Panel Three

Hearing - Housing and Community Opportunity

Robo-Signing, Chain of Title, Loss Mitigation and Other Issues in Mortgage Servicing

Date: November 18, 2010

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Witness List & Prepared Testimony:

- **Mr. Adam Levitin**, Associate Professor of Law, Georgetown University Law Center
- **Mr. Anthony B. Sanders**, Professor of Finance, Distinguished Professor of Real Estate Finance, School of Management, George Mason University
- **Ms. Julia Gordon**, Senior Policy Counsel, Center for Responsible Lending
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- **Ms. Anne Anastasi**, President, American Land Title Association

COMMITTEE ON

FINANCIAL SERVICES

Hearing - Housing and Community Opportunity

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Written Testimony of

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Before the
House Financial Services Committee
Subcommittee on Housing and Community Opportunity

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Witness Background Statement

Adam J. Levitin in an Associate Professor of Law at the Georgetown University Law Center, in Washington, D.C., and Robert Zinman Scholar in Residence at the American Bankruptcy Institute. He also serves as Special Counsel to the Congressional Oversight Panel and has been the Robert Zinman Scholar in Residence at the American Bankruptcy Institute.

Before joining the Georgetown faculty, Professor Levitin practiced in the Business Finance & Restructuring Department of Weil, Gotshal & Manges, LLP in New York, and served as law clerk to the Honorable Jane R. Roth on the United States Court of Appeals for the Third Circuit.

Professor Levitin holds a J.D. from Harvard Law School, an M.Phil and an A.M. from Columbia University, and an A.B. from Harvard College.

Professor Levitin has not received any Federal grants nor has he received any compensation in connection with his testimony. The views expressed in Professor Levitin's testimony are his own and do not represent the positions of the Congressional Oversight Panel.

EXECUTIVE SUMMARY

The US is now in its forth year of a mortgage crisis in which over 3 million families have lost their homes and another 2.5 million are currently scheduled to lose theirs. Repeated government loan modification or refinancing initiatives have failed miserably. To this sad state of affairs, there now come a variety of additional problems: faulty foreclosures due to irregularities ranging from procedural defects (including, but not limited to robosigning) to outright counterfeiting of documents; predatory servicing practices that precipitate borrower defaults and then overcharge for foreclosure services that are ultimately paid for by investors; and questions about the validity of transfers in private-label mortgage securitizations. While the extent of these problems is unknown at present, the evidence is mounting that they are not limited to one-off cases, but that there may be pervasive defects throughout the mortgage servicing and securitization processes.

The servicing problems stem from servicers' failed business model. Servicers are primarily in the transaction processing business and are failing miserably at trying to adapt themselves to the loan modification business. Servicers' business model also encourages them to cut costs wherever possible, even if this involves cutting corners on legal requirements, and to lard on junk fees and in-sourced expenses at inflated prices. The financial incentives of mortgage servicers also encourage them to foreclose, rather than modify loans in many cases, even when modification would maximize the net present value of the loan for investors.

The chain of title problems are highly technical, but they pose a potential systemic risk to the US economy. If mortgages were not properly transferred in the securitization process, then mortgage-backed securities would in fact not be backed by any mortgages whatsoever. The chain of title concerns stem from transactions that make assumptions about the resolution of unsettled law. If those legal issues are resolved differently, then there would be a failure of the transfer of mortgages into securitization trusts, which would cloud title to nearly every property in the United States and would create contract rescission/putback liabilities in the trillions of dollars, greatly exceeding the capital of the US's major financial institutions.

These problems are very serious. At best they present problems of fraud on the court, clouded title to properties coming out of foreclosure, and delay in foreclosures that will increase the shadow housing inventory and drive down home prices. At worst, they represent a systemic risk that would bring the US financial system back to the dark days of the fall of 2008.

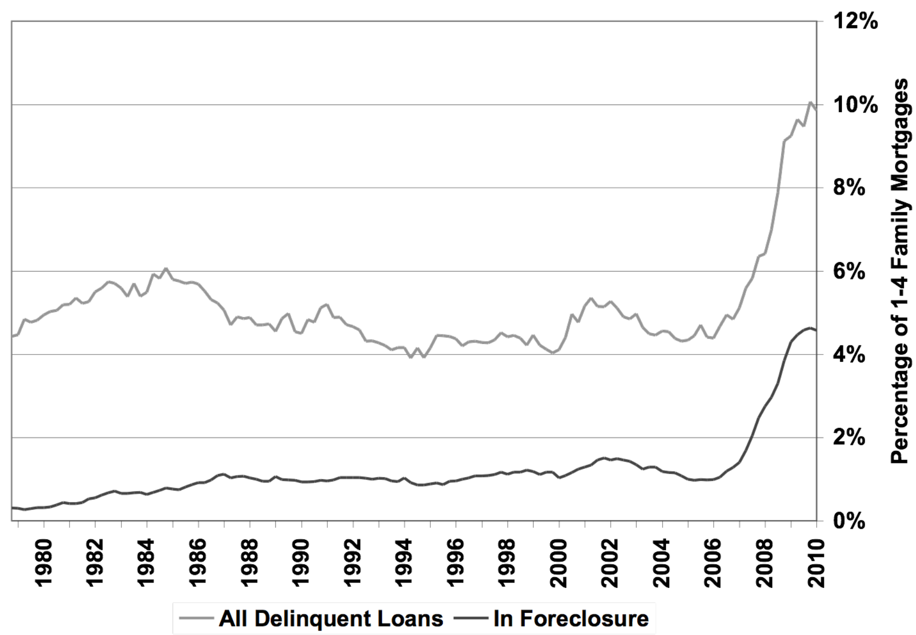
Congress would do well to ensure that federal regulators are undertaking a thorough investigation of foreclosure problems and to consider the possibilities for a global settlement of foreclosure problems, loan modifications, and the housing debt overhang on consumers and financial institutions that stagnate the economy and pose potential systemic risk.

Madam Chairwoman, Members of the Committee:

Good morning. My name is Adam Levitin. I am an Associate Professor of Law at the Georgetown University Law Center in Washington, D.C., where I teach courses in bankruptcy, commercial law, contracts, and structured finance. I also serve as Special Counsel to the Congressional Oversight Panel for the Troubled Asset Relief Program. The views I express today are my own, however.

We are now well into the fourth year of the foreclosure crisis, and there is no end in sight. Since mid-2007 around eight million homes entered foreclosure,[1] and over three million borrowers lost their homes in foreclosure.[2] As of June 30, 2010, the Mortgage Bankers Association reported that 4.57% of 1-4 family residential mortgage loans (roughly 2.5 million loans) were currently in the foreclosure, process a rate more than quadruple historical averages. (See Figure 1.) Additionally, 9.85% of mortgages (roughly 5 million loans) were at least a month delinquent.[3]

Chart 1: Percentage of 1-4 Family Residential Mortgages in Foreclosure[4]



Private lenders, industry associations, and two successive administrations have made a variety of efforts to mitigate the crisis and encourage loan modifications and refinancings. A series of much hyped initiatives, such as the FHASecure refinancing program and the Hope4Homeowners have all met what can charitably be described as limited success. FHASecure, predicted to help 240,000 homeowners,[5] assisted only a few thousand borrowers

[1] HOPE Now Data Reports.
[2] *Id.*
[3] Mortgage Bankers Association, National Delinquency Survey.
[4] Mortgage Bankers Association, National Delinquency Surveys.
[5] *See, e.g.*, Press Release, US Dep't of Housing and Urban Development, Bush Administration to Help Nearly One-Quarter of a Million Homeowners Refinance, Keep Their Homes; FHA to implement new "FHASecure" refinancing product (Aug. 31, 2007), *available at* http://www.hud.gov/news/release.cfm?content=pr07-123.cfm; Press Release, US Dep't of Housing and Urban Development, FHA Helps 400,000 Families Find Mortgage Relief; Refinancing on pace to help half-million homeowners by year's end (Oct. 24, 2008), *available at* http://www.hud.gov/news/release.cfm?content=pr08- 167.cfm.

before it wound down,[6] while Hope4 Homeowners, originally predicted to help 400,000 homeowners,[7] had closed only 130 refinancings as of September 30, 2010.[8] The Home Affordable Modification (HAMP) has also failed, producing 495,898 permanent modifications through September 2010. This number is likely to be a high water mark for HAMP, as new permanent modifications are decreasing rapidly while defaults on permanent modifications rise; if current trends continue, by year's end the number of active permanent HAMP modifications will actually decline.

A number of events over the past several months have roiled the mortgage world, raising questions about:

(1) Whether there is widespread fraud in the foreclosure process;

(2) Securitization chain of title, namely whether the transfer of mortgages in the securitization process was defective, rendering mortgage-backed securities into *non*-mortgage-backed securities;

(3) Whether the use of the Mortgage Electronic Registration System (MERS) creates legal defects in either the secured status of a mortgage loan or in mortgage assignments;

(4) Whether mortgage servicers' have defaulted on their servicing contracts by charging predatory fees to borrowers that are ultimately paid by investors;

(5) Whether investors will be able to "putback" to banks securitized mortgages on the basis of breaches of representations and warranties about the quality of the mortgages.

These issues are seemingly disparate and unconnected, other than that they all involve mortgages. They are, however, connected by two common threads: the necessity of proving standing in order to maintain a foreclosure action and the severe conflicts of interests between mortgage servicers and MBS investors.

It is axiomatic that in order to bring a suit, like a foreclosure action, the plaintiff must have legal standing, meaning it must have a direct interest in the outcome of the litigation. In the case of a mortgage foreclosure, only the mortgagee has such an interest and thus standing. Many of the issues relating to foreclosure fraud by mortgage servicers, ranging from more minor procedural defects up to outright counterfeiting relate to the need to show standing. Thus problems like false affidavits of indebtedness, false lost note affidavits, and false lost summons affidavits, as well as backdated mortgage assignments, and wholly counterfeited notes, mortgages, and assignments all relate to the evidentiary need to show that the entity bringing the foreclosure action has standing to foreclose.

Concerns about securitization chain of title also go to the standing question; if the mortgages were not properly transferred in the securitization process (including through the use of MERS to record the mortgages), then the party bringing the foreclosure does not in fact own the mortgage and therefore lacks standing to foreclose. If the mortgage was not properly transferred, there are profound implications too for investors, as the mortgage-backed securities they believed they had purchased would, in fact be non-mortgage-backed securities, which

[6] Michael Corkery, *Mortgage 'Cram-Downs' Loom as Foreclosures Mount*, WALL ST. J.,, Dec. 31, 2008.
[7] Dina ElBoghdady, *HUD Chief Calls Aid on Mortgages a Failure*, WASH. POST. Dec. 17, 2008, at A1.
[8] *See* FHA Single Family Outlook, Sept. 2010, *at* http://www.hud.gov/offices/hsg/rmra/oe/rpts/ooe/olcurr.xls - 2010-11-02, Row 263 (note that FHA fiscal years begin in October, so that Fiscal Year 2009 began in October 2008).

would almost assuredly lead investors to demand that their investment contracts be rescinded, thereby exacerbating the scale of mortgage putback claims.

Putback claims underscore the myriad conflicts of interest between mortgage servicers and investors. Mortgage servicers are responsible for prosecuting on behalf of MBS investors, violations of representations and warranties in securitization deals. Mortgage servicers are loathe to bring such actions, however, not least because they would often be bringing them against their own affiliates. Servicers' failure to honor their contractual duty to protect investors' interest is but one of numerous problems with servicer conflicts of interest, including the levying of junk fees in foreclosures that are ultimately paid by investors and servicing first lien loans while directly owning junior liens.

Many of the problems in the mortgage securitization market (and thus this testimony) are highly technical, but they are extremely serious.[9] At best they present problems of fraud on the court and questionable title to property. At worst, they represent a systemic risk of liabilities in the trillions of dollars, greatly exceeding the capital of the US's major financial institutions. While understanding the securitization market's problems involves following a good deal of technical issues, it is critical to understand from the get-go that securitization is all about technicalities.

Securitization is the legal apotheosis of form over substance, and if securitization is to work it must adhere to its proper, prescribed form punctiliously. The rules of the game with securitization, as with real property law and secured credit are, and always have been, that dotting "i's" and crossing "t's" matter, in part to ensure the fairness of the system and avoid confusions about conflicting claims to property. Close enough doesn't do it in securitization; if you don't do it right, you cannot ensure that securitized assets are bankruptcy remote and thus you cannot get the ratings and opinion letters necessary for securitization to work. Thus, it is important not to dismiss securitization problems as merely "technical;" these issues are no more technicalities than the borrower's signature on a mortgage. Cutting corners may improve securitization's economic efficiency, but it undermines its legal viability.

Finally, as an initial matter, let me also emphasize that the problems in the securitization world do not affect the whether homeowners owe valid debts or have defaulted on those debts. Those are separate issues about which there is no general controversy, even if debts are disputed in individual cases.[10]

This written testimony proceeds as follows: Part I presents an overview of the structure of the mortgage market, the role of mortgage servicers, the mortgage contract and foreclosure process. Part II presents the procedural problems and fraud issues that have emerged in the mortgage market relating to foreclosures. Part III addresses chain of title issues. Part IV considers the argument that the problems in foreclosures are mere technicalities being used by deadbeats to delay foreclosure. Part V concludes.

[9] I emphasize, however, that this testimony does not purport to be a complete and exhaustive treatment of the issues involved and that many of the legal issues discussed are not settled law, which is itself part of the problem; trillions of dollars of mortgage securitization transactions have been done without a certain legal basis.

[10] A notable exception, however, is for cases where the default is caused by a servicer improperly force-placing insurance or misapplying a payment, resulting in an inflated loan balance that triggers a homeowner default.

I. BACKGROUND ON SECURITIZATION, SERVICING, AND THE FORECLOSURE PROCESS

A. MORTGAGE SECURITIZATION

Most residential mortgages in the United States are financed through securitization. Securitization is a financing method involving the issuance of securities against a dedicated cashflow 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 own books.

Currently, about 60% of all outstanding residential mortgages by dollar amount are securitized.[11] The share of securitized mortgages by number of mortgages outstanding is much higher because the securitization rate is lower for larger "jumbo" mortgages.[12] Credit Suisse estimates that 75% of outstanding first-lien residential mortgages are securitized.[13] In recent years, over 90% of mortgages originated have been securitized.[14] Most second-lien loans, however, are not securitized.[15]

Although mortgage securitization transactions are extremely complex and vary somewhat depending on the type of entity undertaking the securitization, the core of the transaction is relatively simple.[16]

First, a financial institution (the "sponsor" or "seller") assembles a pool of mortgage loans. The loans were either made ("originated") by an affiliate of the financial institution or purchased from unaffiliated third-party originators. Second, the pool of loans is sold by the sponsor to a special-purpose subsidiary (the "depositor") that has no other assets or liabilities. This is done to segregate the loans from the sponsor's assets and liabilities.[17] Third, the depositor sells the loans to a passive, specially created, single-purpose vehicle (SPV), typically a trust in the case of residential mortgages.[18] The SPV issues certificated securities to raise the funds to pay the depositor for the loans. Most of the securities are debt securities—bonds—but there will also be a security representing the rights to the residual value of the trust or the "equity."

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[11] Inside Mortgage Finance, 2010 Mortgage Market Statistical Annual.

[12] *Id.*

[13] Ivy L. Zelman et al., *Mortgage Liquidity du Jour: Underestimated No More* 28 exhibit 21 (Credit Suisse, Equity Research Report, Mar. 12, 2007).

[14] Inside Mortgage Finance, 2010 Mortgage Market Statistical Annual.

[15] Inside Mortgage Finance, 2010 Mortgage Market Statistical Annual. From 2001-2007, only 14% of second lien mortgages originated were securitized. *Id.* Second lien mortgages create a conflict of interest beyond the scope of this paper. In many cases, second lien loans are owned by financial institutions that are servicing (but do not own) the first lien loan. *See* Hearing Before the House Financial Services Committee, Apr. 13, 2009 "Second Liens and Other Barriers to Principal Reduction as an Effective Foreclosure Mitigation Program" (testimony of Barbara DeSoer, President, Bank of America Home Loans) at 6 (noting that Bank of America owns the second lien mortgage on 15% of the first lien mortgages it services); Hearing Before the House Financial Services Committee, Apr. 13, 2009 "Second Liens and Other Barriers to Principal Reduction as an Effective Foreclosure Mitigation Program" (testimony of David Lowman, CEO for Home Lending, JPMorgan Chase) at 5 (noting that Chase owns the second lien mortgage on around 10% of the first lien mortgages it services). The ownership of the second while servicing the first creates a direct financial conflict between the servicer qua servicer and the servicer qua owner of the second lien mortgage, as the servicer has an incentive to modify the first lien mortgage in order to free up borrower cashflow for payments on the second lien mortgage.

[16] The structure illustrated is for private-label mortgage-backed securities. Ginnie Mae and GSE securitizations are structured somewhat differently. The private-label structure can, of course, be used to securitize any asset, from oil tankers to credit card debt to song catalogues, not just mortgages.

[17] This intermediate entity is not essential to securitization, but since 2002, Statement of Financial Accountings Standards 140 has required this additional step for off-balance-sheet treatment because of the remote possibility that if the originator went bankrupt or into receivership, the securitization would be treated as a secured loan, rather than a sale, and the originator would exercise its equitable right of redemption and reclaim the securitized assets. Deloitte & Touche, *Learning the Norwalk Two-Step*, HEADS UP , Apr. 25, 2001, at 1.

[18] The trustee will then typically convey the mortgage notes and security instruments to a "master document custodian," who manages the loan documentation, while the servicer handles the collection of the loans.

The securities can be sold directly to investors by the SPV or, as is more common, they are issued directly to the depositor as payment for the loans. The depositor then resells the securities, usually through an underwriting affiliate that then places them on the market. (See Figure 2, below.) The depositor uses the proceeds of the securities sale (to the underwriter or the market) to pay the sponsor for the loans. Because the certificated securities are collateralized by the residential mortgage loans owned by the trust, they are called residential mortgage-backed securities (RMBS).

A variety of reasons—credit risk (bankruptcy remoteness), off-balance sheet accounting treatment, and pass-through tax status (typically as a REMIC[19] or grantor trust)—mandate that the SPV be passive; it is little more than a shell to hold the loans and put them beyond the reach of the creditors of the financial institution.[20] Loans, however, need to be managed. Bills must be sent out and payments collected. Thus, a third-party must be brought in to manage the loans.[21] This third party is the servicer. The servicer is supposed to manage the loans for the benefit of the RMBS holders.

Every loan, irrespective of whether it is securitized, has a servicer. Sometimes that servicer is a first-party servicer, such as when a portfolio lender services its own loans. Other times it is a third-party servicer that services loans it does not own. All securitizations involve third-party servicers, but many portfolio loans also have third-party servicers, particularly if they go into default. Third-party servicing contracts for portfolio loans are not publicly available, making it hard to say much about them, including the precise nature of servicing compensation arrangements in these cases or the degree of oversight portfolio lenders exercise over their third-party servicers. Thus, it cannot always be assumed that if a loan is not securitized it is being serviced by the financial institution that owns the loan, but if the loan is securitized, it has third-party servicing.

Securitization divides the beneficial ownership of the mortgage loan from legal title to the loan and from the management of the loans. The SPV (or more precisely its trustee) holds legal title to the loans, and the trust is the nominal beneficial owner of the loans. The RMBS investors are formally creditors of the trust, not owners of the loans held by the trust.

The economic reality, however, is that the investors are the true beneficial owners. The trust is just a pass-through holding entity, rather than an operating company. Moreover, while the trustee has nominal title to the loans for the trust, it is the third-party servicer that typically exercises legal title in the name of the trustee. The economic realities of securitization do not track with its legal formalities; securitization is the apotheosis of legal form over substance, but punctilious respect for formalities is critical for securitization to work.

Mortgage servicers provide the critical link between mortgage borrowers and the SPV and RMBS investors, and servicing arrangements are an indispensable part of securitization.[22] Mortgage servicing has become particularly important with the growth of the securitization market.

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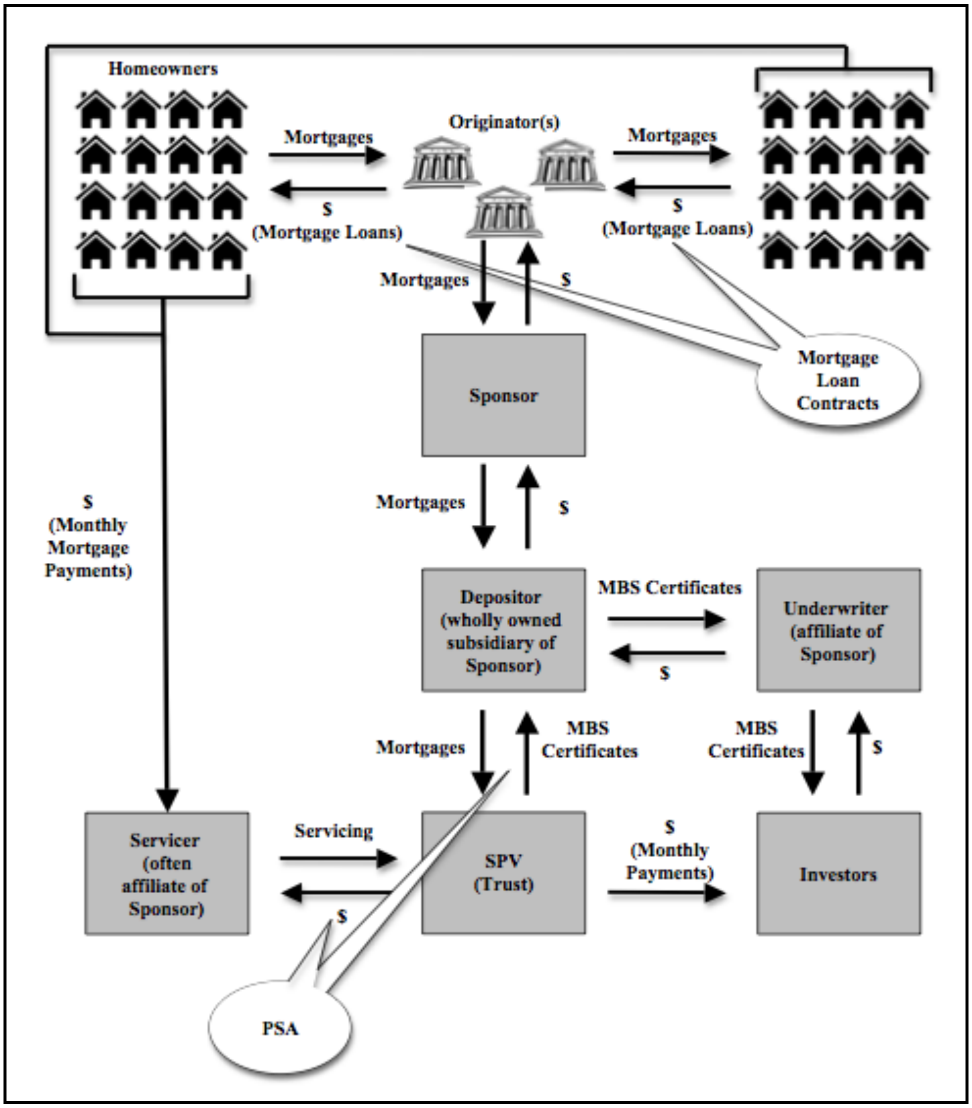
[19] A REMIC is a real estate mortgage investment conduit, as defined under I.R.C. §§ 860A-860G.

