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Fair Lending Refocused: Loan Modification and Loss Mitigation Outcome Reviews

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Mortgage loan servicers are under growing pressure from regulators to adhere to traditional fair lending principles in default servicing operations. Among other things, regulators have suggested that servicers proactively identify and undertake measures to ensure "fair servicing" for all borrowers, particularly where loan modifications are concerned. While examination custom, regulatory guidance, and the Interagency Fair Lending Examination Procedures implemented in the origination context may serve as guideposts, servicers lack clear standards for conducting fair servicing reviews.

This article provides a brief background on the regulatory climate relating to fair lending compliance in the context of loss mitigation and loan modifications. For servicers whose regulators have suggested or mandated self-testing, the authors discuss a matched-pair "plus" approach, which aims to assess at a basic level whether similarly-situated borrowers are treated equally to address regulatory concerns, while the industry awaits more specific regulatory guidance.

Regulatory and Enforcement Attention on Default Servicing. When the Department of Justice established a new Fair Lending Unit within the Housing Unit of its Civil Rights Division in early 2010 ("the Fair Lending Unit"), Assistant Attorney General for Civil Rights Thomas Perez emphasized a heightened enforcement focus on lending practices and consumer protection. Perez indicated that the Fair Lending Unit would focus on loan modifications, stating on June 23, 2010, that the Fair Lending Unit was "identify[ing] potential fair lending violations where much of the lending activity is occurring today—at the back-end of the process—in the loss mitigation process where mortgage modifications and servicing occur."[1] In more recent public statements, officials in the Fair Lending Unit have continued to emphasize scrutiny of loss mitigation practices.

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1. The Office of the Comptroller of the Currency issued a revised electronic version of its *"Fair Lending"* booklet (which is part of the *Comptroller's Handbook*) on January 20, 2010. The revised booklet details new procedures that apply to residential, consumer, and commercial lending, including risk indicators for disparate treatment specific to loan servicing and loss mitigation. Also in early 2010, the OCC issued fair-servicing examination requests relating to modification and foreclosure processes. Activity by state attorneys general doubtlessly will increase in light of the Dodd-Frank Act's codification of the Supreme Court's decision in *Cuomo v. Clearing House Ass'n, L.L.C.*, 129 S.Ct. 2710 (2009), which specifically confers enforcement authority over national banks to ensure their compliance with state consumer protection laws.

Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Consumer Financial Protection Bureau ("CFPB") is tasked with enforcing the requirements of most fair lending laws, as well as promulgating regulations to implement new federal requirements. The Office of Fair Lending and Equal Opportunity has specific duties for oversight and enforcement of fair lending laws and coordination of the CFPB's fair lending efforts with those of other regulators.

In recent months, federal banking regulators have focused on the application of fair lending principles in connection with loan modifications made under the Home Affordable Modification Program ("HAMP"). These regulators are now evaluating such issues in the context of examinations, urging servicers to engage in routine self-testing. Although the Federal Reserve Bank of San Francisco recently released a study concluding that, based on a review of more than 100,000 loans, race-based disparities in HAMP modifications have not materialized, regulators continue to focus on fair servicing issues.[2]

Regulatory scrutiny of workout practices is likely to expand to include propriety modification programs and other foreclosure alternatives as mortgage servicing practices continue to receive unprecedented national attention in the wake of the foreclosure documentation crisis. Consent decrees entered into by the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Reserve Board, and 14 major servicers highlight the breadth of default servicing issues that will now receive the attention of federal regulators. Likewise, recent settlement proposals submitted by the 50-State Attorney General Group to the five largest mortgage servicers—a set of detailed requirements tantamount to national servicing standards—further suggest that mortgage servicing will face significant regulation in the future.

