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Servicing Management®

Fair-Lending Principles Must Underpin Loss Mit

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Servicers face an increasingly challenging business environment. According to the Mortgage Bankers Association's 2009 Q4 National Delinquency Survey, nearly 9.47% of loans are in default. Additionally, the Wall Street Journal reports that nearly one-quarter of all homeowners are currently "underwater," with mortgage balances higher than their home values. The outlook for this year is equally grim, with analysts forecasting over 2.8 million foreclosure filings by year's end.

In response to the deteriorating housing market, the Obama administration, members of Congress, the federal banking agencies, state and local governments, and government-sponsored enterprises, such as Fannie Mae and Freddie Mac, have searched for viable foreclosure alternatives to prevent further consumer distress and the ongoing erosion of the housing finance economy. At the national level, proposals have focused mainly on incentivizing modifications and short sales. Meanwhile, at the state and local levels, governments have taken even more aggressive actions, such as instituting temporary foreclosure moratoria.

So far, the success of these measures has been modest. Public officials and government agencies at all levels are under increasing public pressure to act more aggressively to curb foreclosures.

Stronger enforcement of fair-lending laws in the foreclosure arena is an emerging regulatory frontier. Fair-lending enforcement is a logical extension of recent enforcement actions involving delinquency and default servicing that resulted in consent decrees and monetary penalties against major loan servicers, including EMC Mortgage Corp. and Fairbanks Mortgage.

Limitations of foreclosure alternative programs

When the Obama administration announced the Making Home Affordable program in early 2009, it estimated that 7 million to 9 million homeowners could keep their homes through refinanced or modified mortgages. However, in April 2010, the Congressional Oversight Panel revealed that the program may prevent only about 1 million foreclosures, and that the number of foreclosed homes could be 10 times as many as those saved by loan modifications.

Similarly, the Home Affordable Modification Program (HAMP), which the government predicted would save 3 million to 4 million mortgages from foreclosure by 2012, achieved only 170,000 permanent modifications in its first year. The latest foreclosure alternative program is the Home Affordable Foreclosure Alternatives Program (HAFA), which was rolled out on April 5. It provides short-sale or deed-in-lieu-of-foreclosure incentives to servicers.

Foreclosure alternative programs have largely failed to meet public expectations because they are complicated and involve complex eligibility criteria. For servicers, they can be difficult to administer. For borrowers, the requirements for program participation can seem overwhelming or burdensome. In a faltering economy, moreover, with public and media pressure for quick results, there is little time for the steep learning curve required to digest new program details, train servicing staff, implement new procedures and technologies, and perform quality-control checks on the results.

Enforcement efforts under way

The government's commitment to foreclosure alternative and loss mitigation programs coincides with a heightened attention to compliance by the financial regulatory agencies. Under pressure from Congress, the banking agencies are eager to demonstrate their effectiveness, partly in response to criticism that regulatory lapses contributed to the financial fallout that devastated the housing economy. The federal government's determination to reduce the number of foreclosures provides the federal banking agencies with new investigation landscapes for enforcing pre-existing laws, such as fair-lending laws.

Several bank regulatory agencies are flexing their regulatory muscles by reinforcing the applicability of fair-lending laws to loan servicing. In the home finance arena, fair-lending principles have traditionally been associated with the fair and equitable provision of opportunities for home financing, without discrimination based on a protected class (race, color, national origin, religion, sex, familial status and disability). In reality, fair lending incorporates the full spectrum, from the initial financing inquiry to the end of the loan's life cycle.

The Department of Justice's (DOJ) Civil Rights Division recently announced its intention to scrutinize loan modifications under the prism of fair-lending laws. This year, the DOJ created a Fair Lending Enforcement Unit, headed by a Special Counsel for Fair Lending and a staff of about 30 lawyers, investigators and economists. The unit will implement the mandate of Assistant Attorney General for Civil Rights Thomas E. Perez, who said the DOJ will ensure that underwater homeowners are not subject to discrimination when they try to obtain meaningful loan modifications. In a speech in January, Perez said abusive brokers and loan originators have “turned their sights” to loan modifications.

The Fair Lending Unit will probably evaluate HAMP data and government monitoring data to determine whether minorities are obtaining modifications on a fair and consistent basis. In response to an inquiry, a spokesperson for the DOJ identified these two situations as examples of illegal discrimination: (1) providing modifications on different terms based on race or national origin, and (2) targeting homeowners for modification scams based on race or national origin.

The Office of the Comptroller of the Currency (OCC) has initiated several servicing reviews focused on fair lending, according to people with knowledge of the OCC’s investigation requests. Several major banks have received examination notices citing “possible disparate treatment of customers from different racial groups.” The OCC plans to discuss the details of lenders’ modification and foreclosure processes and has requested voluntary disclosure of the results of the banks’ self-tests for detection of prohibited differences in treatment of modification applications.

The OCC’s Fair Lending booklet (January 2010 revision) states that a bank may not treat a borrower differently in servicing a loan or invoking default remedies based on prohibited factors. The agency’s examiner compliance checklist asks whether employees are notified that they may not authorize or offer loan modifications on prohibited bases. The following are identified as possible risk factors for unlawful discrimination:

- foreclosure disparities between protected classes and others;
- consumer complaints alleging discrimination in loan servicing;
- poorly documented or undocumented servicing decisions; and
- high levels of litigation alleging loan servicing discrimination.

Though state attorneys general have yet to raise specific allegations of discrimination by loan servicers, they have supplemented federal investigations by examining servicers’ loan modification practices generally. For example, Ohio’s attorney general and Department of Commerce recently charged several servicers with failing to offer loss mitigation options free of unfair and deceptive loan modification terms.

The Ohio attorney general is seeking a permanent injunction to prevent unfair and deceptive loan modifications, among other measures. Massachusetts, Maryland and New York have attempted to slow foreclosures by requiring lenders to mediate foreclosure with delinquent borrowers. If states begin to take their cues from federal financial regulators, servicers may see an uptick in state challenges to modification practices that include fair-lending components, because both states and the federal government have fair-lending and related civil rights laws.

Unless the economy improves sharply - and soon - lenders’ loss mitigation programs are likely to be closely scrutinized for possible discrimination involving minority borrowers. Based on recent government announcements, a surge in examinations, investigations and enforcement actions against servicers may be looming. These examinations will attempt to discern whether minority borrowers are getting loan modifications and benefiting from loss mitigation programs on par with their white non-Hispanic counterparts.

Risk-reduction strategies

From a compliance and risk-reduction perspective, mortgage servicers should recognize the likelihood of greater scrutiny of their fair-lending efforts, particularly in the context of defaults and foreclosures. To prepare for the predicted examinations or investigations, lender management must reinforce the applicability of fair-lending principles in the servicing arena. This means adopting and implementing policies for reviewing and deciding loan modification applications, applying these policies fairly and consistently, and thoroughly documenting any exceptions. Customer service personnel should be trained and retrained in fair-lending concepts as applied to the servicing function, and on the enterprise risks that can result if fair-lending principles do not inform the entire loan life cycle. SM

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