Bank of America issues nationwide moratorium on foreclosures

Oct. 8, 2010 | Debra Baer | KPCC/AP

Joe Raedle/Getty Images

Today, the nation's largest bank - Bank of America - says it will temporarily halt the sales of foreclosed properties in all 50 states as it reviews how it handled foreclosures.

California lawmakers are praising Bank of America's announcement today that it's halting foreclosures in all 50 states. The largest bank in the country says it will refrain from taking possession of homes from defaulted borrowers until it completes a review of its documents.

In a statement, state Assemblyman Ted Lieu said Bank of America is doing the right thing. On Thursday, the Democrat from Torrance called for a temporary moratorium on foreclosures in California and an investigation into growing evidence of sloppy or fraudulent document processing by banks and their lawyers.

Last week, Bank of America halted foreclosures in 23 states. It's the first bank to expand the freeze nationwide in response to pressure by state and federal officials over violations in document processing.

Democratic Congresswoman Loretta Sanchez of Orange County commended BofA for - in her words - "finally deciding to halt the practice of kicking people out of their homes first, and asking questions later."

Attorney General and gubernatorial candidate Jerry Brown called on the state's other lenders to halt foreclosures until they can demonstrate that they're following state law.

The move came as PNC Financial Services became the fourth major bank to announce that it would stop foreclosures in at least some states. It added to growing concerns that mortgage lenders have been evicting homeowners despite flawed court papers.

Bank of America, the largest U.S. bank, had said a week earlier it would stop foreclosures in the 23 states where the process must be approved by a judge. Ally Financial's GMAC Mortgage unit and JPMorgan Chase had announced similar plans.

Bank of America's nationwide halt will apply to homes that the bank is taking back itself and those for which it has transferred the papers to mortgage buyers Fannie Mae and Freddie Mac.

The bank said it had not found any widespread problems in the foreclosure process, but "We'll go back and check our work one more time," CEO Brian Moynihan told the National Press Club in Washington.

A Bank of America spokesman acknowledged that the bank acted in response to pressure from state attorneys general and other public officials inquiring about the accuracy of foreclosure documents.

"We feel the need to address that and demonstrate that our process is accurate," said the spokesman, Dan Frahm.

A document obtained last week by The Associated Press showed a Bank of America official acknowledging in a legal proceeding that she signed thousands of foreclosure documents a month and typically did not read them. The official, Renee Hertzler, said in a February deposition that she signed up to 8,000 such documents a month.

The bank said it would take a few weeks to tackle the problem. It did not say how many foreclosure cases would be affected but estimated the figure would be in the tens of thousands.

The Associated Press contributed to this report.

A Primer On The Foreclosure Crisis

Published: Monday, 11 Oct 2010 **|** 2:48 PM ET
By: John Carney
Senior Editor, CNBC.com

Last week, **Bank of America** announced that it was halting foreclosures in all fifty-states while it reviewed its foreclosure process for defects. Now several lawmakers on Capitol Hill are calling for other banks to initiate nationwide foreclosure freezes—a move which the Obama administration is currently opposing.

Photo: Jeff Turner

So what's going on here? Why is the foreclosure machinery of our nation's largest banks suddenly grinding to a halt? What does this mean for the financial sector and the economy?

Let's start with the most basic questions first. Then I'll explain some of the possible implications for homeowners, banks, and the economy.

How did this thing get started?

Ever since the housing bubble burst, there have been signs that there are serious problems with foreclosure practices. In some cases, the financial institution claiming it owns the mortgage has not been able to produce the underlying loan documents. In 2007, a federal judge held that **Deutsche Bank lacked standing to foreclose in 14 cases** because it could not produce the documents proving that it had been assigned the rights in the mortgages when they were securitized.

This decision was followed by similar rulings in other states stopping foreclosure proceedings. Typically the judges would find that the banks that were servicing mortgages pooled into bonds weren't able to prove they owned the mortgages.

Why can't they prove they own the mortgages?

Every time a mortgages changes hands, the new owners are supposed to receive an "assignment" of the mortgage notes from the buyers. The assignment is typically a short little document signed by both the seller and buyer of the mortgage acknowledging the sale, which is then attached to the mortgage documents themselves and delivered to the new owner.