[20] *See* Anna Gelpern & Adam J. Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage Backed Securities*, 82 S. CAL. L. REV. 1075, 1093-98. (2009).

[21] *See* Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 HOUSING POL'Y DEBATE 753, 754 (2004).

[22] The servicing of nonsecuritized loans may also be outsourced. There is little information about this market because it does not involve publicly available contracts and does not show up in standard data.

Figure 2. Private-Label Mortgage Securitization Structure[23]



B. The Mortgage Servicing Business[24]

The nature of the servicing business in general militates toward economies of scale and automation. Servicing combines three distinct lines of business: transaction processing, default management, and loss mitigation. Transaction processing is a highly automatable business, characterized by large economies of scale. Default management involves collections and activities related to taking defaulted loans through foreclosure. Like transaction processing,

[23] *See* ACE Sec. Corp. Home Equity Loan Trust, Series 2006-NC3, Prospectus Supplement (Form 424B5) S-11 (Nov. 21, 2006), *available at* http://www.sec.gov/Archives/edgar/data/1380884/000114420406049985/v058926_424b5.htm.
[24] This section of my testimony comes from Adam J. Levitin & Larry Cordell, *What RMBS Servicing Can Learn from CMBS Servicing*, working paper, November 2010.

default management can be automated,[25] as it does not require any negotiation with the homeowner, insurers, or junior lienholders.[26]

Loss mitigation is considered an *alternative to foreclosure*, and includes activities such as repayment plans, loan modifications, short sales and deeds in lieu of foreclosure. Loss mitigation is always a negotiated process and is therefore labor-intensive and expensive. Not only must the homeowner be agreeable to any loss mitigation solution, but so too must mortgage insurers and junior lienholders if they are parties on the loan. Because each negotiation is separate and requires a trained employee, there are very few opportunities for automation or economies of scale. Labor expenses are also considered overhead, which are all non-reimbursable expenses to servicers. And, to the extent that loss mitigation is in the form of a loan modification, redefault and self-cure risk always lurk in the background. Moreover, loss mitigation must generally be conducted in addition to default management; the servicer must proceed with foreclosure even if attempting to find an alternative, so the cost of loss mitigation is additive. Yet, while taking a loan through foreclosure is likely to involve lower costs than pursuing loss mitigation, it may not ultimately maximize value for RMBS investors because loss severities in foreclosure can easily surpass those on a re-performing restructured loan.

The balance between these different parts of a servicer's business changes over the course of the housing cycle. When the housing market is strong, the transaction processing dominates the servicing business, but when the housing market is weak, default management and loss mitigation become more important.

The very short weighted average life (WAL) of RMBS trusts combined with very low defaults in most economic environments encouraged servicers to place disproportionate weight on performing loan servicing, which historically has been characterized by small servicing fees and enormous economies of scale. Thus, on a typical loan balance of $200,000 today, a servicer might earn between $500 and $1,000 per year.[27] Given the low-level of annual income per loan, the short WAL of each loan, and low default rates in most economic environments before 2006, servicers had few incentives to devote resources to loss mitigation, but large incentives to invest in performing loan automation to capture the large economies of scale. This left servicers wholly unprepared for the elevated level of defaults that began in 2007.

C. RMBS Servicer Compensation

RMBS servicers' duties and compensation are set forth in a document called a "Pooling and Servicing" agreement (PSA) also governs the rights of the RMBS certificate holders. RMBS servicers are compensated in four ways. First, they receive a "servicing fee," which is a flat fee of 25—50 basis points (bps) and is a first priority payment in the RMBS trust.[28] This is by far the greatest portion of servicer income. This fee is paid out proportionately across all loans regardless of servicer costs through the economic cycle.

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[25] *See In re Taylor,* 407 B.R. 618 (Bankr. E.D. Pa. 2009), *rev'd* 2010 WL 624909 (E.D. Pa. 2010).

[26] Arguably servicers have a fourth line of business—the management of real estate owned (REO). REO are foreclosed properties that were not purchased by third-parties at the foreclosure sale. REO management involves caring for and marketing the REO. It does not require negotiations with the homeowner (who is evicted) or junior lienholders (whose liens are generally extinguished by the foreclosure).

[27] Servicing fees are generally 25—50 bps, which translates into $500--$1000 per year in servicing fees.

[28] Generally the servicing fee is 25 bps for conventional fixed rate mortgages, 37.5 bps for conventional ARM loans, 44 bps for government loans and 50 bps for subprime.

Second, servicers earn "float" income. Servicers generally collect mortgage payments at the beginning of the month, but are not required to remit the payments to the trust until the 25th of the month. In the interim, servicers invest the funds they have collected from the mortgagors, and they retain all investment income. Servicers can also obtain float income from escrow balances collected monthly from borrowers to pay taxes and insurance during the course of the year.

Third, servicers are generally permitted to retain all ancillary fees they can collect from mortgagors. This includes things like late fees and fees for balance checks or telephone payments. It also includes fees for expenses involved in handling defaulted mortgages, such as inspecting the property. Finally, servicers can hold securities themselves directly as investors, and often hold the junior-most, residual tranche in the securitization.

Servicers face several costs. In addition to the operational expenses of sending out billing statements, processing payments, maintaining account balances and histories, and restructuring or liquidating defaulted loans, private label RMBS servicers face the expense of "servicing advances."[29] When a loan defaults, the servicer is responsible for advancing the missed payments of principal and interest to the trust as well as paying taxes and insurance on the property. They continue to pay clear through liquidation of the property, unless these advances are not deemed recoverable.

The servicer is able to recover advances it has made either from liquidation proceeds or from collections on other loans in the pool, but the RMBS servicer does not receive interest on its advances. Therefore, advances can be quite costly to servicers in terms of the time value of money and can also place major strains on servicers' liquidity, as the obligation to make advances continues until the loan is liquidated or the servicer believes that it is unlikely to be able to recover the advances. In some cases, servicers have to advance years' worth of mortgage payments to the trust.

While RMBS servicers do not receive interest on servicing advances, they are compensated for their "out-of-pocket" expenses. This includes any expenses spent on preserving the collateral property, including force-placed insurance, legal fees, and other foreclosure-related expenses. Large servicers frequently "in-source" default management expenses to their affiliates.

D. Monitoring of RMBS Servicers

RMBS servicing arrangements present a classic principal-agent problem wherein the agent's incentives are not aligned with the principal and the principal has limited ability to monitor or discipline the agent.

1. Investors

Investors are poorly situated to monitor servicer behavior because they do not have direct dealings with the servicer. RMBS investors lack information about servicer loss mitigation

[29] In Agency securities, servicers generally stop advancing after borrowers owe their fifth payment, at 120 days past due. For GSE loans, they are then removed from the securities and taken on balance sheet. Servicer advances for the four payments are typically not reimbursed until termination.

activity. Investors do not have access to detailed servicer expense reports or the ability to examine loss mitigation decisions. Investors are able to see only the ultimate outcome. This means that investors are limited in their ability to evaluate servicers' performance on an ongoing basis. And even if investors were able to detect unfaithful agents, they have little ability to discipline them short of litigation.

2. Trustees

RMBS feature a trustee, but the name is deceptive. The trustee is not a common law trustee with general fiduciary duties. Instead, it is a limited purpose corporate trustee whose duties depend on whether there has been a default as defined UN the PSA. A failure to pay all tranches their regularly scheduled principal and interest payments is *not* an event of default. Instead, default relates to the financial condition of the servicer, whether the servicer has made required advances to the trust, whether the servicer has submitted its monthly report, and whether the servicer has failed to meet any of its covenants under the PSA.

Generally, before there is an event of default, the trustee has a few specifically assigned ministerial duties and no others.[30] These duties are typically transmitting funds from the trust to the RMBS investors and providing investors performance statements based on figures provided by the servicer. The trustee's pre-default duties do *not* include active monitoring of the servicer.

Trustees are generally entitled to rely on servicers' data reporting, and have little obligation to analyze it.[31] Indeed, as Moody's has noted, trustees lack the ability to verify most data reported by servicers; at best they can ensure that the reported data complies with any applicable covenant ratios:

> The trustee is not in a position to verify certain of the numbers reported by the servicer. For example, the amount of delinquent receivables and the amount of receivables charged off in a given month are figures that are taken from the servicer's own computer systems. While these numbers could be verified by an auditor, they are not verifiable by the trustee.[32]

Likewise, as attorney Susan Macaulay has observed, "In most cases, even if the servicer reports are incorrect, or even fraudulent, absent manifest error, the trustee simply has no way of knowing that there is a problem, and must allocate the funds into the appropriate accounts, and make the mandated distributions, in accordance with the servicer reports."[33]

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[30] *See, e.g.*, Wells Fargo Mortgage Backed Securities 2006-AR10 Trust § 8.01 ("Prior to the occurrence of an Event of Default of which a Responsible Officer of the Trustee shall have actual knowledge and after the curing of all such Events of Default which may have occurred, the duties and obligations of the Trustee shall be determined solely by the express provisions of this Agreement, the Trustee shall not be liable except for the performance of such duties and obligations as are specifically set forth in this Agreement, no implied covenants or obligations shall be read into this Agreement against the Trustee and, in the absence of bad faith on the part of the Trustee, the Trustee may conclusively rely, as to the truth of the statements and the correctness of the opinions expressed therein, upon any certificates or opinions furnished to the Trustee, and conforming to the requirements of this Agreement."). *See also* Moody's Investor Service, Structured Finance Ratings Methodology: Moody's Re-examines Trustees' Role in ABS and RMBS, Feb. 4, 2003, at 4. (noting "Some trustees have argued that their responsibilities are limited to strictly administrative functions as detailed in the transaction documents and that they have no "fiduciary" duty prior to an event of default.").

[31] MBIA Ins. Corp. v. Royal Indem. Co., 519 F. Supp. 2d 455 (2007), *aff'd* 321 Fed. Appx. 146 (3d Cir. 2009) ("Royal argues that Wells Fargo [the trustee] had the contractual obligation to analyze data using certain financial accounting principles and to detect any anomalies that analysis might have uncovered. As Royal suggests, this analysis may not have been very labor-intensive. Yet, the contract did not call for any analysis at all. It simply required Wells Fargo to perform rote comparisons between that data and data contained in various other sources, and to report any numerical inconsistencies. Wells Fargo did just that.").

[32] Moody's Investor Service, *supra* note 30, at 4.

[33] Susan J. Macaulay, *US: The Role of the Securitisation Trustee,* GLOBAL SECURITISATION AND STRUCTURED FINANCE 2004. Macaulay further notes that:

Similarly, trustees usually wait for servicers to notify them of defaults,[34] and Moody's has noted that trustees are often unresponsive to information from third parties indicating that an unreported default might have occurred.[35] Thus, trustees enforce servicer representations and warranties largely on the honor system of servicer self-reporting.

For private-label securities, trustees also lack the incentive to engage in more vigorous monitoring of servicer loss mitigation decisions. The trustee does not get paid more for more vigorous monitoring. The trustee generally has little ability to discipline the servicer except for litigation. Private-label RMBS trustees have almost no ability to fire or discipline a servicer. Servicers can only be dismissed for specified acts, and these acts are typically limited to the servicer's insolvency or failure to remit funds to the trust. Occasionally servicers may be dismissed if default levels exceed particular thresholds.

Trustees also have no interest in seeing a servicer dismissed because they often are required to step in as back-up servicer.[36] In the event of a servicer default, the trustee takes over as servicer (which includes the option of subcontracting the duties), and assumes the duty of making servicing advances to the trust. The back-up servicer role is essentially an insurance policy for investors, and activation of that role is equivalent to payment on a claim; a trustee that has to act as a back-up servicer is likely to lose money in the process, especially when some of the trustees do not themselves own servicing operations.

Trustees also often have close relationships with particular servicers. For example, Professor Tara Twomey and I have shown that Bank of America/Countrywide accounts for nearly two-thirds of Deutsche Bank's RMBS trustee business.[37] In such circumstances, trustees are unlikely to engage in meaningful monitoring and disciplining of servicers.[38] Amherst Securities points out that early payment default provisions are not effectively enforced by trustees, to the point where in cases where borrowers did not make a single payment on the mortgage, only 37 percent were purchased out of the trust, much smaller amounts for loans making only one to six payments.[39] Thus, for private-label RMBS, there is virtually no supervision of servicers.[40]

GSE and Ginnie Mae securitization have greater oversight of servicers. The GSEs serve as master servicers on most of their RMBS; they therefore have a greater ability to monitor servicer compliance. The GSEs require servicers to foreclose according to detailed timelines, and

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It is almost always an event of default under the indenture if the trustee does not receive a servicer report within a specified period of time, and the trustee must typically report such a failure to the investors, any credit enhancement provider, the rating agencies and others. However, the trustee generally has no duties beyond that with respect to the contents of the report, although under the TIA, the trustee must review any reports furnished to it to determine whether there is any violation of the terms of the indenture. Presumably this would include verifying that any ratios represented in any reports conform to financial covenants contained in the indenture, etc. It would not however, require the trustee to go beyond the face of the report, i.e. to conduct further investigation to determine whether the data underlying the information on the reports presented to it were, in fact, true. Virtually all indentures, whether or not governed by the TIA, explicitly permit the trustee to rely on statements made to the trustee in officers' certificates, opinions of counsel and documents delivered to the trustee in the manner specified within the indenture.

Id.

[34] Moody's Investor Service, *supra* note 30, at 4.

[35] *Id.*

[36] Eric Gross, *Portfolio Management: The Evolution of Backup Servicing*, Portfolio Financial Servicing Company (PFSC) (July 11, 2002) *at* http://www.securitization.net/knowledge/article.asp?id=147&aid=2047.

[37] Adam J. Levitin & Tara Twomey, *Mortgage* Servicing, 28 YALE J. ON REG. (forthcoming 2011).

[38] *See* Ellington Credit Fund, Ltd. v. Select Portfolio, Inc., No. 1:07-cv-00421-LY, W.D. Tex., Plaintiffs' First Amended Complaint, July 10, 2007 (RMBS residual tranche holder alleging that trustee was aware that servicer was in violation of PSA and failed to act).

[39] *See* Amherst Mortgage Insight, "The Elephant in the Room—Conflicts of Interest in Residential Mortgage Securitizations", 15, May 20, 2010.

[40] For MBS with separate master and primary servicers, the master servicer may monitor the primary servicer(s), but often the master and primary servicers are the same entity.

servicers that fail to comply face monetary penalties. Recognizing the benefits inherent in effective loss mitigation, Fannie Mae places staff directly in all of the largest servicer shops to work alongside loss mitigation staff at their servicers.[41] Freddie Mac constructed servicer performance profiles to directly monitor servicers, sharing results directly with servicers and rating agencies. Since each GSE insures against credit losses on the loans, their ongoing monitoring provides consistent rules and a single point of contact to approve workout packages and grant exceptions, something absent in private label RMBS.

3. Ratings and Reputation

Like any repeat transaction business, servicers are concerned about their reputations. But reputational sanctions have only very weak discipline on servicer behavior.

While Regulation AB requires servicers to disclose information about their experience and practices,[42] they are not required to disclose information about performance of past pools they have serviced. In any event, reputational sanctions are ineffective because loss severities are more likely to be attributed to underwriting quality than to servicing decisions.

Rating agencies also produce servicer ratings, but these ratings are a compilation of the evaluation of servicers on a multitude of characteristics. Rating agencies have been known to incorporate features of Freddie Mac's servicer performance profiles in their servicer assessments and to incorporate loss mitigation performance into their ratings. But details of their methodology used to measure these assessments are not disclosed. They give no indication of whether a servicer is likely to make loss mitigation decisions based solely on the interests of the securitization trust. Ratings are also combined with other criteria, such as the servicer's own financial strength and operational capacity. In other words, servicer ratings go to the question of whether a servicer will have to be replaced because it is insolvent or lacks the ability to service the loans, with much less weight given to whether the servicer acts in the investors' interests.

C. The Mortgage Contract and Foreclosure Process

The mortgage contract consists of two documents, a promissory note (the "note" or the "mortgage loan") and a security instrument (the "mortgage" or the "deed of trust").[43] The note is the IOU that contains the borrower's promise to repay the money loaned. If the note is a negotiable instrument, meaning that it complies with the requirements for negotiability in Article 3 of the Uniform Commercial Code,[44] then the *original physical note* is itself the right to payment.[45]

The mortgage is the document that connects the IOU with the house. The mortgage gives the lender a contingent right to the house; it provides that *if* the borrower does not pay according to the terms of the note, then the lender can foreclose and have the property sold *according to the*

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[41] PMI insurers have recently started to embed staff in servicer shops to monitor loss mitigation efforts. Harry Terris & Kate Berry, *In the Trenches*, AM. BANKER, Aug. 27, 2009.

[42] 17 C.F.R. § 229.1108.

[43] The note and the mortgage can be combined in a single document, but that is not common practice, both because the mortgage can be granted subsequent to the creation of the debt and because of borrower privacy concerns about the terms of the note, which would become public if the note and mortgage were combined and recorded in local property records.

[44] *See* UCC 3-104.

[45] UCC 3-203, Cmt. 1 ("An instrument is a reified right to payment. The right is represented by the instrument itself.").

terms of the mortgage and applicable state and federal law. The applicable law governing foreclosures is state law.[46]

State real estate law, including foreclosure law, is non-uniform, making it difficult to state what the law is as a generic matter; there is always the possibility that some jurisdictions may deviate from the majority rule. That said, no state requires a borrower's note to be recorded in local land records for the note to be valid, and, as a general matter, state law does not require the mortgage to be recorded either in order for the mortgage to be enforceable against the borrower. Recording of the mortgage is necessary, however, to establish the mortgage's priority relative to the claims of other parties, including other mortgagees, judgment lien creditors and tax and workmen's' liens against the property. The basic rule of priority is first in time, first in right; the first mortgage to be recorded has senior priority. An unrecorded mortgage will thus, generally have junior priority to a subsequently issued, but recorded mortgage. The difference between enforceability and priority is an important one, discussed in more detail below, in the section of this testimony dealing with MERS.

State law on foreclosures is also non-uniform. Roughly, however, states can be divided into two groups: those where foreclosure actions are conducted through the courts ("judicial foreclosure") and those where foreclosure actions are conducted by private sales ("nonjudicial foreclosure"). This division maps, imperfectly, with whether the preferred security instrument is a mortgage or a deed of trust.[47]

Mortgage loans cost more in states that have judicial foreclosure; what this means is that borrowers in judicial foreclosure states are paying more for additional procedural rights and legal protections; those procedural rights are part of the mortgage contract; failure to honor them is a breach of the mortgage contract. Note, that a default on the mortgage note is not a breach of the contract per se; instead it merely triggers the lender's right to foreclose per the applicable procedure.

In a typical judicial foreclosure proceeding, the homeowner receives a notice of default and if that default is not cured within the required period, the mortgagee then files a foreclosure action in court. The action is commenced by the filing of a written complaint that sets forth the mortgagee's allegations that the homeowner owes a debt that is secured by a mortgage and that the homeowner has defaulted on the debt. Rules of civil procedure generally require that legal actions based upon a writing include a copy of the writing as an attachment to the complaint, although there is sometimes an exception for writings that are available in the public records. While the mortgage is generally filed in the public records, assignments of the mortgage are often not (an issue complicated by MERS, discussed below), and the note is almost never a matter of public record.

It is important to understand that most judicial foreclosures do not function like the sort of judicial proceeding that is dramatized on television, in which all parties to the case appear in court, represented by attorneys and judgment only follows a lengthy trial. Instead, the norm in foreclosure cases is a default judgment. Most borrowers do not appear in court or contest their

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[46] There is a federal foreclosure statute that can be utilized by the federal government. *See* 12 U.S.C. §§ 3701-3713 (multi-family property foreclosures); §§3751-3768 (single-family property foreclosures).

[47] Mortgages sometimes also include a power of sale, permitting nonjudicial foreclosure. In a deed of trust, the deed to the property is transferred in trust for the noteholder to a deed of trust trustee, often a local attorney. The note remains the property of the lender (the deed of trust beneficiary). When there is a default on the note, the lender notifies the deed of trust trustee and the lender or its agent is typically appointed as substitute deed of trust trustee to run the foreclosure sale.

foreclosures, and not all of those who do are represented by competent counsel, not least because of the difficulties in paying for counsel. Most borrowers that the borrower does not contest the foreclosure or appear in court. In most cases, only the lender's attorney appears, and judges routinely dispatch dozens or hundreds of foreclosure cases in a sitting. Homeowners in foreclosure actions are among the most vulnerable of defendants, the least able to insist up on and vindicate their rights, and accordingly the ones most susceptible to abuse of legal process.

II. PROCEDURAL PROBLEMS AND FRAUD

The first type of problems in the mortgage market are what might generously be termed "procedural defects" or "procedural irregularities." There are numerous such problems that have come to light in foreclosure cases. The extent and distribution of these irregularities is not yet known. No one has compiled a complete typology of procedural defects in foreclosures; there are, to use Donald Rumsfeld's phrase, certainly "known unknowns" and well as "unknown unknowns."

A. AFFIDAVITS FILED WITHOUT PERSONAL KNOWLEDGE (ROBOSIGNING)

Affidavits need to be based on personal knowledge to have any evidentiary effect; absent personal knowledge an affidavit is hearsay and therefore generally inadmissible as evidence. Accordingly, affidavits attest to personal knowledge of the facts alleged therein.

The most common type of affidavit is an attestation about the existence and status of the loan, namely that the homeowner owes a debt, how much is currently owed, and that the homeowner has defaulted on the loan. (Other types of affidavits are discussed in sections II.B. and II.C., *infra*). Such an affidavit is typically sworn out by an employee of a servicer (or sometimes by a law firm working for a servicer). Personal knowledge for such an affidavit would involve, at the very least, examining the payment history for a loan in the servicer's computer system and checking it against the facts alleged in a complaint.