Mortgage servicing also has captured the interest of Congress, sparking a multitude of hearings on default servicing issues in recent months. In May 2011, Senator Jeff Merkley introduced the Regulation of Mortgage Servicing Act (S. 967), which would set national servicing standards. Notably, the bill defines reasonable efforts to determine a

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2. *See* J. Michael Collins and Carolina Reid, Who Receives a Mortgage Modification? Race and Income Differentials in Loan Workouts, Federal Reserve Bank of San Francisco (Dec. 2010). The study used data on 105,769 non-agency securitized subprime loans made in 2005 to examine the incidence of defaults and modifications among loans managed by a large trustee of securitized loans covering 94 loan servicers in California, Oregon, and Washington. The authors concluded that there is no evidence that minority borrowers are less likely to receive a modification or less aggressive modification.

borrower's eligibility for a loan modification or other foreclosure alternative. Congress has begun to hold hearings on these issues.[3]

Though they do not relate directly to traditional fair lending principles, these recent developments highlight the importance of implementing policies and procedures designed to ensure that all borrowers receive equal treatment in the context of loan workouts. Self-testing protocols relating to modification outcomes for defaulted loans are a natural outgrowth of fair lending concerns relating to underwriting and pricing, which have been long-standing in the context of loan originations. Without doubt, servicers will face a host of challenges in developing such protocols, including complexities rooted in the absence of regulatory guidance on how such reviews should be conducted and in nuances intrinsic to defaults which make matched-pair analysis more complex in the loss mitigation context. Indeed, while all loan applicants clearly are seeking to obtain a loan, borrowers in default are unlikely to be interested in pursuing the very same workout options.

This complexity is exacerbated by the reality that some borrowers may even not be interested in pursuing loss mitigation. The reasons for, and longevity of, a default are individualized, from temporary job loss or reduction in income for one or both of the borrowers to seemingly permanent job loss or reduced income, as well as reduced desire to make sacrifices to remain in a home whose value is "underwater."

Notwithstanding these realities, servicers likely will face regulatory expectations that they engage in self-examination in connection with loan workouts. At the same time, they face increasing litigation risk under the Equal Credit Opportunity Act, 15 U.S.C. § 1691, and the Fair Housing Act, 42 U.S.C. §§ 3601–3619.

The new focus on loan modifications and loss mitigation raises the question of how institutions should apply traditional fair lending principles to default servicing. Where self-testing is expected despite lack of specific guidance for its conduct, servicers face a challenge, but they simultaneously have an opportunity to demonstrate proactive and meaningful commitment to fair servicing. Servicers encountering regulatory requests for self-testing might consider augmenting compliance programs to incorporate carefully-crafted tools to assess fair servicing in the workout context.

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3. *See, e.g., Housing Finance Reform: National Mortgage Servicing Standards: Hearings before the United States Senate Committee on Banking, Housing and Urban Affairs*, 112th Cong. (Aug. 2, 2011);

Old Tool in a New Light: Matched-Pair "Plus." Traditionally, in fair lending analyses, regulators have focused on the potential for race-based outcome disparities with respect to loan originations. Evaluation of Home Mortgage Disclosure Act ("HMDA") data has been a focal point, particularly with respect to loan pricing.[4] In evaluating such data, statistical analysis often is coupled with loan-level file review. Statistical screening of mortgage loan originations typically is intended to identify HMDA outliers—financial institutions with the largest, statistically significant pricing disparities.

Subsequent to such findings, regulators often undertake a comparative loan file review to discern whether observed statistical pricing disparities are likely to be the result of discrimination or legitimate pricing factors. Testers select a sample of loan files from the protected class and control groups, reviewing the key underwriting factors and outcomes in order to identify possible differentials on metrics such as denial rates, pricing, or product offerings. The analysis evaluates whether any disparities can be explained by legitimate non-discriminatory business justifications. Where the institution cannot provide such explanations, examiners and enforcement officials have (rightly or wrongly) inferred that the disparities are due to discriminatory conduct. Financial institutions have incorporated many of the same testing techniques when undertaking self-monitoring.

