borrowers.

The Department of Justice's (DOJ's) Civil Rights Division also has become involved with enforcement of fair-lending laws as they increasingly intersect with loan modifications. DOJ's newly formed Fair Lending Enforcement Unit, established by executive order by President Obama, includes a special counsel for fair lending and a staff of about 30, consisting of attorneys, economists and support staff.

Assistant Attorney General for Civil Rights Thomas E. Perez, who leads the new unit, predicts an increase in the number of fair-lending cases being investigated and prosecuted by DOJ. Of the 38 fair-lending discrimination matters initiated by DOJ's Civil Rights Division in the first year of the Obama administration, 29 were referrals from bank regulatory agencies, according to Alejandro Miyar, public affairs specialist and spokesman for DOJ. Perez has taken particular aim at abusive brokers and loan originators who profited during the housing boom and he says have "turned their sights" on loan modifications, stating, "We must be sure [underwater homeowners] are not again subject to discrimination in their attempts to secure meaningful modifications."

One way for the government to evaluate whether loan modifications are being fairly offered is through evaluation of data provided by lenders under the Home Affordable Modification Program (HAMP). Servicers participating in HAMP must report on modified loans in accordance with the program's Supplemental Directive 09-06 (Home Affordable Modification Program—Data Collection and Reporting Requirements Guidance).

Among the data to be reported are government monitoring data, including the race, ethnicity, and gender of the borrower and co-borrower. The disaggregated data will be used to check that minority homeowners are not disadvantaged in the modification program, according to Perez. Believing that loan modifications are the best and last opportunity for many Americans to save their homes from foreclosure, DOJ's Civil Rights Division will target illegal discrimination involving modifications. DOJ's Miyar says illegal discrimination involving modifications can take several forms, including providing modifications on different terms based on race or national origin, or targeting homeowners for modification scams based on race or national origin.

Joining the FTC and DOJ in prioritizing fair loan modifications is the Office of the Comptroller of the Currency (OCC). At the beginning of 2010, the OCC initiated several fair-servicing reviews, documented in examination requests to at least four major banks. The OCC letters notify the banks of examinations focused on "possible disparate treatment of customers from different racial groups."

The examinations will include discussions with servicers about their modification and foreclosure processes. In connection with these exams, the OCC has asked the banks to voluntarily disclose the results of any self-tests conducted to detect prohibited differences in treatment of modification applications. It is too early to know what these fair-servicing examinations will reveal, but the request letters themselves make it clear that examining mortgage modifications for any alleged discrimination is a top OCC priority.

The OCC revised its *Fair Lending* booklet on Jan. 20, 2010 (available at www.occ.gov/handbook/fairlep.pdf). The OCC's general guidelines expressly state that a bank may not treat a borrower differently in servicing a loan or invoking default remedies based on prohibited factors. The examiners' compliance checklist (Appendix A, Compliance Management Analysis Checklist) includes an inquiry on whether employees are told they may not authorize or offer loan modifications on a prohibited basis.

The revised OCC booklet indicates several specific risk indicators for possible discriminatory treatment in loan servicing and loss mitigation. Among the items identified as potential risk indicators are disparities between protected classes and others in the completion of foreclosures; the prevalence of consumer complaints alleging discrimination in loan servicing; undocumented or poorly documented servicing decisions; and high levels of litigation in which loan servicing discrimination is claimed.

The booklet revision and its newly added risk indicators for servicing reflect the OCC's focus on fair lending during the entire loan life cycle, not simply at the origination stage.

State agency responses

At the state level, state attorneys general are scrutinizing servicing practices involving loss mitigation and foreclosure. Early in the housing crisis, some states adopted temporary foreclosure moratoria, but most of these have expired and foreclosures are again on the rise.

AGs in Massachusetts and Ohio, among the most proactive in responding to the rising tide of foreclosures, have sued to restrict foreclosures they deem unfair. The state AGs' underlying claims range from predatory lending (Ohio case against Fremont Mortgage and Massachusetts case against New Century Financial) to discrimination in the loan origination process (Massachusetts case against H&R Block and Option One Mortgage).

Settlements in these cases permitted suspension of foreclosures pending individual loan-file reviews and stays of foreclosures that state AGs found contrary to consumer-protection laws.

Ohio has challenged the loan-modification practices of three servicers through its AG and Department of Commerce. The state claims that the servicers violated the Ohio Consumer Sales Practices Act by failing to provide competent and adequate customer service; failing to investigate consumer complaints or respond to consumers' requests for assistance; and failing to offer loss-mitigation options to borrowers free of unfair and deceptive loan-modification terms. The Ohio AG is seeking a permanent injunction to prevent unfair and deceptive loan modifications, among other things.

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Other states, such as New York and Maryland, have attempted to slow the tide of foreclosures by enacting laws requiring lenders to mediate foreclosures with borrowers. New York judges have occasionally cancelled mortgages or dismissed foreclosure complaints based on a lender's failure to cooperate in such conferences. On April 13, Maryland adopted a law to require lenders to send loan-modification or loss-mitigation applications to homeowners at least 45 days before filing for foreclosure, and to conduct a loss-mitigation analysis at least 30 days before any foreclosure sale. Foreclosure-mediation hearings will be handled by the state's office of administrative hearings.

The legal strategies adopted in states such as Maryland, Massachusetts, New York and Ohio may provide a blueprint for other state actions if foreclosures continue to rise. With less new lending and more foreclosures, the state agencies regulating financial institutions are likely to refocus their regulatory agendas and enforcement resources on homeowners' most pressing problems. Avoiding foreclosure and remaining in their homes will be high on the list of consumer problems until the housing market and broader economy recover.