The problem with affidavits filed in many foreclosure cases is that the affiant lacks any personal knowledge of the facts alleged whatsoever. Many servicers, including Bank of America, Citibank, JPMorgan Chase, Wells Fargo, and GMAC, employ professional affiants, some of whom appear to have no other duties than to sign affidavits. These employees cannot possibly have personal knowledge of the facts in their affidavits. One GMAC employee, Jeffrey Stephan, stated in a deposition that he signed perhaps 10,000 affidavits in a month, or approximately 1 a minute for a 40-hour work week.[48] For a servicer's employee to ascertain payment histories in a high volume of individual cases is simply impossible.

When a servicer files an affidavit that claims to be based on personal knowledge, but is not in fact based on personal knowledge, the servicer is committing a fraud on the court, and quite possibly perjury. The existence of foreclosures based on fraudulent pleadings raises the

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[48] *See* Deposition of Jeffrey Stephan, GMAC Mortgage LLC v. Ann M. Neu a/k/a Ann Michelle Perez, No. 50 2008 CA 040805XXXX MB, (15th Judicial Circuit, Florida, Dec. 10, 2009) at 7, *available at* http://api.ning.com/files/s4SMwlZXvPu4A7kq7XQUsGW9xEcYtqNMPCm0a2hISJu88PoY6ZNqanX7XK41Fyf9gV8JIHDme7KcFO2cvHqSEMcplJ8vwnDT/091210gmacmortgagevsannmneu1.pdf (stating that Jeffrey Stephan, a GMAC employee, signed approximately 10,000 affidavits a month for foreclosure cases).

question of the validity of foreclosure judgments and therefore title on properties, particularly if they are still in real estate owned (REO).

B. Lost Note Affidavits for Notes that Are Not Lost

The plaintiff in a foreclosure action is generally required to produce the note as evidence that it has standing to foreclose. Moreover, under the Uniform Commercial Code, if the note is a negotiable instrument, only a holder of the note (or a subrogee)—that is a party in possession of the note— may enforce the note, as the note is the reified right to payment.[49]

There is an exception, however, for lost, destroyed, or stolen notes, which permits a party that has lost possession of a note to enforce it.[50] If a plaintiff seeks to enforce a lost note, it is necessary "to prove the terms of the instrument" as well as the "right to enforce the instrument."[51] This proof is typically offered in the form of a lost note affidavit that attests to the prior existence of the note, the terms of the note, and that the note has been lost.

It appears that a surprisingly large number of lost note affidavits are filed in foreclosure cases. In Broward County, Florida alone, over 2000 such affidavits were filed in 2008-2009.[52] Relative to the national population, that translates to roughly 116,000 lost note affidavits nationally over the same period.[53]

There are two problems with the filing of many lost note affidavits. First, is a lack of personal knowledge. Mortgage servicers are rarely in possession of the original note. Instead, the original note is maintained in the fireproof vault of the securitization trustee's document custodian. This means that the servicer lacks personal knowledge about whether a note has or has not been lost.[54] Merely reporting a communication from the document custodian would be hearsay and likely inadmissible as evidence.

The second problem is that the original note is frequently not in fact lost. Instead, it is in the document custodian's vault. Servicers do not want to pay the document custodian a fee (of perhaps $30) to release the original mortgage, and servicers are also wary of entrusting the original note to the law firms they hire. Substitution of counsel is not infrequent on defaulted mortgages, and servicers are worried that the original note will get lost in the paperwork shuffle if there is a change in counsel. When pressed, however, servicers will often produce the original note, months after filing lost note affidavits. The Uniform Commercial Code (UCC) requires that a party seeking to enforce a note be a holder (or subrogee to a holder) or produce evidence that a note has been lost, destroyed, or stolen; the UCC never contemplates an "inconvenience affidavit" that states that it is too much trouble for a servicer to bother obtaining the original note. But that is precisely what many lost note affidavits are effectively claiming.

Thus, many lost note affidavits are doubly defective: they are sworn out by a party that does not and cannot have personal knowledge of the alleged facts and the facts being alleged are

[49] UCC 3-301; 1-201(b)(21) (defining "holder").

[50] UCC 3-309. Note that UCC 3-309 was amended in the 2001 revision of Article 3. The revision made it easier to enforce a lost note. Not every state has adopted the 2001 revisions. Therefore, UCC 3-309 is non-uniform law.

[51] UCC 3-309(b).

[52] Gretchen Morgenson & Andrew Martin, *Battle Lines Forming in Clash Over Foreclosures*, N.Y. TIMES, Oct. 20, 2010, at A1.

[53] According to the US Census Bureau, Broward County's population is approximately 1.76 million, making it .57% of the total US population of 307 million. Broward does have a significantly higher than average foreclosure rate, roughly 12% over the past two years, according to Core Logic Loan Performance data, making it approximately 3 times the national average.

[54] The 2001 version of UCC 3-309 permits not only a party that has lost a note but a buyer from such a party to enforce a lost note.

often false as the note is not in fact lost, but the servicer simply does not want to bother obtaining it.

C. JUNK FEES

The costs of foreclosure actions are initially incurred by servicers, but servicers recover these fees off the top from foreclosure sale proceeds before MBS investors are paid. This reimbursement structure limits servicers' incentive to rein in costs and actually incentives them to pad the costs of foreclosure. This is done in two ways. First, servicers charge so-called "junk fees" either for unnecessary work or for work that was simply never done. Thus, Professor Kurt Eggert has noted a variety of abusive servicing practices, including "improper foreclosures or attempted foreclosures; imposition of improper fees, especially late fees; forced-placed insurance that is not required or called for; and misuse of escrow funds."[55] Servicers' ability to retain foreclosure-related fees has even led them to attempt to foreclose on properties when the homeowners are current on the mortgage or without attempting any sort of repayment plan.[56] Consistently, Professor Katherine Porter has documented that when mortgage creditors file claims in bankruptcy, they generally list amounts owed that are much higher than those scheduled by debtors.[57]

There is also growing evidence of servicers requesting payment for services not performed or for which there was no contractual right to payment. For example, in one particularly egregious case from 2008, Wells Fargo filed a claim in the borrower's bankruptcy case that included the costs of two brokers' price opinions allegedly obtained in September 2005, on a property in Jefferson Parish, Louisiana when the entire Parish was under an evacuation order due to Hurricane Katrina.[58]

Similarly, there is a frequent problem of so-called "sewer summons" issued (or actually not issued) to homeowners in foreclosures. Among the costs of foreclosure actions is serving notice of the foreclosure (a court summons) on the homeowner. There is disturbing evidence that homeowners are being charged for summons that were never issued. These non-delivered summons are known as "sewer summons" after their actual delivery destination.

One way in which these non-existent summons are documented is through the filing of "affidavits of lost summons" by process servers working for the foreclosure attorneys hired by mortgage servicers. A recent article reports that in Duval County, Florida (Jacksonville) the number of affidavits of lost summons has ballooned from 1,031 from 2000-2006 to over 4,000 in the last two years, a suspiciously large increase that corresponds with a sharp uptick in foreclosures.[59]

Because of concerns about illegal fees, the United States Trustee's Office has undertaken several investigations of servicers' false claims in bankruptcy[60] and brought suit against

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[55] Kurt Eggert, *Comment on Michael A. Stegman et al.'s "Preventive Servicing Is Good for Business and Affordable Homeownership Policy": What Prevents Loan Modifications?*, 18 HOUSING POL'Y DEBATE 279 (2007).

[56] Eggert, *Limiting Abuse*, *supra* note 21, at 757.

[57] Katherine M. Porter, *Mortgage Misbehavior*, 87 TEX. L. REV. 121, 162 (2008).

[58] *In re* Stewart, 391 B.R. 327, 355 (Bankr. E.D. La. 2008).

[59] Matt Taibi, *Courts Helping Banks Screw Over Homeowners,* ROLLING STONE, Nov. 25, 2010, *at* http://www.rollingstone.com/politics/news/17390/232611?RS_show_page=7.

[60] Ashby Jones, *U.S. Trustee Program Playing Tough With Countrywide, Others*, LAW BLOG (Dec. 3, 2007, 10:01 AM), *at* http://blogs.wsj.com/law/2007/12/03/us-trustee-program-playing-tough-with-countrywide-others.

Countrywide,[61] while the Texas Attorney General has sued American Home Mortgage Servicing for illegal debt collection practices.[62]

The other way in which servicers pad the costs of foreclosure is by in-sourcing their expenses to affiliates at above-market rates. For example, Countrywide, the largest RMBS servicer, force places insurance on defaulted properties with its captive insurance affiliate Balboa.[63] Countrywide has been accused of deliberately extending the time to foreclosure in order to increase the insurance premiums paid to its affiliate, all of which are reimbursable by the trust, before the RMBS investors' claims are paid.[64] Similarly, Countrywide in-sources trustee services in deed of trust foreclosures to its subsidiary Recon Trust.[65]

Thus, in Countrywide's' 2007 third quarter earnings call, Countrywide's President David Sambol emphasized that increased revenue from in-sourced default management functions could offset losses from mortgage defaults.

> Now, we are frequently asked what the impact on our servicing costs and earnings will be from increased delinquencies and loss mitigation efforts, and what happens to costs. And what we point out is, as I will now, is that *increased operating expenses in times like this tend to be fully offset by increases in ancillary income in our servicing operation, greater fee income from items like late charges, and importantly from in-sourced vendor functions* that represent part of our diversification strategy, a counter-cyclical diversification strategy such as our businesses involved in foreclosure trustee and default title services and property inspection services.[66]

In June, 2010, Countrywide settled with the FTC for $108 million on charges that it overcharged delinquent homeowners for default management services. According to the FTC,

> Countrywide ordered property inspections, lawn mowing, and other services meant to protect the lender's interest in the property… But rather than simply hire third-party vendors to perform the services, Countrywide created subsidiaries to hire the vendors. The subsidiaries marked up the price of the services charged by the vendors – often by 100% or more – and Countrywide then charged the homeowners the marked-up fees.[67]

Among the accusations brought against Countrywide in a recent investor notice of default filed by the Federal Reserve Bank of New York along with BlackRock and PIMCO, is that Countrywide has been padding expenses via in-sourcing on the 115 trusts covered by the letter.[68]

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[61] Complaint, Walton v. Countrywide Home Loans, Inc. (*In re* Atchely), No. 05-79232 (Bankr. N.D. Ga. filed Feb. 28, 2008).

[62] Complaint, State v. Am. Home Mtg. Servicing, Inc., No. 2010-3307 (Tex. Dist. Ct. 448th Jud. Dist. filed Aug. 30, 2010).

[63] Amherst Mortgage Insight, 2010, "The Elephant in the Room—Conflicts of Interest in Residential Mortgage Securitizations," 23, May 20, 2010.

[64] *Id*.

[65] Center for Responsible Lending, *Unfair and Unsafe: How Countrywide's irresponsible practices have harmed borrowers and shareholders*, CRL Issue Paper, Feb. 7, 2008, at 6-7.

[66] Transcript, "Countrywide Financial Corporation Q3 2007 Earnings Call," Oct. 26, 2007 (emphasis added) (also mentioning "Our vertical diversification businesses, some of which I mentioned, are counter-cyclical to credit cycles, like the lender-placed property business in Balboa and like the in-source vendor businesses in our loan administration unit.").

[67] FTC, Press Release, June 7, 2010, *Countrywide Will Pay $108 Million for Overcharging Struggling Homeowners; Loan Servicer Inflated Fees, Mishandled Loans of Borrowers in Bankruptcy*.

[68] Kathy D. Patrick, Letter to Countrywide Home Loan Servicing LP and the Bank of New York, dated Oct. 18, 2010, *available at* http://www.scribd.com/Bondholders-Letter-to-BofA-Over-Countrywide-Loans-inc-NY-Fed/d/39686107.

Countrywide is hardly the only servicer accused of acting in its interests at the expense of investors. Carrington, another major servicer, also owns the residual tranche on many of the deals it services. Amherst Mortgage Securities has shown that Carrington has been much slower than other servicers to liquidate defaulted loans.[69] Delay benefits Carrington both as a servicer and as the residual tranche investor. As a servicer, delay helps Carrington by increasing the number of monthly late fees that it can levy on the loans. These late fees are paid from liquidation proceeds before any of the MBS investors.

As an investor in the residual tranche, Carrington has also been accused of engaging in excessive modifications to both capture late fees and to keep up the excess spread in the deals, as it is paid directly to the residual holders.[70] When loans were mass modified, Carrington benefited as the servicer by capitalizing late fees and advances into the principal balance of the modified loans, which increased the balance on which the servicing fee was calculated. Carrington also benefited as the residual holder by keeping up excess spread in the deals and delaying delinquency deal triggers that restrict payments to residual holders when delinquencies exceed specified levels. Assuming that the residual tranche would be out of the money upon a timely foreclosure, delay means that Carrington, as the residual holder, receives many more months of additional payments on the MBS it holds than it otherwise would.[71]

It is important to emphasize that junk fees on homeowners ultimately come out of the pocket of MBS investors. If the homeowner lacks sufficient equity in the property to cover the amount owed on the loan, including junk fees, then there is a deficiency from the foreclosure sale. As many mortgages are legally or functionally non-recourse, this means that the deficiency cannot be collected from the homeowner's other assets. Mortgage servicers recover their expenses off the top in foreclosure sales, before MBS investors are paid. Therefore, when a servicer lards on illegal fees in a foreclosure, it is stealing from investors such as pension plans and the US government.

D. Complaints that Fail to Include the Note

Rule of civil procedure generally require that a compliant based on a writing include, as an attachment, a copy of a writing. In a foreclosure action, this means that both the note and the mortgage and any assignments of either must be attached. Beyond the rules of civil procedure requirement, these documents are also necessary as an evidentiary matter to establish that the plaintiff has standing to bring the foreclosure. Some states have exceptions for public records, which may be incorporated by reference, but it is not always clear whether this exception applies in foreclosure actions. If it does, then only the note, which is not a public record, would need to be attached.

[69] Amherst Mortgage Insight, 2010, "The Elephant in the Room—Conflicts of Interest in Residential Mortgage Securitizations", pp. 22-24, May 20, 2010.

[70] See Amherst Mortgage Insight, "Why Investors Should Oppose Servicer Safe Harbors", April 28, 2009. Excess spread is the difference between the income of the SPV in a given period and its payment obligations on the MBS in that period, essentially the SPV's periodic profit. Excess spread is accumulated to supplement future shortfalls in the SPV's cashflow, but is either periodically released to the residual tranche holder. Generally, as a further protection for senior MBS holders, excess spread cannot be released if certain triggers occur, like a decline in the amount of excess spread trapped in a period beneath a particular threshold.

[71] Carrington would still have to make servicing advances on any delinquent loans if it stretched out the time before foreclosure, but these advances would be reimbursable, and the reimbursement would come from senior MBS holders, rather than from Carrington, if it were out of the money in the residual.

Many foreclosure complaints are facially defective and should be dismissed because they fail to attach the note. I have recently examined a small sample of foreclosure cases filed in Allegheny County, Pennsylvania (Pittsburgh and environs) in May 2010. In over 60% of those foreclosure filings, the complaint failed to include a copy of the note. Failure to attach the note appears to be routine practice for some of the foreclosure mill law firms, including two that handle all of Bank of America's foreclosures.

I would urge the Committee to ask Bank of America whether this was an issue it examined in its internal review of its foreclosure practices.

E. Counterfeit and Altered Documents and Notary Fraud

Perhaps the most disturbing problem that has appeared in foreclosure cases is evidence of counterfeit or altered documents and false notarizations. To give some examples, there are cases in which multiple copies of the "true original note" are filed in the same case, with variations in the "true original note;"[72] signatures on note allonges that have clearly been affixed to documents via Photoshop;[73] "blue ink" notarizations that appear in blank ink; counterfeit notary seals;[74] backdated notarizations of documents issued before the notary had his or her commission;[75] and assignments that include the words "bogus assignee for intervening asmts, whose address is XXXXXXXXXXXXXXXXX."[76]

Most worrisome is evidence that these frauds might not be one-off problems, but an integral part of the foreclosure business. A price sheet from a company called DocEx that was affiliated with LPS, one of the largest servicer support firms, lists prices for various services including the "creation" of notes and mortgages. While I cannot confirm the authenticity of this price sheet or date it, it suggests that document counterfeiting is hardly exceptional in foreclosure cases.

While the fraud in these cases is not always by servicers themselves, but sometimes by servicer support firms or attorneys, its existence should raise serious concerns about the integrity of the foreclosure process. I would urge the Committee to ask the servicer witnesses what steps they have taken to ascertain that they do not have such problems with loans in their servicing portfolios.

G. The Extent of the Problem

The critical question for gauging the risk presented by procedural defects is the extent of the defects. While Federal Reserve Chairman Bernanke has announced that federal bank regulators are looking into the issue and will issue a report this month, I do not believe that it is

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Brief of Antonio Ibanez, Defendant-Appellee, US Bank Nat'l Assn, as Trustee for the Structured Asset Securities Corporation Mortgage Pass-Through Certificates, Series 2006-Z v. Ibanez; Wells Fargo Bank, N.A. as Trustee for ABFC 2005-Opt 1 Trust, ABFC Asset Backed Certificates Series 2005-OPT 1, No 10694, (Mass. Sept. 20, 2010), at 10 (detailing 3 different "certified true copies" of a note allonge and of an assignment of a mortgage); http://4closurefraud.org/2010/04/27/foreclosure-fraud-of-the-week-two-original-wet-ink-notes-submitted-in-the-same-case-by-the-florida-default-law-group-and-jpmorgan-chase/ (detailing a foreclosure file with two different "original" wet ink notes for the same loan).

[73] http://4closurefraud.org/2010/04/08/foreclosure-fraud-of-the-week-poor-photoshop-skills/.

[74] *See* WSTB.com, *at* http://www.wsbtv.com/video/25764145/index.html.

[75] Deposition of Cheryl Samons, Deutsche Bank Nat'l Trust Co., as Trustee for Morgan Stanley ABS Capital 1 Inc. Trust 2006-HE4 v. Pierre, No. 50-2008-CA-028558-XXXX-MB (15th Judicial Circuit, Florida, May 20, 2009, *available at* http://mattweidnerlaw.com/blog/wp-content/uploads/2010/03/depositionsammons.pdf.

[76] http://www.nassauclerk.com/clerk/publicrecords/oncoreweb/showdetails.aspx?id=809395&rn=0&pi=0&ref=search.

within the ability of federal bank regulators to gauge the extent of procedural defects in foreclosure cases. To do so would require, at the very least, an extensive sampling of actual foreclosure filings and their examination by appropriately trained personnel. I am unaware of federal bank regulators undertaking an examination of actual foreclosure filings, much less having a sufficient cadre of appropriately trained personnel. Bank examiners lack the experience or training to evaluate legal documents like foreclosure filings. Therefore, any statement put forth by federal regulators on the scope of procedural defects is at best a guess and at worse a parroting of the "nothing to see here folks" line that has come from mortgage servicers.

I would urge the Committee to inquire with federal regulators as to exactly what steps they are taking to examine foreclosure irregularities and how they can be sure that those steps will uncover the extent of the problem. Similarly, I would urge the Committee to ask the servicer witnesses what specific irregularities they examined during their self-imposed moratoria and by what process. It defies credulity that a thorough investigation of all the potential problems in foreclosure paperwork could be completed in a month or two, much less by servicers that have taken so long to do a small number of loan modifications.

III. Chain of Title Problems

A second problem and potentially more serious problem relating to standing to foreclose is the issue of chain of title in mortgage securitizations.[77] As explained above, securitization involves a series of transfers of both the note and the mortgage from originator to sponsor to depositor to trust. This particular chain of transfers is necessary to ensure that the loans are "bankruptcy remote" once they have been placed in the trust, meaning that if any of the upstream transferors were to file for bankruptcy, the bankruptcy estate could not lay claim to the loans in the trust by arguing that the transaction was not a true sale, but actually a secured loan.[78] Bankruptcy remoteness is an essential component of private-label mortgage securitization deals, as investors want to assume the credit risk solely of the mortgages, not of the mortgages' originators or securitization sponsors. Absent bankruptcy remoteness, the economics of mortgage securitization do not work in most cases.

Recently, arguments have been raised in foreclosure litigation about whether the notes and mortgages were in fact properly transferred to the securitization trusts. This is a critical issue because the trust has standing to foreclose if, and only if it is the mortgagee. If the notes and mortgages were not transferred to the trust, then the trust lacks standing to foreclose. There are several different theories about the defects in the transfer process; I do not attempt to do justice to any of them in this testimony.

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[77] Chain of title problems appear to be primarily a problem for private-label securitization, not for agency securitization because even if title were not properly transferred for Agency securities, it would have little consequence. Investors would not have incurred a loss as the result of an ineffective transfer, as their MBS are guaranteed by the GSEs or Ginnie Mae, and when a loan in an Agency pool defaults, it is removed from the pool and the owned by the GSE or Ginnie Mae, which is then has standing to foreclose.

[78] Bankruptcy remote has a second meaning, namely that the trust cannot or will not file of bankruptcy. This testimony uses bankruptcy remote solely in the sense of whether the trust's assets could be clawed back into a bankruptcy estate via an equity of redemption. The Uniform Commercial Code permits a debtor to redeem collateral at face value of the debt owed. If a pool of loans bore a now-above-market interest rate, the pool's value could be above the face value of the debt owed, making redemption economically attractive.

It can be very difficult to distinguish true sales from secured loans. For example, a sale and repurchase agreement (a repo) is economically identical to a secured loan from the repo buyer to the repo seller, secured by the assets being sold.

While the chain of title issue has arisen first in foreclosure defense cases, it also has profound implications for MBS investors. If the notes and mortgages were not properly transferred to the trusts, then the mortgage-backed securities that the investors' purchased were in fact *non-mortgage-backed securities*. In such a case, investors would have a claim for the rescission of the MBS,[79] meaning that the securitization would be unwound, with investors receiving back their original payments at par (possibly with interest at the judgment rate). Rescission would mean that the securitization sponsor would have the notes and mortgages on its books, meaning that the losses on the loans would be the securitization sponsor's, not the MBS investors, and that the securitization sponsor would have to have risk-weighted capital for the mortgages. If this problem exists on a wide-scale, there is not the capital in the financial system to pay for the rescission claims; the rescission claims would be in the trillions of dollars, making the major banking institutions in the United States would be insolvent.