When a mortgage is securitized it is typically sold to a Wall Street firm, which pools the mortgage with thousands of others. Investors buy slices of the pool, entitling them to cash-flows from the mortgage payments. The actual mortgages are assigned to a newly created investment vehicle. A servicer is tasked with ensuring the payments to borrowers get divided up properly and that delinquent borrowers get foreclosed upon.

Here's where things get tricky. When a mortgage is securitized, the investors in the mortgage bonds don't get assignments or notes. The investment vehicle doesn't get the assignments or notes either. Instead, the physical notes are typically sent to a document repository company. The transfer of interests is noted in an electronic database.

But during the height of the housing bubble, investment banks were churning out mortgage bonds in such a frenzy, sometimes the assignments never got executed and mortgage notes never got delivered. Keep in mind that this was during the years when lenders were giving out low-doc and no-doc mortgages. It was inevitable that the fast and loose and slightly documented culture would not stop at the mortgage originator but stretch all the way through the process. (For more on this, **see RortyBomb's excellent discussion of the securitization process**, complete with nifty and highly informative charts.)

For most mortgages, the note probably still exists somewhere. One problem that has arisen, however, is that some of the original mortgage lenders have gone under or been acquired by a larger bank. This can make tracking down the notes difficult, if not impossible.

Why am I just learning about this mess now?

This issue has been quietly simmering in the background of the housing crisis for quite some time. Gretchen Mortgenson of the New York Times wrote about it back in 2007. It gave rise to a **"show me the note" movement of people contesting foreclosure proceedings**.

But what really kicked off the latest developments was the **deposition of a GMAC loan officer named Jeffrey Stephan**, which revealed deep and perhaps pervasive flaws in the foreclosure practices of our largest banks.

Stephan admitted in a sworn deposition in Pennsylvania that he signed off on up to 10,000 foreclosure documents a month for five years. He said that he hadn't reviewed the mortgage or foreclosure documents thoroughly. He quickly became known by the pejorative "robo-signer" for this way of getting mortgages through. This prompted Ally, which owns the GMAC mortgage company, to halt foreclosures in 23 so-called "judicial states." Because Stephan also signed foreclosures for hundreds of other mortgage companies, including **J.P. Morgan Chase** [JPM 37.63

0.12 (+0.32%)], the problem is not limited to GMAC. In fact, JP Morgan Chase also halted foreclosures in the judicial states.

Wait, what's this about judicial states?

The majority of states in the country allow banks to foreclose on defaulted mortgages without going to court. They simply deliver the borrower a notice of the foreclosure sale. This is the method of foreclosure preferred by banks, since it is much faster and easier to execute the foreclosure sale, and much more difficult for borrowers to contest.

Twenty-three states, however, require banks to go to court to get a foreclosure order. These are the "judicial states." In these states, banks are typically required to produce a sworn and notarized affidavit of a loan officer and submit the mortgage documents. Often, however, judges will issue foreclosure orders without the mortgage documents so long as the borrower doesn't contest this point.

Keep in mind that in both judicial and non-judicial states, there are strong legal presumptions that favor the banks. So long as they have the mortgage note and the loan is delinquent—or so long as no one argues that they aren't the owners of the mortgage or that borrower is not in default—the bank will almost always get the foreclosure.

But as the "show me the note" movement took off, more and more homeowners began to contest foreclosures by demanding to see the notes and, if the loan had been transferred or securitized, the assignment agreements. This typically was not fatal to banks seeking foreclosures. They could make up for the lost notes with lost note affidavits and retro-actively build an assignment chain. The worst that would happen, from the bank's perspective, was that the foreclosure would be delayed.

In some cases, however, banks seem to have not even been able to manage even this kind of corrective action. Evidence has been produced to show that notarizations have been faked, documents forged, and folks like Stephan have simply been operating as foreclosure bots.

So is this just a concern for "judicial states?"

Although banks first shut down foreclosures in judicial states, the lack of documentation is a problem in any jurisdiction. Homeowners contesting foreclosures in both non-judicial and judicial states can win if the bank cannot provide documents proving it owns the mortgage.

In judicial states, however, the banks are especially exposed because they must initiate a lawsuit to get a foreclosure. If they have been submitting false documents to the court, they could be sanctioned and fined. Realizing that they had few internal controls over their own foreclosure practices, banks wisely shut down foreclosures in the states where they had the most exposure.