Evaluating outcome disparities in the loss mitigation context presents unique challenges not present in the origination context. For servicers seeking to proactively monitor potential differences as to loan modifications, the general analytic rubric used when evaluating originations is instructive, but not wholly sufficient. Such loan file review should incorporate a matched-pair "plus" analysis measuring, among other things, assistance level and outcome. To conduct such self-testing, servicers would collect ordinary credit characteristics in addition to information on borrower hardships. Statistical analysis, which would include data relating to loss mitigation behavior (*e.g.,* whether a borrower completed a loss mitigation package, entered into a workout plan, etc.), credit characteristics, and financial and demographic information, may show whether there are raw disparities in the default servicing outcomes of borrowers in particular groups. Critically, the more qualitative "plus" observations, which may include factors such as commensurate lengths of unemployment or commensurate monthly payment increases following rate adjustments, will shed light on the legitimate non-discriminatory business justifications for any raw disparities.

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4. Underscoring the deep suspicion of discretion in mortgage loan pricing, Section 1403 of the Dodd-Frank Wall Street Reform and Consumer Protection Act amends Section 129B of the Truth in Lending Act to prohibit "compensation that varies based on the terms of the loan (other than the amount of the principal)."

Borrowers having suffered permanent setbacks such as divorce (between mortgagors), or a reduction-in-force (without feasible opportunities for new employment or new employment at similar wages) would be inappropriate for comparison.

Servicers may then compare such borrowers on measures such as level of assistance as well as modification outcome and terms. For example, they may assess the number of times a servicer attempts to contact the borrower, distinguishing servicer-initiated contacts from borrower-initiated contacts to control for the fact that borrowers may be unresponsive to outbound servicer efforts. They may also review for outcome by looking at the frequencies and key terms of completed modifications, including interest rate, fee forgiveness, and principal reduction, principal deferment, and the like. In this process, the "plus" analysis permits consideration of the possibility that for some borrowers, modification may not superior to extinguishing the mortgage obligation; rather, the optimal outcome for a particular borrower may be an alternative under which the borrower does not retain the property, such as short sale or deed in lieu of foreclosure. At its core, a matched-pair plus analysis is preferably because it more accurately evaluates whether similarly-situated borrowers with similar credit characteristics receive similar treatment.

Certain problems inherent in matched-pair analysis will continue to exist in a matched-pair plus analysis. Specifically, differences in foreseeable income, property values, and the direction of property values will remain problematic. Making the analysis more challenging, in the default servicing context, servicers often do not have access to race and ethnicity data as a matter of course, and even with respect to HAMP modifications, many borrowers do not respond to data requests.

Notwithstanding these complications, regulators will be looking at loan modification outcomes and may expect that servicers are doing the same in connection with their compliance programs. Accordingly, servicers may take reasonable measures to control for these problems. With respect to the lack of race and ethnicity data, for example, certain analyses might be run on the census tract level comparing outcomes in predominantly minority census tracts to those in predominantly Caucasian census tracts.

The Role of Discretion in Loss Mitigation. The issue of discretion is likely to be a focal point for both servicers and regulators as loss mitigation continues to receive unprecedented scrutiny. Historically, regulators have associated decision-making discretion with the potential for race-based outcome disparities, assuming that discretion invites discrimination. Yet, in the default servicing context, some of the most successful modification programs provide workout personnel with the greatest degree of discretion. In many ways, this result is unsurprising. The circumstances that lead to default vary widely, so the resolution of defaults typically does not lend itself to a one-size-fits-all solution.

Insofar as regulators and servicers have the common goal of facilitating the best outcomes for borrowers, regulators must treat discretion in servicing with less suspicion in examinations. Evaluation of servicers' compliance activities, and loss mitigation outcomes must recognize that decisioning in loss mitigation programs is far more multivariate than in the loan origination context; and accordingly, that some level of discretion is necessary in order to allow workout personnel to craft the most desirable solution for the borrower.

Servicers are justified in working with borrowers to determine that modification may be superior to liquidation for some, while short sales may be optimal for others. Regulators should *encourage* servicers to work with borrowers in this manner as discretion, applied in this manner, may lead to motivated borrowers remaining in their homes and, for those who cannot or do not wish to do so, more graceful exits. As in any situation where discretion is permitted, servicers must do what they can to ensure that discretion is not misused. Here, that means clearly written policies and procedures, robust training, thorough documentation of decisioning, and, insofar as exceptions are made, clear identification of the reasons for the departures.

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