The key questions for evaluating chain of title are what method of transferring notes and mortgages is actually supposed to be used in securitization and whether that method is legally sufficient both as a generic matter and as applied in securitization deals. There is a surprising lack of consensus on both counts. Scholars and attorneys cannot agree either on what methods would work generically, much less determine which were used in securitization transactions. This means there is a great deal of legal uncertainty over these issues. Even among banks' attorneys, different arguments appear in different litigation. For example, one possible method of transfer—a sale under Article 9 of the Uniform Commercial Code—has never, to my knowledge, been made by banks' attorneys in foreclosure litigation when chain of title has been questioned, even though it is one of the two methods that a recent American Securitization Forum (ASF) white paper argues is proper.[80] Even among the banks' lawyers, then, there is lack of consensus on what law governs transfers.

The following section outlines the potential methods of transfer and some of the issues that arise regarding specific methods. It is critical to emphasize that the law is not settled on most of the issues regarding securitization transfers; instead, these issues are just starting to be litigated.

A. Transfers of Notes Generally

As a generic matter, a note can be transferred in one of four methods:

(1) The note can be sold via a contract of sale, which would be governed by the common law of contracts.

(2) If the note is a negotiable instrument,[81] it could be negotiated, meaning that it would be transferred via endorsement and delivery, with the process governed by Article 3 of the Uniform Commercial Code (UCC).[82] The endorsement can either be a specific

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[79] This claim would not be a putback claim necessarily, but could be brought as a general contract claim. It could not be brought as a securities law claim under section 11 of the Securities Act of 1933 because the statute of limitations for rescission has expired on all PLS.

[80] American Securitization Forum, *Transfer and Assignment of Residential Mortgage Loans in the Secondary Mortgage Market*, ASF White Paper Series, Nov. 16, 2010, *at* http://www.americansecuritization.com/uploadedFiles/ASF_White_Paper_11_16_10.pdf. The ASF white paper notes that it has been reviewed and approved by 13 major (but unnamed) law firms. The ASF white paper does not report whether any of these firms have outstanding opinion letter liability on securitization transactions.

[81] It is not clear whether mortgage notes are necessarily negotiable instruments.

[82] The note endorsement process works just like endorsements on checks and is governed by the same law.

endorsement to a named endorsee or an endorsement in blank that converts the note into bearer paper.

(3) The note could be converted into an electronic note and transferred according to the provisions of the federal E-SIGN Act.[83]

(4) The note could be sold pursuant to UCC Article 9, if it was sold after 2001.[84] In 49 states (South Carolina being the exception), Article 9 provides a method for selling a promissory note, which requires that there be an authenticated (signed) agreement, value given, and that the seller have rights in the property being transferred.[85] This process is very similar to a common law sale.

B. TRANSFERS OF MORTGAGES GENERALLY

There is general agreement that as a generic method, any of these methods of transfer would work to effectuate a transfer of the note. No method is mandatory. Whether or not the chosen process was observed in practice, is another matter, however.[86] Concerns about non-compliance is discussed below.

There are also several conceivable ways to transfer mortgages, but there are serious doubts about the validity of some of the methods:

(1) The mortgage could be assigned through the traditional common law process, which would require a document of assignment. There is general consensus that this process works.

(2) The mortgage could be negotiated. This method of transfer is of questionable effectiveness. A mortgage is not a negotiable instrument, and concepts of negotiability do not fit well with mortgages. For example, if a mortgage were negotiated in blank, it should become a "bearer mortgage," but this concept is utterly foreign to the law, not least as the thief of a bearer mortgage would have the ability to enforce the mortgage (absent equitable considerations). Similarly, with a bearer mortgage, a homeowner could never figure out who would be required to grant a release of the mortgage upon payoff. And, in many states (so-called title theory states), a mortgage is considered actual ownership of real property, and real property must have a definite owner (not least for taxation purposes).

(3) The mortgage could "follow the note" per common law. While there is a good deal of case law using this mellifluous phrase, common law is not wholly settled on the principle,

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[83] 15 U.S.C. § 7021. E-SIGN imposes a number of requirements on electronic note transfers and also requires consent of the issuer (maker) of the note.

[84] The revisions of UCC Articles 1 and 9 went into effect nationally in 2001.

[85] UCC 9-203. The language of Article 9 is abstruse, but UCC Revised Article 1 defines "security interest" to include the interest of a buyer of a promissory note. UCC 1-201(b)(35). Article 9's definition of "debtor" includes a seller of a promissory note, UCC 9-102(a)(28)(B), and "secured party" includes a buyer of a promissory note, UCC 9-102(a)(72)(D). Therefore UCC 9-203, which would initially appear to address the attachment (enforceability) of a security interest also covers the sale of a promissory note. South Carolina has not adopted the revised Article 1 definition of security interest necessary to make Article 9 apply to sales of promissory notes.

[86] Note that common law sales and Article 9 sales do not affect the enforceability of the note against the obligor on the note. UCC 9-308, Cmt.6, Ex. 3 ("Under this Article, attachment and perfection of a security interest in a secured right to payment do not of themselves affect the obligation to pay. For example, if the obligation is evidenced by a negotiable note, then Article 3 dictates the person to whom the maker must pay to discharge the note and any lien security it."). UCC Article 3 negotiation and E-SIGN do affect enforceability as they enable a buyer for value in good faith to be a holder in due course and thereby cut off some of the obligor's defenses that could be raised against the seller. UCC 3-305, 3-306; 15 U.S.C. § 7021(d).

and its meaning is not entirely clear (e.g., does it mean that a transfer of the note effectuates a transfer of the mortgage or that the mortgage and the note cannot be separated and both must be transferred—by their own processes— in order for either transfer to work). There are also several instances where the mortgage clearly does not follow the note. For example, the basic concept of a deed of trust is that the security instrument and the note are separated; the deed of trust trustee holds the security, while the beneficiary holds the note. Likewise, the mortgage follows the note concept would imply that the theft of a note also constitutes theft of a mortgage, thereby giving to a thief more than the thief was able to actually steal. Another situation would be where a mortgage is given to a guarantor of a debt. The mortgage would not follow the debt, but would (at best) follow the guarantee. And finally, the use of MERS, a recording utility, as original mortgage (a/k/a MOM) splits the note and the mortgage. MERS has no claim to the note, but MERS is the mortgagee. If taken seriously, MOM means that the mortgage does not follow the note. While MERS might claim that MOM just means that the beneficial interest in the mortgage follows the note, a transfer of the legal title would violate a bankruptcy stay and would constitute a voidable preference if done before bankruptcy.

(4) the mortgage could "follow the note" if it is an Article 9 transfer.[87] There is consensus that this process would work *if* Article 9 governs the transfer of the note.

C. Transfers in Residential Mortgage Securitization Transactions

All the methods described above for transferring notes and mortgages are simply generic methods. There may be additional requirements for a valid transfer, either as a function of trust law or as agreed upon by the parties themselves by contract. Notably, the American Securitization Forum's white paper considers neither of these possibilities.[88]

1. Trust Law

Trust law creates additional requirements for transfers. RMBS typically involve a transfer of the assets to a New York common law trust. Transfers to New York common law trusts are governed by the common law of gifts. In New York, such a transfer requires actual delivery of the transferred assets in a manner such that no one else could possibly claim ownership.[89] This is done to avoid fraudulent transfer concerns. For a transfer to a New York common law trust, the mere recital of a transfer, is insufficient to effectuate a transfer;[90] there must be delivery in as perfect a manner as possible.[91] Similarly, an endorsement in blank might not be sufficient to effectuate a transfer *to a trust* because endorsement in blank turns a note into bearer paper to which others could easily lay claim.

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[87] UCC 9-203(g). If the transfer is not an Article 9 transfer, then the Article 9 provision providing that the mortgage follows the note would not apply.

[88] *See supra*, note 80.

[89] *See* Vincent v. Putnam, 248 N.Y. 76, 83 (N.Y. 1928) ("The delivery must be such as to vest the donee with the control and dominion over the property and to absolutely divest the donor of his dominion and control, and the delivery must be made with the intent to vest the title of the property in the donee….Equity will not help out an incomplete delivery.").

[90] *Id.* at 84 ("Mere words never constitute a delivery.").

[91] *In re* Van Alstyne, 207 N.Y. 298, 309 (N.Y. 1913).

2. Private Contract

The UCC is simply a set of default rules.[92] Parties are free to contract around it, and need not do so explicitly.[93] Parties can thus impose by contract additional requirements for transfers to those in Articles 3 and 9 or, alternatively, ease the requirements. PSAs appear to be precisely this type of variation by agreement from the UCC. If so, then they would govern the transfers as a simple matter of contract law. Deviation from the PSA requirements would be allowed, but only by the extent permitted by contract law, and even if there were a deviation that constituted a material breach of the contract, it would not void the transfer on a self-executing basis.

3. Private Contract + Trust Law

Trust law and private contract law combine to make a much more rigid set of transfer requirements that contract law would by itself. New York law provides that a trustee's authority is limited to that provided in the trust documents.[94] New York law also provides that any transfer in contravention of the trust documents is void.[95] Therefore, if the PSA—the trust document—says that the transfer must be done in a certain way and the transfer did not comply, the transfer is void, irrespective of whether it would comply with the Uniform Commercial Code or other law. The trust document creates a higher level of conduct to which the transfer must comply.

PSAs require a specific form of transfer. First, the PSA contains a recital of the transfer.[96] But per New York trust law, that recital alone is insufficient to effectuate a transfer to a common law trust.[97] Second, PSAs contain a provision that calls for delivery to the trustee for every mortgage loan in the deal of

> the original Mortgage Note bearing all intervening endorsements showing a complete chain of endorsement from the originator to the last endorsee, endorsed *"Pay to the order of _____________, without recourse"* and signed (which may be by facsimile signature) in the name of the last endorsee by an authorized officer.[98]

The reason for requiring this complete chain of endorsement from originator up through the Depositor before a final endorsement to the trust is to provide a clear evidentiary basis for all of the transfers in the chain of title in order to remove any doubts about the bankruptcy remoteness of the assets transferred to the trust. Absent a complete chain of endorsements, it

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[92] A few provisions of the UCC are mandatory, but these do not affect the chain of title issue.

[93] UCC 1-203; 1-201(b)(3) (defining "agreement").

[94] 14-140 Warren's Weed New York Real Property § 140.58 ("It is a fundamental principle of trust law that the instrument under which the trustee acts is the charter of his rights. Therefore, in administering the trust, he must act in accordance with its terms. This rule applies to every kind of trustee, regardless of whether the trustee is to hold, invest or pay over income, or to sell or liquidate for the benefit of creditors.").

[95] N.Y. E.P.T. L. § 7.2-4.

[96] Pooling and Servicing Agreement, Securities Asset Backed Receivables LLC Trust 2005-FR3, § 2.01(b), July 1, 2005, *available at* http://www.secinfo.com/dRSm6.z1Fa.d.htm ("The Depositor, concurrently with the execution and delivery hereof, hereby sells, transfers, assigns, sets over and otherwise conveys to the Trustee for the benefit of the Certificateholders, without recourse, all the right, title and interest of the Depositor in and to the [mortgage notes].")

[97] Vincent v. Putnam, 248 N.Y. 76, 84 (N.Y. 1928) ("Mere words never constitute a delivery.").

[98] Pooling and Servicing Agreement, Securities Asset Backed Receivables LLC Trust 2005-FR3, § 2.01(b), July 1, 2005, *available at* http://www.secinfo.com/dRSm6.z1Fa.d.htm. Deal language may vary, and some PSAs merely require endorsement in blank, not the chain of endorsements on the note. *See, e.g.*, Pooling and Servicing Agreement, Asset Backed Finance Corp. 2006-OPT- 1 Trust, July 1, 2006, *available at* http://www.secinfo.com/dRSm6.v2K1.c.htm#8mq6 (requiring delivery to the trustee of "the original Mortgage Note, endorsed in blank or with respect to any lost Mortgage Note, an original Lost Note Affidavit, together with a copy of the related Mortgage Note" but not of intervening endorsements.).

could be argued that the trust assets were transferred directly from the originator to the trust, raising the concern that if the originator filed for bankruptcy, the trust assets could be pulled back into the originator's bankruptcy estate.

D. COMPLIANCE

Regardless of the legal method that applies for transferring notes and mortgages, there is a question of whether there was compliance with that method in actual securitization deals. The American Securitization Forum white paper says nothing on this count, nor can it; evaluating compliance would involve examining actual loan files. This is something that federal bank regulators should be doing, and I would urge the Committee to underscore that point in conversations with the regulators.

There are, of course, a multitude of potential non-compliance problems, including the premature shredding of notes[99] or the signing of assignments by purported agents of now-defunct companies. The scope of these problems is unclear; they may plague individual deals or just individual loans within those deals. On the other hand, if the PSAs set forth the transfer requirements, there may well be widespread non-compliance with the endorsement requirements of the PSAs. Most notes contain only a single endorsement in blank, not "all intervening endorsements showing a complete chain of endorsement from the originator to the last endorsee" before a final endorsement in blank. This would appear to mean that such transfers are void under New York law and that the mortgages were never actually transferred to the trusts issuing the MBS and this could not be corrected because of various timeliness requirements in PSAs.

It bears emphasis that the validity of transfers to the trusts is an unsettled legal issue. It is not as clear as either the American Securitization Forum or any law firm with outstanding securitization opinion letter liability would have one believe. There are questions both about what law actually governs the transfers and about whether there was compliance with the law. If there is a widespread chain of title problem, however, it would create a systemic crisis, as title on most properties in the US would be clouded and the contract rescission/putback liability because of the failed transfers would greatly surpass the market capitalization of the country's major banks.

IV. YES, BUT WHO CARES? THESE ARE ALL DEADBEATS

A. DOES BANKS' CONVENIENCE TRUMP RULE OF LAW?

A common response from banks about the problems in the securitization and foreclosure process is that it doesn't matter as the borrower still owes on the loan and has defaulted. This "No Harm, No Foul" argument is that homeowners being foreclosed on are all a bunch of deadbeats, so who really cares about due process? As JPMorganChase's CEO Jamie Dimon put it "for the most part by the time you get to the end of the process we're not evicting people who

[99] *See* Florida Bankers' Ass'n Comment to the Florida Supreme Court on the Emergency Rule and Form Proposals of the Supreme Court Task Force on Residential Mortgage Foreclosure Cases, at 4, *at* http://www.scribd.com/doc/38213950/Notes-Are-Destroyed ("The reason 'many firms file lost note counts as a standard alternative pleading in the complaint' is because the physical document was deliberately eliminated to avoid confusion immediately upon its conversion to an electronic file.").

deserve to stay in their house."[100]

Mr. Dimon's logic condones vigilante foreclosures: so long as the debtor is delinquent, it does not matter who evicts him or how. (And it doesn't matter if there are some innocents who lose their homes in wrongful foreclosures as long as "for the most part" the borrowers are in default.) But that is not how the legal system works. A homeowner who defaults on a mortgage doesn't have a right to stay in the home if the proper mortgagee forecloses, but any old stranger cannot take the law into his own hands and kick a family out of its home. That right is reserved solely for the proven mortgagee.

Irrespective of whether a debt is owed, there are rules about who can collect that debt and how. The rules of real estate transfers and foreclosures have some of the oldest pedigrees of any laws. They are the product of centuries of common law wisdom, balancing equities between borrowers and lenders, ensuring procedural fairness and protecting against fraud.

The most basic rule of real estate law is that only the mortgagee may foreclosure. Evidence and process in foreclosures are not mere technicalities nor are they just symbols of rule of law. They are a paid-for part of the bargain between banks and homeowners. Mortgages in states with judicial foreclosures cost more than mortgages in states without judicial oversight of the foreclosure process.[101] This means that homeowners in judicial foreclosure states are buying procedural protection along with their homes, and the banks are being compensated for it with higher interest rates. Banks and homeowners bargained for legal process, and rule of law, which is the bedrock upon which markets are built function, demands that the deal be honored.

Ultimately the "No Harm, No Foul," argument is a claim that rule of law should yield to banks' convenience. To argue that problems in the foreclosure process are irrelevant because the homeowner owes *someone* a debt is to declare that the banks are above the law.

B. Are They All Deadbeats?

Not every homeowner in foreclosure is a deadbeat. There are some homeowners who are in foreclosure while current on their mortgages, others who are in foreclosure after having been told by their servicers that they have received loan modifications, and others who are in foreclosure because of warehouse lending fraud problems whereby their original lender sold their same mortgage multiple times. There are also homeowners who are in foreclosure because of predatory servicing practices such as charges for forced-placed insurance at way-above-market rates and misapplication of payments (such as illegally applying payments first to late fees and then the principal and interest owed so as to make the payment only qualify as a partial payment, thus incurring another late fee). These homeowners are hardly deadbeats; they are in foreclosure not because of their own behavior, but because of their servicer's behavior.

Ultimately, we don't know how many homeowners in foreclosure are truly in default on their mortgages. To actually determine that would require a detailed examination of homeowners' payment history, an examination that would take several hours in most cases, and homeowners currently lack the right to receive servicing statements showing how their payments

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[100] Tamara Keith & Renee Montaigne, *Sorting Out the Banks' Foreclosure Mess*, NPR, Oct. 15, 2010.

[101] *See* Karen Pence, *Foreclosing on Opportunity: State Laws and Mortgage Credit*, 88 REV. ECON. & STAT. 177 (2006) (noting that the availability—and hence the cost—of mortgages in states with judicial foreclosure proceedings is greater than in states with non-judicial foreclosures).

are applied. A servicer's assertion that the homeowner is delinquent is not conclusive evidence, especially if the assertion is in a robosigned affidavit. Most homeowners in foreclosure are likely in default, but given that most homeowners lack legal representation, we should be cautious in assuming too much. Sometimes a default judgment is an admission that the plaintiff is correct, and sometimes it is just a sign of lack of resources to litigate.

V. CONCLUSION

The foreclosure process is beset with problems ranging from procedural defects that can be readily cured to outright fraud to the potential failure of the entire private label mortgage securitization system.

In the best case scenario, the problems in the mortgage market are procedural defects and they will be remedied within reasonably quickly (perhaps taking around a year). Remedying them will extend the time that properties are in foreclosure and increase the shadow housing inventory, thereby driving down home prices. The costs of remedying these procedural defects will also likely be passed along to future mortgage borrowers, thereby frustrating attempts to revive the housing market and the economy through easy monetary policy.

In the worst case scenario, there is systemic risk, as there could be a complete failure of loan transfers in private-label securitization deals in recent years, resulting in trillions of dollars of rescission claims against major financial institutions. This would trigger a wholesale financial crisis.

Perhaps the most important lesson from 2008 is the need to be ahead of the ball of systemic risk. This means (1) ensuring that federal regulators do a serious investigation as discussed in this testimony above and (2) considering the possible legislative response to a crisis. The sensible course of action here is to avoid gambling on unsettled legal issues that could have systemic consequences. Instead, we should recognize that stabilizing the housing market is the key toward economic recovery, and that it is impossible to fix the housing market unless the number of foreclosures is drastically reduced, thereby reducing the excess inventory that drives down housing prices and begets more foreclosures. Unless we fix the housing market, consumer spending will remain depressed, and as long as consumer spending remains depressed, high unemployment will remain and the US economy will continue in a doldrums that it can ill-afford given the impending demographics of retirement.

This suggests that the best course of action is a global settlement on mortgage issues, the key elements of which must be (1) a triage between homeowners who can and cannot pay with principal reduction and meaningful modifications for homeowners with an ability to pay and speedier foreclosures for those who cannot, (2) a quieting of title on securitized properties, and (3) a restructuring of bank balance sheets in accordance with loss recognition.

A critical point in any global settlement, however, must be removing mortgage servicers from the loan modification process. Servicers were historically never in the loan modification business on any scale, and four years of hoping that something would change have demonstrated that servicers never will manage to successfully modify many loans on their own. They lack the capacity, they lack the incentives, and the lack the will.

If we want to see more loan modifications—and I would submit that this is important not just as a type disaster relief for deserving homeowners, but as an indispensable measure for stabilizing the housing market and the economy—then we need to take servicers out of the loan modification process and have modifications done either by a government agency or by the courts or by outcome-neutral third parties.

A global settlement would also be an allocation of the losses from the implosion of the housing bubble. Those losses are not avoidable. The Treasury Department's unspoken hope that the economy will grow its way out of those losses and that they can be recognized against future retained earnings was optimistic to begin with and given the performance of the economy of the past two years, it is Pollyannaism to continue in such a belief. Instead, if the economy is to move forward without losing a decade or more in a long-shot bet on sudden resurrection, we must face the losses from the financial crisis and allocate them sensibly. There are only a limited number of places where we can put those losses: homeowners, banks, MBS investors (including many pension funds), or the government. There are political choices to be made in any allocation, but failure to make an explicit allocation is also a choice—that the losses will be borne by homeowners and MBS investors. We should be cognizant of these choices.

I recognize that for many, the preferred course of action is not to deal with a problem until it materializes and certainly to avoid any loss allocation that might threaten US financial institutions. But if we pursue that route, we may well be confronted with an unmanageable crisis. We cannot rebuild the US housing finance system until we deal with the legacy problems from our old system, and these are problems that are best addressed sooner, before an acute crisis, then when it is too late.

COMMITTEE ON

FINANCIAL SERVICES

Hearing - Housing and Community Opportunity

Robo-Signing, Chain of Title, Loss Mitigation and Other Issues in Mortgage Servicing

Written Testimony of

Anthony B. Sanders

Professor of Finance

Distinguished Professor of

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Statement of Anthony B. Sanders
Subcommittee on Housing and Community Opportunity
U.S. House of Representatives
November 18, 2010

Chairman Waters, Ranking Member Capito, Members of the Committee, thank you for the opportunity to testify before you today.

The U.S. mortgage market grew at a phenomenal pace from 1998 through 2009 with the GSEs (Fannie Mae, Freddie Mac) and Federal Home Loan Banks alone accounting for $5 trillion in debt to fund mortgage growth (see Figure 1). As we sit here today, there are over 42 million mortgages outstanding in the U.S. Of the over 42 million mortgages, approximately 60% were securitized (or assigned to another party).[1]

Loan assignments have occurred in the United States since before the Great Depression. Yet only recently have Congress and the Administration taken notice of loan assignments. What is particularly interesting is that despite the myriad of Federal housing agencies, pseudo-agencies and financial system regulators that have been in existence since the Great Depression, the Federal government has ignored the fundamental problem with loan assignment regarding the location of the title or other document defects pertaining to foreclosure.