Consumer responses

The consumer advocacy bar claims servicing companies' practices are responsible for high rates of foreclosure and the attendant social problems, ranging from property vandalism to a rising divorce rate.

The National Consumer Law Center (NCLC), Boston, sued several major servicers in February and March 2010, claiming they failed to honor loan-modification agreements reached with borrowers. The plaintiffs claim they met their obligations in the trial-modification stage under the HAMP program, but the lenders refused to convert their modifications to permanent status.

Other civil rights groups are joining the loan-modification fray. The Lawyers' Committee for Civil Rights Under Law, Washington, D.C., launched the Loan Modification Scam Prevention Network, which will mobilize *pro bono* legal resources nationally to "crack down on scammers, increase scam reporting, educate homeowners and work with law enforcement," according to a press release from the organization. The campaign is designed to improve data collection and complaint coordination about loan-modification scams and educate homeowners about how scammers work.

Private parties are also filing "fair-servicing" lawsuits, based on discrimination claims. In 2007, in *Rodriguez et al. v. Bear Stearns Cos. Inc. et al.,* a nationwide class of African-American and Hispanic/Latino borrowers alleged intentional discrimination against minority borrowers in violation of the Civil Rights Act and Fair Housing Act. The Fair Housing Act allegations were based on a disparate impact theory. Specifically, the plaintiffs said the defendants intentionally acquired non-prime loan portfolios with high proportions of minority borrowers, believing these borrowers were less sophisticated and therefore less likely to resist predatory loan servicing practices.

The *Rodriguez* case was dismissed in 2009 based on the plaintiffs' failure to state a claim under the Civil Rights Act, with the Fair Housing Act claims dismissed later that year. The court said it was "difficult" to determine whether the lender's alleged practice of servicing prime and subprime loans differently was enough to support a *prima facie* case of disparate impact sufficient to support a Fair Housing Act claim. The decision, while welcomed by lenders, does not close the door on potential lawsuits where allegedly discriminatory practices are more precisely identified by the plaintiffs than they were in the *Rodriguez* case. Indeed, *Rodriguez* may ultimately be instructive for plaintiffs' attorneys as they draft complaints that will survive summary judgment motions.

Lessons for servicers

A surge in fair-servicing examinations, investigations, lawsuits and enforcement actions may await the residential mortgage servicing industry. The extent to which racial and ethnic minority borrowers are awarded loan modifications versus white non-Hispanics may be a key factor in deciding whether claims of unfair or discriminatory servicing are meritorious.

The foreclosure-alternative programs of the largest banks and servicers may be the first reviewed by regulators because their enormous servicing portfolios consist of loans acquired from others, including lenders no longer in business (such as Countrywide Financial Corporation and Washington Mutual Inc.). Without review of the new servicers' operations, it might be impossible to ensure that hard-pressed homeowners are receiving a fair shake at modifying their loans.

How should lenders react to this new scrutiny of their servicing practices? Minimizing the fair-lending risk associated with loan servicing involves the recognition of the extension of fair-lending concepts to servicing activities and the adoption of best practices combined with self-testing, servicing staff fair lending training and an assessment of the servicing-control environment to ensure that all borrowers receive fair and consistent treatment. Special focus should be given to the following areas.

■ *Loss-mitigation strategies:* Regulators are beginning to analyze whether minorities are being offered alternatives to foreclosure as often as non-minority borrowers. Servicers should adopt carefully crafted policies and procedures for reviewing, granting and denying loan modifications and apply them consistently, with carefully documented exceptions. Exception reports should indicate the timing associated with the modification decision, because delays associated with modifications to minority groups may be suggestive of disparate treatment.

■ *Communication and training in loan-modification processes and procedures:* Servicers have been criticized for moving loan administration personnel into foreclosures, modifications and workouts without previous experience. Although demand for experienced workout staff may exceed present supply, lenders must make education and compliance a priority. They must also provide employees with thorough training in managing workouts and foreclosures with knowledge and sensitivity, including sensitivity to the fair-lending aspects of residential finance and civil rights laws. Where possible, homeownership or foreclosure counseling conducted through professional counselors may be a useful tool for customers, supplementing the servicer's own personnel.

■ *Monitoring consumer complaints and litigation:* A high level of consumer complaints and/or litigation involving discrimination claims can be a red flag for fair-lending violations. Servicers should have policies to promptly deal with borrower complaints, and monitor the nature of claims in all lawsuits filed so that discrimination claims are addressed without delay.

■ *Self-assessments of loan-modification data:* The federal banking agencies are beginning to analyze lenders' loan-modification data and are sharing the data with DOJ in anticipation of future investigations. Therefore, loan-modification data must be carefully understood by lenders' management teams. The DOJ's Fair Lending Enforcement Unit advises servicers to establish "robust compliance systems" and to evaluate whether any of their policies and practices may have an illegal disparate impact on members of protected classes. Self-testing is a key tool in uncovering potential disparate treatment in the fair-servicing context. Companies should consider conducting attorney-client privileged analyses of their modification data to address the root causes of disparities, if any.

■ *Internal monitoring of legal compliance:* All servicers should have procedures for comprehensive monitoring of regulatory changes, which result in implementation of revised policies when applicable laws and rules change. Regulatory compliance professionals should no longer be confined to loan origination functions, but should be active in the default, loss-mitigation and loan-modification process as well. **MB**

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