In non-judicial states, banks aren't required to submit anything to the court until they are sued by a homeowner seeking to stop a foreclosure. That means that they are far less likely to submit fraudulent documents, since the process has already been slowed. Nonetheless, banks may still find themselves swamped by challenges. No one really knows how badly the missing documentation problem is at the banks.

The Wall Street Journal told me this is just about "paperwork" and politics. Are we making a mountain out of a molehill?

Our friends at the Journal are seriously misguided on this issue. (Note: my brother, Brian Carney, is on the editorial board of the Journal.)

The requirement that banks be able to prove ownership of mortgages by producing notes and assignments reflects a long-settled view about the necessity of written contracts in real estate transactions. Long before the founding of our Republic, England adopted what is commonly called the "Statute of Frauds." It required that real estate conveyances be recorded in writing and signed. Similar laws apply in almost every state in the Union.

Part of the point of the writing requirement is to allow the government the transparency it needs to enforce property rights, including the right to foreclose on a home. If courts were to treat this as mere "paperwork" that was irrelevant to the cases, both property rights and the rule-of-law would suffer. It's surprising that the Journal's editorial page would take this stance.

Now, if the problem truly is just sloppy work on the part of robo-signers, banks can likely resume foreclosures before too long. But many suspect that the reason banks were falsifying their knowledge about the possession of loan documents is that the banks do not actually have the documents and don't know where to find them. This could permanently impair their ability to foreclose on some properties.

What does this mean for the banks?

In the first place, the slowdown in foreclosure sales might hit the revenues of the banks. The defaulted loans aren't spinning off revenue and now the foreclosures aren't producing revenue either. If the foreclosure freezes last long enough, this could it the bottom lines of the banks. At the very least, banks should be adjusting the estimates on the likelihood of short-term recovery values for their mortgage portfolios.

The fact that banks securitized loans but did not get proper assignments of the mortgage notes may find themselves liable to lawsuits from investors. A typical mortgage bond issuance includes representations and warranties that all the proper documentation has been obtained. Banks could find themselves liable for a breach of these warranties.

This could also turn into a fight between investors of junior and senior tranches of mortgage bonds. Here's how the **Journal describes this fight**:

> When houses that have been packaged into a mortgage bond are liquidated at a foreclosure sale—the very end of the foreclosure process—the holders of the junior, or riskiest debt, would be the first investors to take losses. But if a foreclosure is delayed, the servicer must typically keep advancing payments that will go to all bondholders, including the junior debt holders, even though the home loan itself is producing no revenue stream.
>
> The latest events thus set up an odd circumstance where junior bondholders—typically at the bottom of the credit structure—could actually end up better off

> than they expected. Senior bondholders, typically at the top, could end up worse off.
>
> Not surprisingly, senior debt holders want banks to foreclose faster to reduce expenses. Junior bondholders are generally happy to stretch things out. What is more, it isn't entirely clear how the costs of re-processing tens of thousands of mortgages will be allocated. Those costs could be "significant" said Andrew Sandler, a Washington, D.C., attorney who represents mortgage companies.

The most damaging thing that could happen to banks would be the discovery that they simply cannot prove they hold a mortgage on a house. In that case, the loan would probably have to be written down to near zero. Even for current loans, the regulatory reserve requirements would double as the loan would no longer be a functional mortgage but an ordinary consumer loan. Depending on the size of the “no docs” portion of the loan portfolio, this might be a minor blip or require a bank to raise new capital to fill the hole in the balance sheet.

What does this mean for the housing market and the economy?

Get ready to hear the phrase “pig through the python” a lot. For example, “We need to get the pig through the python very quickly so that the market can be free of uncertainty.”

This is the favorite metaphor of bankers discussing the foreclosure crisis. The idea is that anything that slows down foreclosures will unsteady the housing market. There’s a lot of truth to this. Buyers will hesitate to bid on foreclosure sales if they are not confident the foreclosure is legitimate. Other buyers may worry that the lack of foreclosure sales in an area is a false indicator of the health of the local housing market.

Banks concerned about the recovery values of their mortgage portfolios and higher capital requirements, may pull back lending even further than they already have. In short, this could be the beginning of the second leg of the credit crunch.

Companies mentioned in the post

Bank of America [BAC 11.449 -0.081 (-0.7%)]

Deutsche Bank [DB 57.88 -0.04 (-0.07%)]

JPMorgan [JPM 37.63 0.12 (+0.32%)]