Economic Harm to Borrowers

What is the economic harm to borrowers of alleged document defects pertaining to foreclosure? The answer is none. First, the loans are in default. Second, the average length of time to foreclosure and liquidation is over 17 months. If each borrower is living in the dwelling and not paying interest (say $1,000 per month), that translates to $17,000 in lost earnings to the lenders/investors.[2] Suppose that 3,000,000 borrowers are in the foreclosure process; that translates into a potential loss of $51 billion to lender/investors over and above the loss incurred by lenders/investors.[3] Thus, the $51-102 billion cost to lenders/investors is the cost of delaying foreclosure.[4] "Insofar as the foreclosure process often takes 17 months, lenders/investors are not receiving any payment for interest or principal and are incurring transaction costs. In the meantime, the borrowers are not making any payments on a house in which they are still living – effectively receiving over a year of housing rent-free."[5]

In the case of loan default, the lender has the right to take the asset and sell it in order to recoup the amount owed, if possible. Document defects pertaining to foreclosure, if material, can slow down the foreclosure process. Therefore, lenders/investors have the economic incentive to clear up any material document defects pertaining to foreclosure as soon as reasonably possible.

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[1] As of 2009, 85.6% of mortgages were securitized (see Table 1).
[2] If we assume a $150,000 loan at 7% over 30 years, the payment would be approximately $1,000. If we double the loan amount to $300,000, the payment would rise to just under $2,000 per month.
[3] If the average loan size is $300,000, the loss to lenders/services rises to $102 billion.
[4] Additional costs facing lenders/investors beyond the point of loan default is the decline in the value of the collateral.
[5] Of course, not all borrowers that defaulted on their loans are still living in the same dwelling.

Robo-Signing and Economic Harm

Once again, the critical point is that borrowers have defaulted on their loans and the lenders/servicers are trying to foreclose on the dwelling to recoup the amount owed. The acid test for robo-signing, the allegation that some documents were not read, is whether the borrower was materially and adversely affected. Only if it can be shown that borrowers were inappropriately identified as having defaulted on their loan and subsequently foreclosed upon is there a material problem. Otherwise, the borrowers have not been harmed.

Creating Economic Harm through Moratoriums

Any proposed moratorium on foreclosures, whether at the Federal or State levels, represents a danger to the stability of the housing market. Government intervention in the housing market (such as HAMP and the tax credit) has failed to slow or merely delayed defaults. The housing market needs to heal and it can only do so if defaulted loans can be brought to market through foreclosure. Preventing foreclosures extends losses to lenders/investors and allows non-paying households to continue staying in the dwelling. In addition, there are sales of foreclosed properties that will be delayed if a moratorium is undertaken.

The Creation of MERS

MRES (Mortgage Electronic Registration Systems was created to deal with the flood of paperwork related to mortgage securitization. MERS focused on eliminating mortgage loan assignments by providing an electronic registry to track the many transfers that occur in the mortgage market. Even if MERS was a perfect solution to the registration of mortgages, since financial institutions and the GSEs are owners of MERS, it would seem reasonable to have assumed that each of the regulatory bodies for the thrifts, banks and GSEs would have thoroughly investigated the practices and procedures of MERS. If they had investigated MERS, they could have discovered potential problems with the MERS.

Where Were the Regulators?

If material document defects were pervasive in the economy, why weren't our regulatory agencies on top of the problem and seeking solutions? It is notable that the leading thrifts that securitized loans were Countrywide, Indymac and WAMU, all supervised by the Office of Thrift Supervision (OTS) which was the regulatory body for the thrift industry. As defaults and foreclosures mounted, the OTS should have been painfully aware that a problem with foreclosure could arise if the title and accurate supporting loan documentation could not be produced. It should be determined if the OTS was aware of the problem and considered it to be trivial, if they were aware of the problem and chose to do nothing or they were unaware of the potential problem.

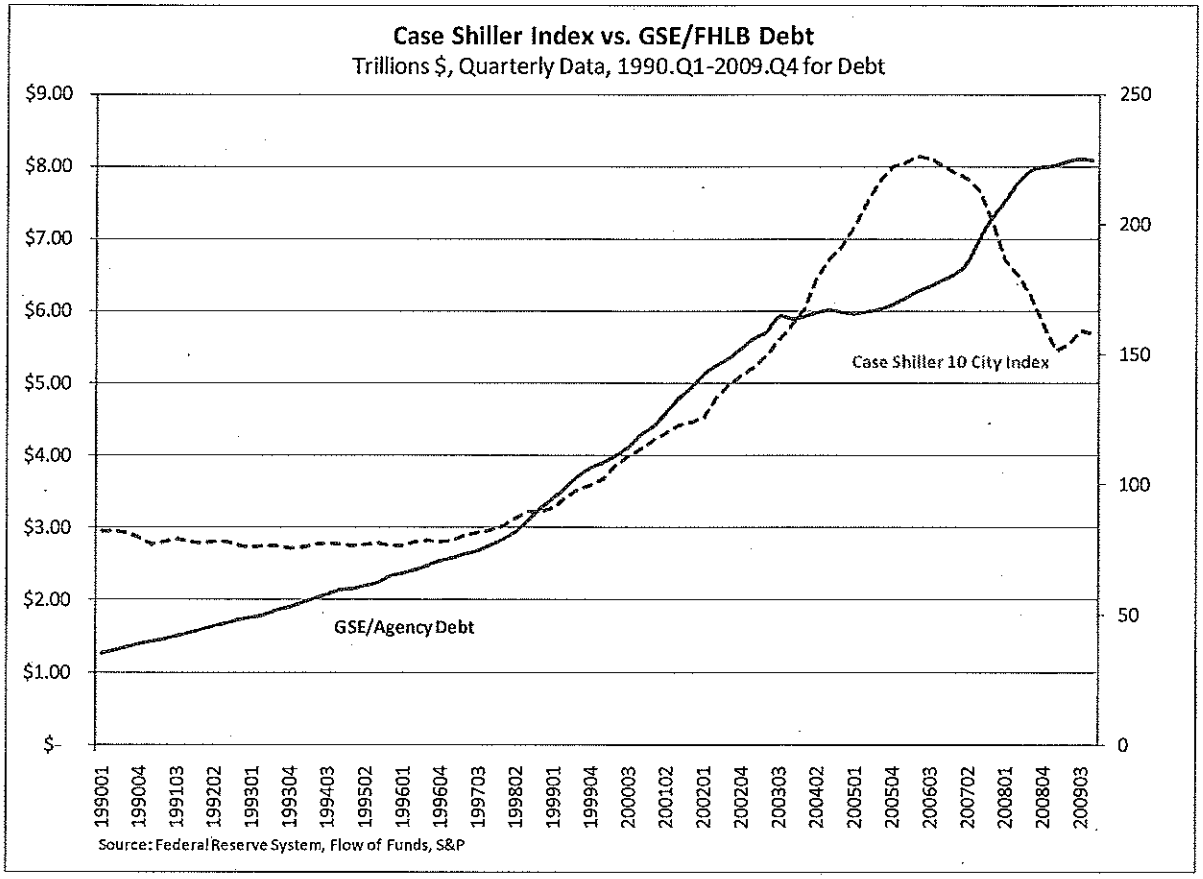
Of course, the same questions should be asked to the Federal Deposit Insurance Corporation (FDIC) that regulates the state-chartered banks, the Office of the Comptroller of the Currency that regulates the nationally-chartered banks and the Federal Reserve that regulates state-chartered member banks. And then there are state bank and thrift regulators. With so much regulatory power were the FDIC, OCC and Fed not investigating the potential foreclosure document issue and taking corrective action if it was material?

Proposed Solutions

1. All relevant loan documents should be immediately scanned and a digital file created. This file (which we call a "Securitization Packet") would travel with the loan when it is sold. This

digitized file should be kept at either the Federal Reserve or a private market enterprise (with regulatory oversight).

2. The regulatory bodies (whether it is the Federal Reserve, the FDIC or OCC) should develop requirements for the assignment of loans requiring notification of what entity has purchased the loan and the new servicer, if applicable. That is, the regulatory bodies can either set standards or work with the industry on setting standards.



Case Shiller Index vs. GSE/FHLB Debt
Trillions $, Quarterly Data, 1990.Q1-2009.Q4 for Debt
$9.00
$8.00
$7.00
$6.00
$5.00
$4.00
$3.00
$2.00
$1.00
$-
250
200
150
100
50
0
Case Shiller 10 City Index
GSE/Agency Debt
199001
199004
199103
199202
199301
199304
199403
199502
199601
199604
199703
199802
199901
199904
200003
200102
200201
200204
200303
200402
200501
200504
200603
200702
200801
200804
200903
Source: Federal Reserve System, Flow of Funds, S&P

Securitization Rates for Home Mortgages
(Dollars in Billions)

	Total	Conforming	Prime jumbo	Sub/Alt A	FHA/VA	Seconds
2001 Securitization rate	60.7%	72.3%	32.0%	45.8%	98.7%	13.5%
MBS issuance	$1,344.7	$914.9	$142.2	$98.4	$172.7	$15.6
Estimated originations	$2,215.0	$1,265.0	$445.0	$215.0	$175.0	$115.0
2002 Securitization rate	63.0%	74.5%	30.0%	66.0%	97.8%	15.0%
MBS issuance	$1,817.4	$1,270.4	$171.5	$176.1	$172.2	$24.8
Estimated originations	$2,885.0	$1,706.0	$571.0	$267.0	$176.0	$165.0
2003 Securitization rate	67.5%	77.7%	36.5%	68.1%	99.3%	9.3%
MBS issuance	$2,662.4	$1,912.4	$237.5	$269.1	$218.5	$20.4
Estimated originations	$3,945.0	$2,460.0	$650.0	$395.0	$220.0	$220.0
2004 Securitization rate	62.6%	73.7%	45.3%	72.9%	95.8%	13.8%
MBS issuance	$1,826.8	$892.3	$233.4	$521.1	$126.4	$49.1
Estimated originations	$2,920.0	$1,210.0	$515.0	$715.0	$132.0	$355.0
2005 Securitization rate	67.7%	80.5%	49.2%	79.3%	99.5%	16.6%
MBS issuance	$2,111.8	$879.1	$280.7	$797.4	$85.6	$60.7
Estimated originations	$3,120.0	$1,092.0	$570.0	$1,005.0	$86.0	$365.0
2006 Securitization rate	67.6%	82.5%	45.6%	81.4%	100.2%	17.3%
MBS issuance	$2,016.0	$816.9	$219.0	$814.3	$83.2	$74.2
Estimated originations	$2,980.0	$990.0	$480.0	$1,000.0	$83.0	$430.0
2007 Securitization rate	74.2%	91.4%	51.3%	92.8%	97.7%	9.3%
MBS issuance	$1,804.2	$1,062.0	$178.1	$432.5	$98.6	$32.9
Estimated originations	$2,430.0	$1,162.0	$347.0	$466.0	$101.0	$355.0
2008 Securitization rate	78.5%	97.8%	6.8%	2.9%	92.8%	0.0%
MBS issuance	$1,177.3	$899.8	$6.6	$1.9	$269.0	$0.0
Estimated originations	$1,500.0	$920.0	$97.0	$64.0	$290.0	$114.0
2009 Securitization rate	85.6%	93.4%	0.0%	0.0%	98.9%	0.0%
MBS issuance	$1,553.0	$1,106.8	$0.0	$0.0	$446.2	$0.0
Estimated originations	$1,815.0	$1,185.0	$92.0	$10.0	$451.0	$77.0

Notes: Total MBS excludes re-securitizations, scratch-and-dent MBS and deals backed by seasoned loans. Conforming includes conventional conforming mortgages and Fannie/Freddie MBS excluding pools with average loan age over 3 months. Seconds include home-equity lines of credit and closed-end seconds; some second mortgages are also securitized in subprime and other MBS products.

Source: Inside MBS & ABS

COMMITTEE ON

FINANCIAL SERVICES

Hearing - Housing and Community Opportunity

Robo-Signing, Chain of Title, Loss Mitigation and Other Issues in Mortgage Servicing

Testimony of Julia Gordon

Senior Policy Counsel

Center for Responsible Lending

Testimony of Julia Gordon
Center for Responsible Lending

Before the U.S. House of Representatives
Subcommittee on Housing and Community Opportunity
of the Committee on Financial Services

"Robo-Signing, Chain of Title, Loss Mitigation and Other Issues in Mortgage Servicing"

November 18, 2010

Good morning Chairman Waters, Ranking Member Moore, and members of the subcommittee. Thank you for the invitation to discuss the mortgage servicing industry's response to the foreclosure crisis that has devastated families, destroyed neighborhoods, and triggered a global financial crisis. We believe servicers have failed to prevent a very large proportion of unnecessary foreclosures, and that significant additional steps are required to ensure that foreclosures only occur when the alternatives do not produce a more economically favorable outcome.

I serve as Senior Policy Counsel at the Center for Responsible Lending (CRL), a nonprofit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of Self-Help, a nonprofit community development financial institution. For thirty years, Self-Help has focused on creating asset building opportunities for low-income and minority families, primarily through financing safe, affordable home loans. In total, Self-Help has provided over $5.6 billion of financing to 64,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across America.

I. Introduction and Summary

Almost four years ago, our organization released a report warning that the reckless and abusive lending practices of the previous two decades would lead to approximately 2 million subprime foreclosures. At the time, our report was denounced by the mortgage industry as absurdly pessimistic. Sadly, the system was even more larded with risk than we had understood, and the damage has been far worse, spreading from the subprime to the prime sectors, catalyzing a housing-lead recession, and triggering historic levels of unemployment.

Since we issued the report, there have already been more than 2.5 million homes lost, and Wall Street analysts recently predicted there could be as many as 11 million more foreclosures filed.[1] The foreclosure crisis has had catastrophic consequences for families and communities, especially communities of color. First, millions of homeowners ended up in dire straits due to abusive mortgage originations, incompetent and predatory mortgage practices, ineffective government oversight, and a complex securitization system that lacks accountability all the way up and down the chain. Now, millions more are in danger due to the toxic combination of underwater loans and unemployment that festers in so many areas.

In this situation, the mortgage servicing system should serve as a resource for both homeowners and investors harmed by unscrupulous originators and securitizers. Instead, the servicing system is compounding the problem. It has become crystal clear to even the casual observer that the servicing system cannot or will not serve either the best interests of homeowners or investors for a variety of reasons, including that the system's capacity is too strained to function correctly and that crosscutting financial incentives mean that when servicers and their subcontractors act in their own best interest, it is not necessarily also in the best interest of either investors or homeowners.

Ultimately, the fate of these homeowners impacts all of us. Foreclosures bring down home values across the board and devastate communities and municipal budgets. Even worse, since the housing sector historically has led the way out of economic downturns, weakness in the housing sector is slowing economic recovery and hampering efforts to create jobs and reduce unemployment.

Things did not need to be this bad. If the Bush Administration had moved quickly back in 2007, or if the Obama Administration and Congress had acted more forcefully in early 2009, we could have significantly limited the breadth and depth of the foreclosure crisis. In particular, reforming the bankruptcy code to permit judges to modify the loans on principal residences could have made a significant impact on the problem. Instead, the response ultimately consisted of initiatives that relied exclusively on voluntary assistance from servicers in return for minor monetary incentives.

In evaluating how well this approach has worked, the facts speak for themselves: nearly three million have already lost their homes, and almost six million more are in danger of joining them. [2] The principal federal response to the crisis, the Home Affordable Modification Program (HAMP), has produced fewer than a half million permanent modifications. More than 60% of borrowers have not even been evaluated for a modification.[3] Servicers have routinely failed to follow the loss mitigation guidelines contained both in the HAMP program and in the contracts of investors such as FHA and the GSEs, and the dual-track system of loss mitigation while also proceeding to foreclosure has resulted in foreclosures taking place before evaluation for loan modifications or other alternative has occurred, while that process is occurring, or even after a successful modification agreement has already been reached.

Beyond loss mitigation failures, mortgage servicers also are engaging in other shoddy, abusive, and even illegal accounting and legal practices. Recently, the public has learned about profound problems with the system for proving that the foreclosing party has the legal right to do so. Servicers also have a track record of poor accounting practices, including misapplying payments and force-placing insurance improperly. These various problems have resulted in the so-called "robosigning" scandal, in which employees have lied about having personally reviewed the information alleged in their summary judgment affidavits -- in part to save costs by cutting corners, but in part because the servicer simply does not have the ability to produce the mortgage note or prove that other facts alleged in the affidavit are true.

It is shocking that servicers have characterized these problems as "technical" ones that somehow don't matter because the homeowners are in default in any account.[4] re simply "technical" issues, case after case demonstrates that is not true. Regardless of the homeowner's default status, one of the bedrock principles of our legal system is that a person cannot have their private property taken without due process. But more than that, while the lack of regulatory oversight has resulted in a paucity of relevant data, the sheer volume of anecdotal accounts of profound mistakes and abuses suggests that in a significant number of cases, people are experiencing wrongful foreclosure.[5]

Much recent discussion has focused on whether calls for a foreclosure moratorium given the servicing problems will hurt the economy by delaying market clearing. We do not think this is the right question. Instead, we should be asking whether the servicing system currently is able to distinguish properly between those instances where foreclosure is unavoidable and those where another option would produce a more favorable financial result.

Unfortunately, every available piece of evidence suggests the system cannot yet reliably make this distinction. This failure to prevent foreclosures that would save money for both investors and homeowners is both perverse and bad for economic recovery. Additionally, to get the housing market back on track, buyers need assurances that the foreclosures are legal and not vulnerable to challenge. Having banks claim to “fix” thousands of mortgages within a couple of weeks without more information is unlikely to restore public confidence in the system. Consequently, a temporary pause in pursuing foreclosures during which defined, objective, and transparent measures are taken to ensure the integrity of the system is likely to be the best way to stabilize the market.

Today, we urge everyone concerned about the stability of the housing market and the sustainability of our economic recovery to address the foreclosure problem head-on with every tool available. For too long, we have listened to the insistence of the servicers that they can solve this problem on their own. While it always seemed improbable that would be the case, after almost four years, we now know that is impossible.

It is high time for Congress, the Administration, banking regulators, federal and state law enforcement officials, and state legislatures to employ *every tool at their disposal* to end a crisis that has spiraled out of control for years now, unnecessarily, wasting billions (maybe even trillions) of dollars and standing in the way of broad economic recovery . In these recommendations, we describe many ways in which these various actors can help produce the results that will best serve investors, homeowners, and the market as a whole.

Recommendations for Congress

- Change the bankruptcy code to permit modifications of mortgages on principal residences.
- Mandate loss mitigation prior to foreclosure.
- Level the playing field in court by funding legal assistance for homeowners.
- Ensure that homeowners receiving mortgage debt forgiveness or modifications do not find their new financial security undermined by a burdensome tax bill.

Recommendations for Federal Agencies (non-HAMP-related)

- The federal prudential banking regulators should immediately focus on the servicing operations of their supervisees.
- The Consumer Financial Protection Bureau should make regulating servicers one of its first priorities.
- Fannie Mae and Freddie Mac should serve as models to the industry.
- HUD, VA, and other government housing programs should enforce their servicing rules, especially those related to mandatory loss mitigation.

Recommendations for Improving HAMP

- Aggressively enforce HAMP guidelines through serious penalties and sanctions for noncompliance.
- Create an independent, formal appeals process for homeowners.
- Evaluate all borrowers for HAMP, 2MP, and HAFA or other sustainable proprietary solutions before proceeding with foreclosure.
- To ensure that loan modifications are sustainable, require servicers to reduce principal whenever the alternative waterfall yields a positive net present value (NPV) or at least to disclose the positive NPV to investors, require servicers to reduce principal on second liens proportional to any reduction of principal undertaken with respect to the first lien, and require servicers to reduce principal appropriately when the underlying mortgage exhibits predatory characteristics.
- Increase the mandatory forbearance period for unemployed homeowners to six months and reinstitute the counting of unemployment benefits as income.
- Mandate automatic conversions of successful trial modifications and reimburse homeowners who pay their trial modifications but are not converted for any interest and fees paid during that period.
- Require servicers to provide the homeowner with the relevant written documentation any time a modification is denied due to investor restrictions.
- Share loan-level data with the public to ensure that everyone has access to the most complete source of data on foreclosure prevention.
- Permit homeowners who experience additional hardship to be eligible for a new HAMP review and modification.
- Mandate an additional 30 days after HAMP denial to apply for Hardest Hit Program monies and HAMP reconsideration if the HHP application is approved.
- Clarify existing guidelines to streamline the process and carry out the intention of the program.

Recommendations for States

- State legislatures should mandate loss mitigation prior to foreclosure.
- States should exercise their supervisory and enforcement authority over servicers doing business in their jurisdiction.

II. Background: The foreclosure crisis has impacted tens of millions of people directly or through spillover effects, with a particularly severe impact on minority communities, and mortgage servicers have routinely engaged in careless, predatory and illegal practices.

A. The foreclosure crisis impacts millions of people, both directly and through spillover effects.

With one in seven borrowers delinquent on their mortgage or already in foreclosure[6] and nearly one in four mortgages underwater,[7] continued weakness in the housing sector is already impairing economic recovery and hampering efforts to create jobs and reduce unemployment. According to industry analysts, the total number of foreclosures by the time this crisis abates could be anywhere between 8 and 13 million.[8] A recent study by CRL estimated that 2.5 million foreclosure sales were completed between 2007 and 2009 alone, while another 5.7 million borrowers are at imminent risk of foreclosure[9]

Beyond the impact of the foreclosures on the families losing their homes, foreclosure “spillover” costs to neighbors and communities are massive. Tens of millions of households where the owners have paid their mortgages on time every month are suffering a decrease in their property values that amounts to hundreds of billions of dollars in lost wealth just because they are located near a property in foreclosure. Depending upon the geography and time period, the estimated impact of each foreclosure ranges from 0.6 percent to 1.6 percent in lost value to nearby homes. CRL estimates that the foreclosures projected to occur between 2009 and 2012 will result in $1.86 trillion in lost wealth, which represents an average loss of over $20,000 for each of the 91.5 million houses affected.[10] These losses are on top of the overall loss in property value due to overall housing price declines.[11]

Furthermore, since African-American and Latino borrowers have disproportionately been impacted by foreclosures, these spillover costs will disproportionately be borne by communities of color. CRL has estimated that African-American and Latino communities will lose over $360 billion dollars in wealth as a result of this spillover cost.

In addition, foreclosures cost states and localities enormous sums of money in lost tax revenue and increased costs for fire, police, and other services because vacant homes attract crime, arson, and squatters. As property values decline further, more foreclosures occur, which only drives values down still more. The Urban Institute estimates that a single foreclosure results in an average of $19,229 in direct costs to the local government.[12]

The crisis also severely impacts tenants in rental housing. According to the National Low-Income Housing Coalition, a fifth of single-family (1-4 unit) properties in foreclosure were rental properties and as many as 40 percent of families affected by foreclosure are tenants.[13] While tenants now have some legal protection against immediate eviction,[14] most of them will ultimately be forced to leave their homes.[15] Furthermore, a great deal of housing stock is now owned by the banks rather than by new owners. Banks are not in the business of renting homes and are not well suited to carry out the duties required of a landlord.

Compounding the problem of renters losing homes to foreclosures is the impact that the crisis has on other sources of affordable housing. A policy brief from the Joint Center for Housing Studies reports that dramatic changes at Freddie Mac and Fannie Mae and coincident changes in credit markets have disrupted and increased the cost of funding for the continued development of multi-family (5+ units) properties, despite the fact that underwriting and performance has fared better in this segment than in single-family housing.[16] As a result, even though a general over-supply of single-family housing persists, the deficit in the long-term supply of affordable rental housing is at risk of increasing.[17]

B. Toxic loan products lie at the heart of the mortgage meltdown.

In response to the foreclosure crisis, many in the mortgage industry have evaded responsibility and fended off government efforts to intervene by blaming homeowners for mortgage failures, saying that lower-income borrowers were not ready for homeownership or that government homeownership policies dictated the writing of risky loans.[18] This argument is both insulting and wrong. Empirical research shows that the elevated risk of foreclosure was an inherent feature of the defective nonprime and exotic loan products that produced this crisis, and that these same borrowers could easily have qualified for far less risky mortgages that complied with all relevant government policies and regulations.

A number of studies demonstrate that loan performance and loan quality are strongly related. For example, Vertical Capital Solutions found that the least risky loans[19] significantly outperformed riskier mortgages during every year that was studied (2002-2008), regardless of the prevailing economic conditions and in every one of the top 25 metropolitan statistical areas.[20] That study also confirmed that loan originators frequently steered customers to loans with higher interest rates than the rates for which they qualified and loans loaded with risky features, and that 30 percent of the borrowers in the sample (which included all types of loans and borrowers) could have qualified for a safer loan. The Wall Street Journal commissioned a similar study that found 61 percent of subprime loans originated in 2006 “went to people with credit scores high enough to often qualify for conventional [i.e., prime] loans with far better terms.”[21]

Even applicants who did not qualify for prime loans could have received sustainable, thirty-year, fixed-rate subprime loans for—at most—half to eight tenths of a percent above the initial rate on the risky ARM loans they were given.[22]

CRL's own research has demonstrated that common subprime loans with terms such as adjustable rates with steep built-in payment increases and lengthy and expensive prepayment penalties presented an elevated risk of foreclosure *even after accounting for differences in borrowers' credit scores*.[23] A complementary 2008 study from the University of North Carolina at Chapel Hill supports the conclusion that risk was inherent in the structure of the loans themselves.[24] In this study, the authors found a cumulative default rate for recent borrowers with subprime loans to be more than three times that of comparable borrowers with lower-rate loans. Furthermore, the authors found that adjustable interest rates, prepayment penalties, and mortgages sold by brokers were all associated with higher loan defaults. In fact, when risky features were layered into the same loan, the resulting risk of default for a subprime borrower was four to five times higher than for a comparable borrower with the lower- and fixed-rate mortgage from a retail lender.

Finally, CRL conducted a more targeted study to focus on the cost differences between loans originated by independent mortgage brokers and those originated by retail lenders. In that study, we found that for subprime borrowers, broker-originated loans were consistently far more expensive than retail-originated loans, with additional interest payments ranging from $17,000 to $43,000 per $100,000 borrowed over the scheduled life of the loan.[25] Even in the first four years of a mortgage, a typical subprime borrower who used a broker paid $5,222 more than a borrower with similar creditworthiness who received a loan directly from a lender.[26] The data overwhelmingly supports that irresponsible lending and toxic loan products lie at the heart of the crisis.

C. Minority families and communities of color bear a disproportionate burden of the foreclosure crisis.

It is well documented that African-American and Latino families disproportionately received the most expensive and dangerous types of loans during the heyday of the subprime market.[27] New CRL research released this summer shows that, not surprisingly, minorities are now disproportionately experiencing foreclosure.

In June, our report entitled "Foreclosures by Race and Ethnicity: The Demographics of a Crisis" shows that African-Americans and Latinos have experienced completed foreclosures at much higher rates than whites, even after controlling for income.[28] While an estimated 56% involved a white family, when looking at rates within racial and ethnic groups, nearly 8% of both African-Americans and Latinos have already lost a home, compared to 4.5% of white borrowers. We estimate that, among homeowners in 2006, 17% of Latino and 11% of African-American homeowners have lost or are at imminent risk of losing their home, compared with 7% of non-Hispanic white homeowners. The losses extend beyond families who lose their home: From 2009 to 2012, those living near a foreclosed property in African American and Latino communities will have seen their home values drop more than $350 billion.

Another CRL report issued in August, “Dreams Deferred: Impacts and Characteristics of the California Foreclosure Crisis,” shows that more than half of all foreclosures in that state involved Latinos and African Americans.[29] Contrary to the popular narrative, most homes lost were not sprawling "McMansions," but rather modest properties that typically were valued significantly below area median values when the home loan was made.

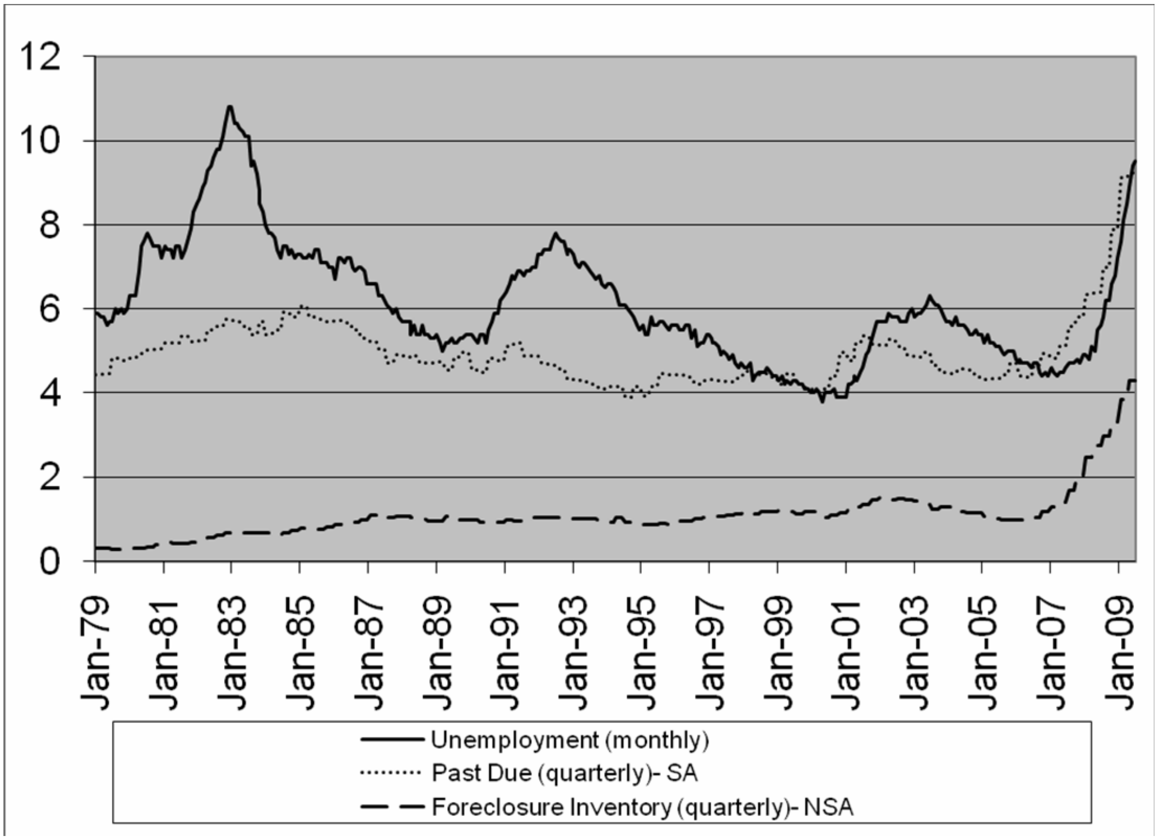
The impact of this crisis on families and communities of color is devastating. Homeownership is the primary source of family wealth in this country, and people often tap home equity to start a new business, pay for higher education and secure a comfortable retirement. In addition, home equity provides a financial cushion against unexpected financial hardships, such as job loss, divorce or medical expenses. Perhaps most important, homeownership is the primary means by which wealth is transferred from one generation to the next, which enables the younger generation to advance further than the previous one. Minority families already have much lower levels of wealth than white families, and therefore this crisis is not only threatening the financial stability and mobility of individual families, but it is also exacerbating an already enormous wealth gap between whites and communities of color.[30]

D. Unemployment is exacerbating the crisis but didn't cause it.

High unemployment did not cause the foreclosure crisis, but because of the crash of the housing market, unemployment is now far more likely to trigger mortgage default than in the past, largely due to widespread negative equity. In past recessions, homeownership served as a buffer against income interruptions because homeowners facing unemployment could sell their homes or tap into their home equity to tide them over. Today, selling homes is difficult to impossible in many markets, and even when sales take place, the seller sees no net proceeds from the sale. Figure 1 below shows that during previous periods of very high unemployment, foreclosure numbers remained essentially flat. Delinquency levels did rise somewhat, but they rose far less than they have risen during the recent crisis.[31] Other research confirms that the risk of default due to unemployment rises when homeowners are underwater on their mortgage.[32]

And why are so many homeowners underwater? It is because the glut of toxic mortgages contributed to inflating the housing bubble and then led to the bursting of the bubble, followed by a self-reinforcing downward spiral of home prices.

Figure 1: Historical relationship of unemployment and foreclosure rate

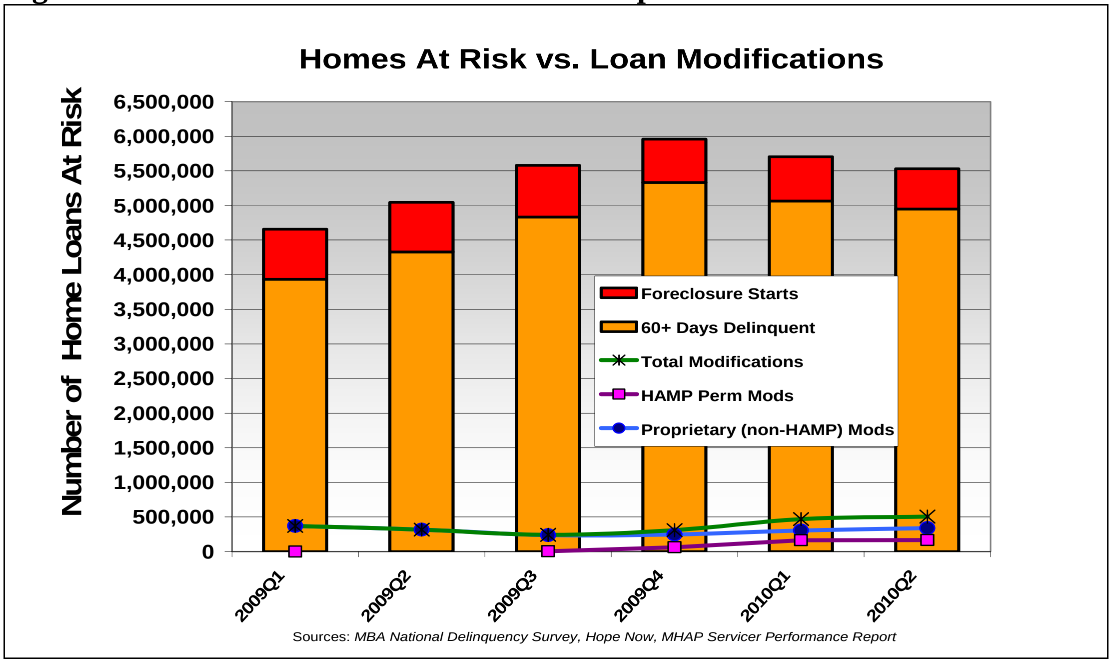


Sources: MBA National Delinquency Survey, Bureau of Labor Statistics.

E. Foreclosures continue to outstrip loan modifications.

Despite both HAMP and proprietary modifications, the number of homeowners in need of assistance continues to overwhelm the number of borrowers who have received a permanent loan modification by ten to one (see Figure 2).

Figure 2. Demand for Relief Continues to Outpace Loan Modifications



About 4.6 million mortgages are in foreclosure or 90 days or more delinquent as of June 30.[33] New foreclosure starts were over 225,000 per month in July and August, having fallen below 200,000 in each of the previous three months. There were roughly 33,000 permanent HAMP modifications in August and 116,000 proprietary modifications.[34] According to the State Foreclosure Prevention Working Group, more than 60% of homeowners with serious delinquent loans are still not involved in any loss mitigation activity.[35]

F. Mortgage servicers engage in a range of predatory and illegal practices both in the foreclosure process and leading up to foreclosure.

For at least a decade, community-based organizations, housing counselors and advocates nationwide have documented a pattern of shoddy, abusive and illegal 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.[36]

The most egregious of these abuses include:

- misapplication of borrower payments, which results in inappropriate and unauthorized late fees and other charges, as well as misuse of borrower funds improperly placed in “suspense” accounts to create income for servicers.
- force-placing very expensive hazard insurance and charging the borrower’s account when the borrower’s hazard insurance has not lapsed, often driving an otherwise current borrower into delinquency and even foreclosure.

- charging unlawful default- and delinquency-related fees for property monitoring and broker price opinions.
- failing or refusing to provide payoff quotations to borrowers, preventing refinancings and short sales.
- improperly managing borrower accounts for real estate tax and insurance escrows, including failure to timely disburse payments for insurance and taxes, causing cancellation and then improper force-placing of insurance as well as tax delinquencies and tax sales.
- abuses in the default and delinquency process, including failing to properly send notices of default, prematurely initiating foreclosures during right to cure periods and immediately following transfer from another servicer and without proper notices to borrowers, initiating foreclosure when borrower is not in default or when borrower has cured the default by paying the required amount, and failing to adhere to loss mitigation requirements of investors.

These practices have become so ingrained in the servicing culture that they are now endemic in the industry. The harm to which borrowers have been subjected as a result of these abuses cannot be overstated. Numerous homeowners are burdened with unsupported and inflated mortgage balances and have been subjected to unnecessary defaults and wrongful foreclosures even when they are not delinquent. Countless families have been removed from their homes despite the absence of a valid claim that their mortgage was in arrears.

Perverse financial incentives in pooling and servicing contracts explain why servicers press forward with foreclosures when other solutions are more advantageous to both homeowner and investor. For example, servicers are entitled to charge and collect a variety of fees after the homeowner goes into default and can recover the full amount of those fees off the top of the foreclosure proceeds.[37] The problem of misaligned incentives is compounded by a lack of adequate resources, management, and quality control.

What's more, recent legal proceedings have uncovered the servicing industry’s stunning disregard of basic due process requirements.[38] Numerous servicers have engaged in widespread fraud in pursuing foreclosures through the courts and, in non-judicial foreclosure states, through power of sale clauses. It is becoming more and more apparent that 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. The public is also now learning what foreclosure defense attorneys have asserted for years: the ownership of potentially millions of mortgages is in question due to "innovations" and short-cuts designed to speed the mortgage securitization process.[39]

As noted above, the illegal practices of servicers during the foreclosure process are not simply a technical problem. Due process when taking private property is a cornerstone of our legal system, and case after case reveals that this is not just a question of dotting the I’s and crossing the T’s, but of unnecessary and even wrongful foreclosures. The rules that the banks have broken in their rush to foreclose were put in place specifically to give people a fair chance to save their homes, and without them, homeowners are powerless to save their homes.

III. It is time for a comprehensive approach to foreclosure prevention that uses all the tools in the toolbox.

A. Congress can pass legislation that would meaningfully realign incentives among servicers, investors, and homeowners.

1. Change the bankruptcy code to permit modifications of mortgages on principal residences.

Our country's well established system for handling problems related to consumer debt is bankruptcy court. The availability of this remedy is so crucial for both creditors and debtors that the Framers established it in the Constitution, and the first bankruptcy legislation passed in 1800. Today, bankruptcy judges restructure debt for corporations and individuals alike.

Shockingly, however, when it comes to the family home -- the primary asset for most people in our country -- these experienced judges are powerless: current law makes a mortgage on a primary residence the only debt that bankruptcy courts are <u>not</u> permitted to modify in Chapter 13 payment plans. Owners of vacation homes, commercial real estate and yachts can have their mortgage modified in bankruptcy court (and the peddlers of predatory mortgages such as New Century or over-leveraged investment banks like Lehman Bros. can have all their debt restructured) but an individual homeowner is left without remedy.

Addressing this legal anomaly would solve almost in one fell swoop a range of problems that have beset efforts to combat foreclosures. First and foremost, bankruptcy does not leave foreclosure prevention to the voluntary efforts of servicers. Instead, a trusted third party can examine documents, review accounting records, and ensure that both the mortgagor and mortgagee are putting all their cards on the table. Moreover, the homeowner is the one who controls when this remedy is sought, rather than the servicer.

Second, in bankruptcy, the judge can reduce the level of the mortgage to the current market value of the property. This stripdown (some call it cramdown), or principal reduction, can help put homeowners in a position to begin to accumulate equity on their home again, thereby shielding them against future income shocks and increasing their incentive to make regular mortgage payments.

Third, a bankruptcy judge has the power to deal with the full debt picture of the homeowner, including any junior liens on the family home and other consumer debt such as medical bills, credit cards, or student loans. Second liens have proven to be one of the most vexing problems facing many foreclosure prevention efforts, and high consumer debt can threaten the sustainability of any mortgage modification made in a vacuum.[40]

Fourth, bankruptcy addresses “moral hazard” objections, meaning the concern that people will want relief even when they don't need or deserve it. Filing a Chapter 13 claim is an onerous process that a person would rarely undertake lightly. Any relief from debt comes at a substantial cost to the homeowner -- including marring the homeowner’s credit report for years to come and subjecting the homeowner’s personal finances to strict court scrutiny.

Fifth, the availability of this remedy would in large part be the very reason why it would not need to be used very often. Once mortgages were being restructured regularly in bankruptcy court, a "template" would emerge as it has with other debts, and servicers would know what they could expect in court, making it much more likely that servicers would modify the mortgages themselves to avoid being under the control of the court. Similarly, the fact that a homeowner had the power to seek bankruptcy would serve as the now-missing stick to the financial incentive carrots provided by other foreclosure prevention programs.

Permitting judges to modify mortgages on principal residences, which carries *zero cost to the U.S. taxpayer*, could potentially help more than a million families stuck in bad loans keep their homes.[41] As foreclosures continue to worsen, more and more analysts and interested parties are realizing the many benefits this legislation could have.[42] Recently, the Federal Reserve Bank of Cleveland published an analysis of using bankruptcy courts to address the farm foreclosure crisis of the 1980s, concluding that using bankruptcy to address that crisis did not have a negative impact on availability or cost of credit.[43]

2. Mandate loss mitigation prior to foreclosure.

Congress has the power to require that all servicers, industry-wide, must engage in loss mitigation, and that the failure to do so is a defense to foreclosure. For many servicers, only a legal requirement will cause them to build the systemic safeguards necessary to ensure that such evaluations occur.

Almost two years ago now, Chairman Waters introduced legislation that would require loss mitigation.[44] This legislation also would have addressed many of the other shoddy servicing practices that have resulted in the problems we see today. We strongly suggest that this legislation be updated to reflect current understandings of the issues and be reintroduced in the 112th Congress.

3. Level the playing field in court by funding legal assistance for homeowners.

All banks and servicers are represented by attorneys, but most homeowners in default or foreclosure cannot afford an attorney. Housing counselors can help people with their mortgages, but only attorneys can contest foreclosures in court. Programs offering free legal assistance can play an integral role in foreclosure prevention, including:

- identifying violations of mortgage lending laws and laws related to the foreclosure process.
- assisting with loan modification applications and the modification process.
- advising homeowners on existing bankruptcy options.
- helping homeowners seek alternatives to foreclosure.
- defending tenants who are being forced out following foreclosure.
- educating homeowners and tenants about the foreclosure process and legal rights.

Recognizing the importance of borrower representation, the Dodd-Frank Act authorized $35 million to establish a Foreclosure Legal Assistance Program through HUD that would direct funding to legal assistance programs in the 125 hardest hit metropolitan areas. Unfortunately, that money has not yet been appropriated.

As the foreclosure crisis continues unabated, other funding for foreclosure legal assistance is drying up. State-administered Interest on Lawyer Trust Account (IOLTA) revenue, a major source of funding for legal aid programs, has declined 75 percent due to interest rate decreases. State budget crises have forced the slashing of legislative appropriations that fund legal aid. Another major private source of funding for anti-foreclosure work, a grant program run by the Institute for Foreclosure Legal Assistance (IFLA), has already made the last grants it can make under current funding and will end in 2011.[45]

Without additional funding, the attorneys who have developed expertise in this area may well lose their jobs, and legal aid groups will not be able to keep pace with the spike in foreclosure-related needs. Already, legal aid programs turn away hundreds of cases. For these reasons, it is crucial to fund the $35 million Foreclosure Legal Assistance Program authorized by the Dodd-Frank Act.

Congress also should clarify that foreclosure prevention funds allocated under TARP and being used in the HAMP and Hardest Hit Programs can be used for legal assistance when appropriate.[46] We know now that there are many types of servicing abuses that cannot be handled by a housing counselor alone.

4. Ensure that homeowners receiving mortgage debt forgiveness or modifications do not find their new financial security undermined by a burdensome tax bill.

Even principal forgiveness or the most carefully structured loan modifications can be seriously undermined if struggling homeowners must treat the forgiven mortgage debt as taxable income. Solving this tax problem has been flagged as a priority by the IRS's Office of the National Taxpayer Advocate.[47]

When lenders forgive any mortgage debt, whether in the context of a short sale, a deed-in-lieu-of-foreclosure, foreclosure, or principal reduction in a loan modification, that amount of forgiven debt is considered income to the homeowner and tax must therefore be paid on it unless the homeowner qualifies for some kind of exclusion to that tax. In 2007, Congress passed the Mortgage Forgiveness Debt Relief Act of 2007 to prevent adverse tax consequences to homeowners in trouble. After passage of this bill, most policymakers considered the problem to have been solved.

Unfortunately, many homeowners are not covered by that legislation because they took cash out of their home during a refinancing to make home repairs, pay for the refinancing, or consolidate other debt.[48] Moreover, even those homeowners already fully covered by the Mortgage Forgiveness Debt Relief Act often fail to take advantage of this exclusion because it is complicated and they do not understand the need to do so to avoid owing additional taxes. [49]The National Taxpayer Advocate reports that in 2007, less than one percent of electronic filers eligible for the exclusion claimed it.[50] If the definition of qualified mortgage debt is expanded, the IRS can take steps through its tax forms to simplify the process for taxpayers claiming the mortgage debt exclusion.

Finally, while the sunset date on this legislation was already extended through 2012, it needs to be extended further, and preferably made permanent, since this particular part of the tax code was originally aimed at corporate deals (where the vast majority of the related tax revenues are generated) rather than at individual consumer debt issues.

B. Federal agencies have significant authority that should be employed to help fight foreclosures.

There are a number of federal regulatory agencies with authority to help fight foreclosures. In a later section, we will provide extensive recommendations for improvements that Treasury can make to HAMP. In this section, we provide other suggestions.

1. The federal prudential banking regulators should immediately focus on the servicing operations of their supervisees.

Federal supervisory banking regulators should use their examination authority and supervisory authority to focus on the servicing operations of their supervisees, with a focus on the legality and propriety of accounting inaccuracies, inappropriate fees and charges, failure to comply with loss mitigation requirements, and other problems identified in this testimony. The methodology and results of these investigations should be made available to the public as extensively as possible. To the extent that problems are found, the regulators should move to correct them quickly and thoroughly through an open and transparent process, and when necessary, referrals should be made to the appropriate enforcement authorities.

2. The Consumer Financial Protection Bureau should make regulating servicers one of its first priorities.

The Consumer Financial Protection Bureau (CFPB) is ideally positioned to provide consumers with a strong voice in the foreclosure fight -- a voice that has largely been absent in the regulatory structure and executive branch. The CFPB already has concurrent supervision authority with federal banking regulators over large banks to examine them for compliance and to assess risks to consumers and markets.[51] Right now, the nation's three largest banks (Bank of America, Wells Fargo, and JP Morgan Chase) account for approximately 50% of all mortgage servicing, so exercising this supervisory function with respect to the operations of these banks can begin immediately. Banks should be examined for compliance with all relevant laws and regulations as well as adherence to the provisions of contracts with investors and government agencies such as FHA and VA.

Moreover, as of July 2011, the CFPB will acquire rule-making authority to prevent abusive, unfair, deceptive and harmful acts and practices and to ensure fair and equal access to products and services that promote financial stability and asset-building on a market-wide basis. For an example of useful rules, the CFPB can look to what some states have already done.[52] It will also have strong enforcement tools, and the States will have concurrent authority to enforce the rules against violators in their jurisdictions. The CFPB should begin now to prepare to use its authority and tools to prevent predatory servicing practices.

Finally, apart from specific regulatory authority, as the voice of consumers in the regulatory structure, the CFPB can help to educate both policymakers and the public about this issue and thereby to help ensure that proposed solutions are as responsive to consumer interests as they are to bank interests.

3. Fannie Mae and Freddie Mac should serve as models to the industry.

Fannie Mae and Freddie Mac (the GSEs), now in conservatorship and supported by taxpayers, should serve as a model for how to prevent unnecessary foreclosures. While it has been a GSE priority to ensure that foreclosures proceed in a timely way, it is important that the desire to avoid delay does not prevent their servicers and attorneys from scrupulously adhering to all laws and guidelines, particularly those regarding loss mitigation reviews. In playing this important role, we recommend that the FHFA revisit its decision not to reduce principal on mortgage loans. Permitting modifications that produce both a positive net present value and a more sustainable loan modification will have a long-term, beneficial impact that needs to be weighed fairly against short-term profitability concerns.

4. HUD, VA, and other government housing programs should enforce their servicing rules, especially those related to mandatory loss mitigation.

FHA, VA, and other government-insured housing finance programs should ensure that their servicers are conducting the required loss mitigation reviews and following all relevant laws and guidelines. In a recent press conference, HUD Secretary Shaun Donovan admitted that an internal HUD investigation indicated that FHA servicers were not always conducting the loss mitigation reviews required by FHA. In addition to recommending that HUD terminate contracts with servicers that are not adhering to the provisions of those contracts, we recommend that HUD release public information concerning the loss mitigation track records of its servicers.

C. The Treasury Department should continue to improve HAMP and its associated programs.

As of September, approximately 470,000 homeowners had received and were still active in a permanent modification.[53] While saving almost a half million homes is a significant accomplishment, it falls far short of the original estimate that HAMP would assist 3-4 million borrowers.[54] The number of new trial modifications also has dropped significantly since HAMP changed its guidelines to require up-front underwriting of the modifications, and the number of conversions to permanent modifications is also declining, with fewer than 28,000 permanent modifications made in September. Given that trajectory, it seems unlikely that the total number of permanent modifications by the end of 2012 will exceed one million.[55]

Part of the reason for the lack of HAMP permanent modifications is the fact that the vast majority of modifications continue to be made outside of HAMP. As of August of this year, only 470,000 permanent modifications were made through HAMP, compared to 3.2 million proprietary modifications.[56] Servicers routinely ask borrowers to waive their right to a HAMP modification.[57] Sometimes, servicers transfer their accounts to other entities that are not bound by the HAMP contract with Treasury. While we do not know all the reasons why this happens, some possibilities are: (1) servicers profit more from the proprietary modifications because the HAMP incentives are insufficient to overcome other financial incentives; (2) the design of the HAMP program does not fit the majority of borrowers; (3) servicers do not want to fill out the detailed reports required by HAMP; or (4) servicers wish to avoid oversight. Whatever the reason, the lack of transparency about proprietary modifications makes it very difficult to compare them with HAMP modifications or to analyze their ultimate suitability for borrowers.

Similarly, the fact that servicers have violated HAMP guidelines and have resisted any kind of independent appeals process has resulted in the widespread negative experience that so many homeowners and their advocates have had with the program. For a whole range of reasons ranging from lack of capacity to conflicts of interest, mortgage servicers in many cases fail to provide many homeowners with a HAMP review that is timely, accurate, and adheres to HAMP guidelines. Stories abound of servicers who have had stunningly bad experiences when servicers ignore HAMP guidelines.

Despite its shortcomings, however, HAMP remains the principal federal response to the foreclosure problem, and without HAMP, homeowners would be even worse off than they are now. We make the following recommendations to refine HAMP's design and improve its performance.

1. Aggressively enforce HAMP guidelines through serious penalties and sanctions for noncompliance.

Over its year and a half of operations, Treasury has improved the HAMP program in a number of ways in response to concerns expressed by homeowners, advocates, and servicers. Unfortunately, servicers do not always comply with all the HAMP guidelines. Although we are told that errors are corrected when they are found during the Freddie Mac compliance process, the continuous flow of reports to the contrary from advocates and the press illustrates that many guidelines are being evaded or ignored.

We recommend that Treasury develop a clear, impartial system of penalties and sanctions for failure to comply with HAMP guidelines. Some HAMP guidelines are more crucial than others (see, for example, the section below on foreclosure stops), and violation of those guidelines should result in stiffer penalties. In addition, Treasury should release full information on the compliance records of each servicer, along with the number of corrective actions that have been taken, and develop a system for logging and investigating complaints from advocates about noncompliance with HAMP guidelines.

2. Create an independent, formal appeals process for homeowners who believe their HAMP denial was incorrect or who cannot get an answer from their servicer.

When a borrower is rejected for a HAMP modification, that borrower should have access to an independent appeals process where someone who does not work for the servicer can review and evaluate the situation. The existing HAMP escalation procedures are inadequate. (Freddie Mac does conduct compliance reviews and will require a servicer to fix any errors it finds, but this process cannot be triggered by request of an individual homeowner.) Since HAMP changed its procedures in January 2010 to require that servicers send letters with reasons for denial, and even more so as HAMP implements the directive contained in the Dodd-Frank Act that servicers disclosure the inputs used to make those decisions, homeowners have increased access to information about their denial, but they still have no way to make a change if that information indicates their denial to be in error.

We recommend that the Treasury establish an Office of the Homeowner Advocate to serve an appeals and ombudsman role within the program, along the lines of the National Taxpayer Advocate. There is legislation currently pending that would establish such an office, although it is unlikely to pass during the 111th Congress (this idea did already succeed in a Senate floor vote with bipartisan support when it was offered as an amendment to another bill, the initial underlying legislation failed.[58] For states or localities that have foreclosure mediation programs, those programs could also be used to handle this type of appeal.

3. Review all borrowers for HAMP, 2MP, and HAFA eligibility or other sustainable proprietary solutions before proceeding with foreclosure.

Prior to June 2010, servicers routinely pursued HAMP evaluations and foreclosures simultaneously. Homeowners trapped in those parallel tracks received a confusing mix of communications, including calls and letters concerning evaluation for a modification, and other formal notifications warning of an impending foreclosure sale. These mixed messages contributed to the failure of some borrowers to send in all their documentation, the early re-default of many trial modifications, and the difficulty servicers have reaching certain borrowers.

Although HAMP guidelines prohibited the actual foreclosure sale from taking place prior to a HAMP evaluation, sales were taking place anyway because the foreclosure proceedings are handled by outside law firms and communications between servicers and foreclosure attorneys regarding HAMP are extremely minimal.[59] Adding insult to injury, when continuing the foreclosure process during HAMP evaluation servicers' lawyers were billing thousands of dollars in attorneys fees that the homeowners were then expected to pay.

With Supplemental Directive 10-02, Treasury directed that for all new applicants, servicers were supposed to complete the HAMP review prior to referring the case to foreclosure. Furthermore, if an applicant was already in foreclosure, services were to stop additional steps toward a foreclosure once that borrower was in a verified trial modification.

Not surprisingly, despite Supp. Dir. 10-02, advocates are still routinely seeing homeowners placed into the foreclosure process even when they have not yet had their HAMP review. In some cases, this is because the homeowner did not qualify for the "foreclosure stop"; in other cases, servicers simply are not complying with the guidelines; in still other cases, the rules are ambiguous. For example, while servicers may not refer a case to a foreclosure attorney before the review, in a non-judicial state, it may not be clear that the foreclosure cannot actually be filed.

Foreclosures and foreclosure sales prior to HAMP evaluation are perhaps the biggest reason for the public's loss of confidence in the program. We recommend that when a borrower applies for HAMP,[60] the servicer should stop all foreclosure referrals, filings, or any actions to advance any goal other than HAMP review. As noted in Recommendation #1 above, when a servicer is found to proceed with a foreclosure prior to evaluation, strict penalties should ensue swiftly.

4. To ensure that loan modifications are sustainable, require servicers to reduce principal whenever the alternative waterfall yields a positive NPV or at least to disclose the positive NPV to investors, require servicers to reduce principal on second liens proportional to any reduction of principal undertaken with respect to the first lien, and require servicers to reduce principal appropriately when the underlying mortgage exhibits predatory characteristics.

Millions of Americans now owe more on their mortgages than their homes are worth. While the overall number of mortgages underwater is estimated to be almost one in four,[61] this ratio is far higher for homeowners who are having trouble affording their mortgage, and the average HAMP borrower owes $1.14 for ever $1.00 the house is worth.[62] Homeowners who are underwater have no cushion to absorb future financial shocks, and they have fewer incentives to sacrifice to stay in the home or to make ongoing investments in maintenance.[63] For these homeowners, even the reduction of monthly payments to an affordable level does not fully solve the problem. As a result, a homeowner's equity position has emerged as a key predictor of loan modification redefault.[64]

Many stakeholders believe that principal reduction is ultimately the only way to help the housing market reach equilibrium and begin to recover.[65] However, even as loan modification activity has ramped up in the overall market, principal reduction has remained relatively rare. One context in which it occurs is in portfolio loans with no second liens, which suggests that banks understand the usefulness of principal reduction but that for securitized loans, there is a conflict of interest between the banks that own the second liens (and who also own the servicers) and the investors who do not want to agree to a write-down on the first lien unless the second lienholder does the same.

In recognition of these realities, HAMP has initiated two programs: the "alternative waterfall" principal reduction program, and 2MP, the second lien program. Unfortunately, although HAMP offers generous financial incentives to cover the write-down, HAMP does not *require* servicers to engage in principal reduction even when it's in the best interests of the investor.[66]

Since the alternative waterfall program just began this month, we do not yet know how it will work. It is likely that the only way principal reduction is ever going to happen on a widespread basis is if it is required. Similarly, although 2MP has existed for over a year and although all four major banks have signed up, it is unclear why that program has only been used 21 times to date.[67] For this reason, HAMP should either require the write-downs or require the servicers to disclose the results of the positive NPV calculations to the investor.

Finally, HAMP should provide a commensurate reduction in principal for loans that exhibit predatory characteristics, such as 2/28s, 3/27s, and non-traditional loans such as interest-only or negatively amortizing loans not underwritten to the fully indexed rate or fully amortizing payment.

5. Increase the mandatory forbearance period for unemployed homeowners to six months and reinstitute the counting of unemployment benefits as income.

Another attempted improvement to HAMP this year was the establishment of a forbearance program for homeowners who lose their job (UP). Under UP, unemployed homeowners get at least three months (more if the servicer chooses) of reduced payments that will end when the homeowner becomes reemployed.

Unfortunately, this program does not adequately address the issue of unemployed homeowners. First, servicers were already doing a lot of three-month forbearances on their own. The problem is that most homeowners need longer than three months, as the average length of unemployment during this downturn is well over six months.[68] Second, when UP was announced, the HAMP guidelines changed so that unemployment income was no longer counted as "income" for a HAMP modification, even if it was guaranteed for at least nine months. Many families have sufficient income in addition to unemployment benefits to qualify for HAMP, and generally they would be better served by a HAMP modification than by a temporary forbearance.

Finally, HAMP should clarify the relationship between UP, HHF, and the new HUD bridge loan program.

6. Mandate automatic conversions of successful trial modifications and reimburse homeowners who pay their trial modifications but are not converted for any interest and fees paid during that period.

First, for borrowers who entered into verified income trial modifications, servicer delays in converting trial modifications to permanent modifications are simply unacceptable. They increase costs to homeowners and create significant periods of uncertainty. There is no reason why trial modifications should not automatically convert to permanent modifications if the borrower makes three timely trial modification payments.

Second, homeowners who have received a stated income trial modification in good faith, have made all their trial payments in a timely way, but have been denied a permanent modification should not end up financially worse off than they were before the trial modification. Currently, however, they often do end up worse off. Throughout the entire period, which is usually longer than three months since servicers are so backed up, these borrowers who are doing everything that is asked of them continue to be reported to credit bureaus as delinquent on their mortgage. Moreover, since the trial modification payments are by definition less than the full contract payment under the mortgage and the terms of the mortgage are not altered during the trial modification, homeowners finish a trial modification owing more on their homes than when they started. We have seen servicers use these arrears, accumulated during the trial modification, as the basis for initiating an immediate foreclosure against a homeowner, post-trial modification.

Homeowners who pay their trial modification payments but are not converted should be given an opportunity to pay back the arrears through regular monthly installments rather than a lump sum payment. Furthermore, the borrower should have the choice to have the arrears capitalized into the loan and the term extended so that their participation in HAMP does not result in an increase in monthly payments (if the PSA prevents a term extension, the amortization period should be extended). Finally, many homeowners end up facing foreclosure solely on the basis of the arrears accumulated during a trial modification. Such foreclosures should be prohibited.

7. Require servicers to provide the homeowner with the relevant written documentation anytime a modification is denied to investor restrictions.

Servicers are required to provide a HAMP modification whenever the NPV is positive, unless the Pooling and Servicing Agreement with the investor prohibits such a modification and the servicer has sought a change in policy from the investor and the investor has not agreed. When a servicer believes a PSA prevents an NPV-positive modification, the servicer is supposed to contact the trustee and any other parties authorized under the terms of the PSA to attempt to obtain a waiver. However, it appears that many servicers are using "investor turndowns" as a reason not to do a modification in violation of HAMP rules, in most cases because the contract does not actually prohibit the modification and in some instances because the servicer has not requested a change in policy from the investor.

Just last week, recognizing this problem, the Treasury Department changed its policy to require servicers to provide basic information related to investor denials.[69] While this is a small step in the right direction, it is crucial that servicers provide the borrower with this information directly, in hard copy form, as he or she is in the best position to act quickly if there is a problem but may be unable to access online databases. To minimize paperwork burden on servicers, we suggest that the servicer provide the borrower or the borrower's representative a photocopy of the limiting language in the PSA along with information on how to electronic access to a complete and unaltered copy of the PSA, and a copy of all correspondence with the lender and investors attempting to obtain authority to perform a modification,

8. Share loan-level data with the public to ensure that everyone has access to the most complete source of data on foreclosure prevention publicly available.

The Treasury Department is collecting a broad range of data from servicers participating in the HAMP program – more data than has ever been collected about the loan modification process by any other public entity. This data can shed great light into how the HAMP program is working: which borrowers are getting modifications and which are not; the geography of modification activity; the types of modifications that are being provided; and the patterns of re-defaults that are occurring. This data is crucial for those working to develop more and better tools to fight foreclosures and prevent a repeat of this crisis.

However, the Treasury Department has severely limited the data it has released. For over a year, it has promised to release the loan-level data to the public, but whenever asked, the promised date of release is pushed back. Treasury should release this data as soon as possible in a raw, disaggregated form so that independent researchers and other interested parties can analyze it themselves. If additional staffing is needed to scrub the data and turn it around quickly, we urge Treasury to assign more people to the task.[70]

Finally, while this data must be purged of private information such as names and social security numbers, some have suggested that race and ethnicity data not be released on a servicer-by-servicer basis. Given the significant racial and ethnic inequities that have plagued the mortgage market, detailed demographic data for each servicer is of vital importance to all stakeholders.

9. Permit homeowners who experience additional hardships to be eligible for additional HAMP modifications.

Even after a homeowner is paying the monthly payments due under a HAMP loan modification, life events may still occur that would once again disrupt these payments, such as job loss, disability, or the death of a spouse. These subsequent, unpredictable events, outside the control of the homeowner, should not result in foreclosure if a further loan modification would save investors money and preserve homeownership.

Foreclosing on homes where homeowners have suffered an involuntary drop in income without evaluating the feasibility of a further HAMP modification is punitive to homeowners already suffering a loss and does not serve the interests of investors. Some servicers provide some modifications upon re-default as part of their loss mitigation program; this approach should be standard and should include continued eligibility for HAMP modifications rather than only specific servicer or investor programs.

10. Mandate an additional 30 days after HAMP denial for the borrower to apply for assistance through a state Hardest Hit Program and then re-evaluate for HAMP if the application is approved.

Under Supplemental Directive 10-07, servicers may, but do not have to, provide borrowers with an additional 30 days after denial for the borrower to apply for HHF and see if the HHF program will get them to a HAMP-positive result. This additional time period should be mandatory. Allowing servicer discretion will lead to inconsistency in the program operation and denial of borrowers who could qualify for HAMP, and is at odds with HAMP's apparent intention that servicers not be allowed to condition HAMP application on HHF application.

Since borrowers can't know in advance if HHF funding will make the difference between HAMP denial or acceptance and won't know if the servicer will give them a chance to apply for HHF funding if they are denied for HAMP, borrowers will have to apply for HHF funds, even if HAMP alone would do the trick. This will result in the use of HHF funds to subsidize HAMP and diminish the impact of the additional HHF funds.

11. Clarify existing guidelines to streamline the process and carry out the intention of the program

These additional issues require some measure of clarification or minor tweaking to prevent abuses and problems:

- **All servicers should accept the standard HAMP application and corrected 4506-T forms.** Borrowers report that servicers reject HAMP applications if borrowers submit a standard application form (RMA) instead of the servicer’s form, or return with corrections a 4506-T form completed by the servicer. Servicers need additional guidance that submission of standard tax and HAMP forms by borrowers is adequate for purposes of HAMP review and that servicers may not deny review because a borrower has corrected misinformation on a servicer form.

- **Equity in a home should not preclude a HAMP modification.** Servicers routinely reject borrowers for HAMP who are in default because they have "too much equity," apparently relying on old guidelines to assess the availability of refinancing. Explicit guidance should be provided to servicers to disregard the amount of equity in a home when evaluating a borrower's HAMP eligibility, aside from its role in the NPV test.

- **Non-borrower surviving spouses and those awarded the home in a divorce decree should be eligible for a HAMP modification**. In Sup. Dir. 09-01 and in FAQ 2200, HAMP appears to permit non-borrower surviving spouses or those who receive the property in a divorce decree although they are not borrowers to obtain a loan modification. Servicers, however, continue to insist that an estate be opened before dealing with the surviving spouse and often initiate foreclosure proceedings instead of reviewing the surviving spouse for a HAMP loan modification. Treasury should state directly that non-borrowers permitted under the Garn-St Germain Act to assume the note are to be treated as eligible borrowers for HAMP, provided they meet the other qualifications.

- **Wholly owned subsidiaries should be covered under the servicer contracts.** Many large servicers operate multiple companies and divisions, often with similar names, yet there is no easy way for homeowners to identify if these divisions are participating. For example, the only Wells Fargo entity listed on the "Contact Your Mortgage Servicer" page of the Making Home Affordable website is the national bank, but most mortgage customers of Wells Fargo will deal with Wells Fargo Home Mortgage, Wells Fargo Financial, or America's Servicing. Advocates continue to report confusion as to coverage, with subsidiaries frequently denying that they are covered by a contract signed by the parent.

- **Servicers should not be able to rescind permanent HAMP modifications.** Although HAMP trial modification contracts indicate that a homeowner can obtain a permanent modification by making three trial modification payments, servicers have been withdrawing trial modification offers, and, worse, cancelling existing permanent modifications, citing investor restrictions and other issues that should have been identified prior to these agreements. While servicers and others have sought to describe these cancellations as clerical errors, they are breaches of contract that epitomize the one-sided dynamic of HAMP modifications.

- **Servicers should pre-sign permanent modification documents.** After a borrower successfully completes a trial modification, the servicer is required to send permanent modification papers to the homeowner. Often, these papers are not pre-signed and such finalizing can often take months. Permanent modifications would increase and the timeline would be shortened if servicers were required to send pre-signed permanent modification agreements to the homeowner. Further efficiency would be derived from the establishment of a timeline for the sending and returning of permanent modification documents.

D. States also should act to prevent servicing abuses and save homes.

1. State legislatures should mandate loss mitigation prior to foreclosure.

States are also in a strong position to prevent unnecessary foreclosures. Although mandatory loss mitigation standards exist in many parts of the market now, lack of enforcement has diminished their impact, and they are not industry-wide. By exercising their control over the foreclosure process, states can require that servicers assess whether foreclosure is in the financial interest of the investor before proceeding to foreclosure. A mandatory loss mitigation standard will function as a low-cost, high-impact foreclosure prevention tool that ensures foreclosure is a last resort.[71]

While states ideally would require servicers to perform a loss mitigation analysis prior to filing for foreclosure, existing laws have incorporated elements of a mandatory loss mitigation standard at other stages of the foreclosure process. Currently, loss mitigation components exist in state foreclosure laws, either implicitly or explicitly, in the following four places: (1) as a pre-condition to foreclosure filing; (2) as part of a foreclosure mediation program; (3) as a pre-condition to foreclosure sale; and (4) as the basis for a challenge post-foreclosure sale.

This range of approaches demonstrates the extent to which a loss mitigation standard can be adapted to any foreclosure process. Because not all foreclosures are preventable, the implementation of this standard will not limit the right of creditors to foreclose on a property where appropriate, but would ensure that the foreclosure sale is a last resort after all other foreclosure prevention strategies have been considered.

States can further promote transparency and accountability by combining a mandatory loss mitigation standard with basic disclosures of the inputs used in the NPV calculation and the results of the calculation, which can be contested by appeal.

To be most effective, a flexible mandatory loss mitigation standard should be combined with:

- a requirement that the foreclosing party provide homeowners with a loss mitigation application in tandem with any pre-foreclosure notice or pre-foreclosure communication;

- a requirement that the foreclosing party submit an affidavit disclosing the specific basis for the denial of a loan modification, including the inputs and outputs of any loss mitigation calculations;

- a defense to foreclosure (or equivalent right in non-judicial foreclosure states) based on failure of the foreclosing party to engage in a good faith review of foreclosure alternatives; and

- public enforcement mechanisms to safeguard against systemic abuses.

- using existing or planned mediation programs as an appeal process when an adverse loss mitigation determination is made.[72]

Finally, state authority to regulate and license mortgage servicers provides yet another avenue through which States can promote servicer accountability and incorporate mandatory loss mitigation. For example, New York recently enacted a strong set of rules that will go a long way toward ending predatory servicing practices and ensuring that homeowners do not lose their homes due to servicer failures.[73] These rules are easily replicable and provide a very useful set of tools for enforcement authorities and advocates.

2. States should exercise their supervisory and enforcement authority over servicers doing business in their jurisdiction.

Where state banking agencies have examination and enforcement authority over servicers operating in their jurisdiction, they, too, should focus on the legality, propriety, and accuracy of accounting, inappropriate or unnecessary fees and charges, failure to comply with loss mitigation requirements, and other problems identified in this testimony.

The recently announced investigation by the state attorneys general is one of the most promising developments to date in the fight against foreclosures. We recommend that in addition to any monetary damages, states seek injunctive relief to help promote sustainable loan modifications and eliminate shoddy and illegal business and legal practices.

Conclusion

Today's foreclosure crisis is the worst housing downturn since the Great Depression. The stakes are high. Not only have millions of families lost their homes, but the crisis is responsible for close to two trillion dollars in additional lost wealth, cuts in municipal services, shortages of affordable housing, and reduction of homeowner disposable income. As foreclosures mount, these related costs will only grow worse.

Even under a best-case scenario, the current crisis will continue and fester if interventions remain on the current narrow course. Unfortunately, there is no "silver bullet" strategy to fix every mortgage or repair every foreclosure-ravaged neighborhood. To make a real difference in preventing foreclosures and reducing associated losses, we need a multi-pronged strategy that strengthens the way current foreclosure prevention programs are implemented and also invests in new approaches.

As policymakers take actions to address the immediate crisis, it is our hope that they also will be mindful of policy failures that enabled the situation. Economic cycles and housing bubbles may always be with us, but the experience of recent years vividly shows the value of sensible lending rules and basic consumer protections, even during economic booms, to prevent another disaster in the future.

We appreciate the chance to testify today and look forward to continuing to work with Congress on these crucial issues.

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[1] Laurie Goodman, Roger Ashworth, Brian Landy, and Lidan Yang, "The Housing Crisis—Sizing the Problem, Proposing Solutions," Amherst Mortgage Insight (Oct. 1, 2010) [hereinafter "Amherst Study," on file with CRL.

[2] Debbie Gruenstein Bocian, Wei Li and Keith S. Ernst, *Foreclosures by Race and Ethnicity: The Demographics of a Crisis,* Center for Responsible Lending (June 18, 2010).

[3] State Foreclosure Prevention Working Group, "Redefault Rates Improve for Recent Loan Modifications" (August 2010), p.1, *available at* http://www.csbs.org/regulatory/Documents/SFPWG/DataReportAug2010.pdf.

[4] Corbett B. Daly and Elinor Comlay, "States hit banks with mortgage probe," Reuters (Oct. 13, 2010) *available at* http://www.reuters.com/article/idUSTRE69B4UY20101013 (in explaining that the robosigning was just a technicality, Jamie Dimon said, "We're not evicting people who deserve to stay in their home.").

[5] *See, e.g.,* James Eli Shiffer, "Help Retracted by Bank Error," StarTribune.com (Nov. 15, 2010), *available at* http://www.startribune.com/local/west/107775738.html (a permanent loan modification revoked; borrower says he never missed a payment); Aldo Svaldi , " Foreclosure paperwork miscues piling up, The Denver Post (Nov. 14, 2010), *available at* http://www.denverpost.com/business/ci_16601567 (describing homeowners trying to pay off their mortgages but unable to, as well as other problems); J. Scott Trubey, "Foreclosure Came Out of Blue for Two Families," The Atlanta Journal-Constitution, (Oct. 28, 2010), *available at* http://www.ajc.com/business/foreclosures-came-out-of-699191.html (in addition to describing specific cases, article notes that Sen. Saxby Chambliss said his office has dealt with hundreds of constituents alleging problems with their lenders, the modification process and foreclosures). *See also* Special Inspector General of the Troubled Asset Relief Program, Report to Congress October 2010 , *available at* http://www.sigtarp.gov/reports/congress/2010/October2010_Quarterly_Report_to_Congress.pdf.

[6] MBA National Delinquency Survey, August 2010 [hereinafter "MBA National Delinquency Survey"]. The combined percentage of loans in foreclosure or at least one payment past due was 13.7 percent on a non-seasonally adjusted basis.

[7] First American Core Logic Negative Equity Report Q22010, *available at* http://www.corelogic.com/uploadedFiles/Pages/About_Us/ResearchTrends/CL_Q2_2010_Negative_Equity_FINAL.pdf.

[8] Rod Dubitsky, Larry Yang, Stevan Stevanovic and Thomas Suehr, *Foreclosure Update: over 8 million foreclosures expected*, Credit Suisse (Dec. 4, 2008) (projecting 10 million foreclosures by 2012 depending on current unemployment rates); Jan Hatzius and Michael A. Marschoun, *Home Prices and Credit Losses:*

Projections and Policy Options, Goldman Sachs Global Economics Paper (Jan. 13, 2009) (projecting 13 million foreclosures by 2014) at 16.

[9] *Supra* note 2.

[10] For methodology, *see* Center for Responsible Lending, "Soaring Spillover: Accelerating Foreclosures to Cost Neighbors $502 Billion in 2009 Alone; 69.5 Million Homes Lose $7,200 on Average; Over Next Four Years, 91.5 Million Families to Lose $1.9 Trillion in Home Value; $20,300 on Average" (May 2009), *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/soaring-spillover-3-09.pdf.

[11] Center for Responsible Lending, *Continued Decay and Shaky Repairs: The State of Subprime Loans Today* (Jan. 8, 2009), *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/continued_decay_and_shaky_repairs.pdf.

[12] G. Thomas Kingsley, Robin Smith, & David Price, *The Impact of Foreclosures on Families and Communities*, The Urban Institute (May 2009), at 21, Fig. 3.

[13] D. Pelletiere, "Renters in Foreclosure: Defining the Problem, Identifying Solutions," National Low-Income Housing Coalition (Jan. 2010), *available at* http://dsl-router.nlihc.org/doc/renters-in-foreclosure.pdf.

[14] The "Helping Families Save Their Home Act of 2000," signed into law by President Obama in May 2009, provided that month-to-month tenants must receive 90 days' notice before having to move out and that tenants with leases may stay until the end of their lease (unless the owner plans to occupy the property, in which case tenants still must receive 90 days notice).

[15] Also, many tenants are not aware of their right to stay in their homes, and when they receive a notice from a bank lawyer naming their landlord and seeking eviction, they leave regardless of their legal rights. *See, e.g.,* Testimony of Deborah Cuevas Hill, The Legal Aid Society of the District of Columbia, before the Committee on Public Services and Consumer Affairs, Council of the District of Columbia (May 28, 2009), *available at* http://www.legalaiddc.org/issues/documents/TestimonyreTOPALegilsation.pdf.

[16] "Meeting Multifamily Finance Housing Needs During and After the Crisis: A Policy Brief," Joint Center for Housing Studies, Harvard University (Jan. 2009), *available at* http://www.jchs.harvard.edu/publications/finance/multifamily_housing_finance_needs.pdf.

[17] *Id.*

[18] It is popular, although incorrect, to blame the Community Reinvestment Act (CRA) and Fannie Mae and Freddie Mac (the GSEs) for the foreclosure crisis. For a complete discussion of why CRA and the GSEs did not cause the crisis, *see* Testimony of Eric Stein, Center for Responsible Lending, before the Senate Committee on Banking (Oct. 16, 2008), *available at* http://www.responsiblelending.org/mortgage-lending/policy-legislation/congress/senate-testimony-10-16-08-hearing-stein-final.pdf.

[19] These were loans with the following characteristics: debt-to-income ratios lower than 41%; fixed rate or loans with at least a 7 year fixed period; a term of 30 years or less; no balloon payments; no interest-only or negative amortization loans; full income documentation; and either an LTV under 80% or, if LTV above 80%, with mortgage insurance.

[20] Vertical Capital Solutions, Historical Performance of Qualified vs. Non-Qualified Mortgage Loans (February 2010) (on file with CRL).

[21] Rick Brooks and Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy: As Housing Boomed, Industry Pushed Loans To a Broader Market,* Wall Street Journal at A1 (Dec. 3, 2007).

[22] Letter from Coalition for Fair & Affordable Lending to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner (Jan. 25, 2007) at 3.

[23] *See e.g.*, Yuliya Demyanyk, "Ten Myths About Subprime Mortgages," Economic Commentary, Federal Reserve Bank of Cleveland (May 2009) *available at* http://www.clevelandfed.org/research/commentary/2009/0509.pdf; Karen Weaver, "The Sub-Prime Mortgage Crisis: A Synopsis," Deutsch Bank (2008) *available at* http://www.globalsecuritisation.com/08_GBP/GBP_GSSF08_022_031_DB_US_SubPrm.pdf (concluding that subprime mortgages "could only perform in an environment of continued easy credit and rising home prices).

[24] Lei Ding, Roberto G. Quercia, Janneke Ratcliff, and Wei Li, "Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models," Center for Community Capital, University of North Carolina at Chapel Hill (Sept. 13, 2008), *available at* http://www.ccc.unc.edu/abstracts/091308_Risky.php.

[25] Center for Responsible Lending, *Steered Wrong: Brokers, Borrowers and Subprime Loans* (April 8, 2008), *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/steered-wrong-brokers-borrowers-and-subprime-loans.pdf.

[26] *Id.*

[27] R.B. Avery, G.B. Canner, and R.E. Cook, Summer 2005. "New Information Reported under HMDA and Its Application in Fair Lending Enforcement," Federal Reserve Bulletin (available at http://www.federalreserve.gov/pubs/bulletin/2005/summer05_hmda.pdf); R.B. Avery, K.P. Brevoort, and G.B. Canner, September 2006. "Higher-Priced Home Lending and the 2005 HMDA Data," Federal Reserve Bulletin (available at http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf); R.B. Avery, K.P. Brevoort, and G.B. Canner, December 2007. "The 2006 HMDA Data" Federal Reserve Bulletin (available at http://www.federalreserve.gov/pubs/bulletin/2007/pdf/hmda06final.pdf); R.B. Avery, K.P. Brevoort, G.B. Canner, December 2008. "The 2007 HMDA Data", Federal Reserve Bulletin (available at http://www.federalreserve.gov/pubs/bulletin/2008/pdf/hmda07final.pdf); R.B. Avery, K.P. Brevoort, G.B. Canner, September 2009, "The 2008 HMDA Data", forthcoming in Federal Reserve Bulletin (available at http://www.federalreserve.gov/pubs/bulletin/2009/pdf/hmda08draft2.pdf). *See also* Debbie Gruenstein Bocian, Keith Ernst and Wei Lee, "Race, Ethnicity and Subprime Loan Pricing." Journal of Economics and Business, Vol. 60, Issues 1-2, January-February 2008, at 110-124; Debbie Gruenstein Bocian and Richard Zhai, "Borrowers in High Minority Areas More Likely to Receive Prepayment Penalties on Subprime Loans,"January 2005, available at http://www.responsiblelending.org/mediacenter/press-releases/archives/rr004-PPP_Minority_Neighborhoods-0105.pdf

[28] *Supra* note 2, at 3.

[29] Debbie Gruenstein Bocian, Peter Smith, Ginna Green and Paul Leonard, Center for Responsible Lending, *Dreams Deferred: Impacts and Characteristics of the California Foreclosure Crisis* (Aug. 2010), *available at* http://www.responsiblelending.org/california/ca-mortgage/research-analysis/dreams-deferred-CA-foreclosure-report-August-2010.pdf.

[30] According to the 2007 Survey of Consumer Finance, the median net worth for white, non-Hispanic families in 2007 was $171,200, compared to $28,300 for families of color. *See* Table 4 of the Survey of Consumer Finance (Tables based on Internal Data, Estimates in Nominal Dollars), *available at* http://www.federalreserve.gov/PUBS/oss/oss2/2007/scf2007home.html.

[31] Similarly, the "cure" rate – the rate at which homeowners who are behind on their mortgages catch up rather than default – has plummeted to an astonishing 6.6 percent. *See* Fitch Ratings, Delinquency Cure Rates Worsening for U.S. Prime RMBS (Aug. 24, 2009).

[32] Laurie Goodman, Roger Ashworth, Brian Landy, Ke Yin, *Negative Equity Trumps Unemployment in Predicting Defaults,* Amherst Mortgage Insight, Amherst Securities Group (Nov. 23, 2009).

[33] Based on MBA Delinquency Survey for 2010 Q2, adjusted to reflect MBA's estimated 88% market coverage.

[34] See Hope Now August Data Report, *available at* http://www.hopenow.com/industry-data.php.

[35] *Supra* note 3.

[36] *See e.g. In re Ocwen Loan Servicing, LLC Mortg. Servicing Litigation,* 491 F.3d 638 (7th Cir. 2007) (allegations by a class of homeowners that Ocwen systematically charged late fees for payments that were sent on time); *Federal Trade Commission (FTC) Settlement* (2003) resulted in $40 million for consumers harmed by illegal loan servicing practices, *available at* http://www.ftc.gov/fairbanks (FTC alleged, among other things, that Fairbanks illegally charged homeowners for "forced placed insurance" and violated the Fair Debt Collection Practices Act); and *FTC Settlement with Countrywide, available at* http://www.ftc.gov/countrywide (Countrywide agreed to pay $108 million dollars to homeowners in response to the FTC's allegations that Countrywide charged illegal fees to homeowners during Chapter 13 bankruptcy proceedings).

[37] For a thorough discussion of the servicing incentive structure, see Testimony of Diane Thompson before the Senate Banking Committee (Nov. 16, 2010), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=df8cb685-c1bf-4eea-941d-cf9d5173873a&Witness_ID=d9df823a-05d7-400f-b45a-104a412e2202 ; *see also* Diane Thompson, "Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior," National Consumer Law Center (Oct. 2009), *available at* http://www.nclc.org/images/pdf/foreclosure_mortgage/mortgage_servicing/servicer-report1009.pdf.

[38] The Center for Responsible Lending is serving as co-counsel in several cases relating to these issues, including a Maine class action filed against GMAC Mortgage, *Archibald et al v. GMAC Mortgage, LLC* (Civil Action, Docket CV-2010-494, Cumberland County Superior Court).

[39] Testimony of Adam Levitan before the Senate Banking Committee (Nov. 16, 2010), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=df8cb685-c1bf-4eea-941d-cf9d5173873a&Witness_ID=2ada1da6-e7cc-4eca-99a4-03584d3748af

[40] As Lewis Ranieri, founder of Hyperion Equity Funds and generally considered "the father of the securitized mortgage market," has recently noted, such relief is the only way to break through the problem posed by second mortgages. Lewis S. Ranieri, "Revolution in Mortgage Finance," the 9th annual John T. Dunlop Lecture at Harvard Graduate School of Design, Oct. 1, 2008, *available at* http://www.jchs.harvard.edu/events/dunlop_lecture_ranieri_2008.mov (last visited Feb. 24, 2010).

[41] Mark Zandi, "Homeownership Vesting Plan," Moody's Economy.com (Dec. 2008), *available at* http://www.dismal.com/mark-zandi/documents/Homeownership_Vesting_Plan.pdf.

[42] Blackrock, the world's largest asset manager, supports using bankruptcy courts to address the need for principal reduction. Bloomberg News, *BlackRock Cramdown Plan,* American Banker (Jan. 22, 2010), *available at* http://www.americanbanker.com/syndication/blackrock-cramdown-plan-1006339-1.html. In April 2010, Bank of America joined Citi in support of this measure as well, so two of the four largest banks now support it. Barbara Desoer, President, Bank of America Home Loans, Hearing Before the Committee

on Financial Services, U.S. House of Representatives, 111th Congress, Second Session, April 13, 2010, transcript *available at* http://financialservices.house.gov/Media/file/hearings/111/Printed%20Hearings/111-120.pdf. Citi reaffirmed its support at this same hearing.

[43] Thomas J. Fitzpatrick IV and James B. Thomson, "Stripdowns and Bankruptcy: Lessons from Agricultural Bankruptcy Reform" (8/3/10), *available at* http://www.clevelandfed.org/research/commentary/2010/2010-9.cfm.

[44] In the Senate Senator Jack Reed also introduced legislation that would mandate loss mitigation (S. 1431).

[45] With a well developed system for making, tracking, and evaluating grants for foreclosure legal assistance, IFLA would be well positioned to assist HUD in administering this funding. IFLA is funded through the Center for Responsible Lending and administered by the National Association of Consumer Attorneys.

[46] Shockingly, the Treasury Department has concluded that HHF funds can be used for housing counselors but not for attorneys. While an interpretation of EESA that denies its use for either purpose may be colorable, there is no credible reason for funding one but not the other.

[47] National Taxpayer Advocate, *2008 Annual Report to Congress*, at 341, 391-96.

[48] The legislation defined "qualified mortgage debt" to include only that debt that was used to purchase a home or make major home improvements. In calculating the tax, any unqualified debt is first subtracted in its entirety from the amount of forgiven debt (not on a pro rata basis). In many cases, the amount of unqualified debt will equal or exceed the amount of debt forgiven, leaving the homeowner to pay tax on the entire forgiven debt – and even in those cases where the amount forgiven exceeds the amount of unqualified debt, the homeowner will still owe tax.

[49] To take advantage of the mortgage debt exclusion, a homeowner now has to file a long-form 1040 (not a 1040EZ) along with a Form 982. Unfortunately, most lower and middle income taxpayers are not accustomed to using these forms, and taxpayers filing long-form 1040s are not eligible to use the various tax clinics offered by the IRS and others for lower-income taxpayers.

[50] *Supra* Note 44 at 394.

[51] Pub. L. No. 111-203, Title X, §§ 1025(e); 1029A. Six of the top ten servicers, as ranked by Mortgage Servicing News, appear to be subject to the OCC's primary supervision.

[52] NY and NC in particular.

[53] HAMP Servicer Performance Report Through September 30, 2010, *available at* http://www.financialstability.gov/docs/SeptemberMHAPublic2010AugustMHAPublic2010.pdf. Although at one point more than a million homeowners had a trial modification under HAMP, the number of homeowners who have fallen out of trial mods (nearly 700,000) now far exceeds the number who have permanent modifications.

[54] There has been some back and forth among Treasury, SIGTARP, and Congress concerning the numerical goals of HAMP, and the current Treasury assertion is that they promised only to "offer assistance" to that many homeowners. While it is clear that language suggests that they do not anticipate 3-4 million borrowers actually obtaining a HAMP mod, it is not clear exactly what it does suggest.

[55] The HAMP report itself contains a chart indicating that as of August 31, only 1.3 million borrowers are even eligible for HAMP under its current guidelines and that number is only likely to decline as we see continued high unemployment. http://www.financialstability.gov/docs/AugustMHAPublic2010.pdf

[56] There were 468,058 permanent HAMP modifications and 3,213,594 proprietary modifications, although it is not clear whether these proprietary modifications were temporary or permanent. See Hope Now August 2010 Data Report, available at http://www.hopenow.com/industry-data/HOPE%20NOW%20Data%20Report%20(August)%2010-05-2010%20v2b.pdf.

[57] According to attorneys who are part of the Institute for Foreclosure Legal Assistance network, servicers often promise borrowers a speedier resolution if they choose a proprietary modification.

[58] The Office of the Homeowner Advocate is contained in S. 3793, the Job Creation and Tax Cuts Act of 2010, introduced by Senator Max Baucus (D-MT); "Franken Homeowner Advocate Amendment Passes" (June 15, 2010), *available at* http://senatus.wordpress.com/2010/06/15/franken-homeowner-advocate-amendment-passes/

[59] One Pennsylvania bankruptcy judge has recently provided troubling details of how "communications" between servicers and their outside law firms take place almost entirely through automated systems without any human interaction. *In re Taylor*, 407 B.R. 618 (E.D. Pa. 2009). That judge concluded, "The thoughtless mechanical employment of computer-driven models and communications to inexpensively traverse the path to foreclosure offends the integrity of our American bankruptcy system."

[60] As of April 2010, all applications must now be fully documented.

[61] First American Core Logic, *supra* note 8.

[62] "Factors Affecting the Implementation of the Home Affordable Modification Program", SIGTARP (March 25, 2010), *available at* http://www.sigtarp.gov/reports/audit/2010/Factors_Affecting_Implementation_of_the_Home_Affordable_Modification_Program.pdf

[63] Although many decry the phenomenon of "walkaways," when people voluntarily default on their mortgages, there are actually far fewer such walkaways than economic theory might predict. *See, e.g.*, Roger Lowenstein, *Walk Away from your Mortgage!*, New York Times (Jan. 10, 2010) (noting that it would be economically rational for more people to walk away from their mortgages). However, it is clear that at some level, the disincentive of being underwater will have an impact on the homeowner's success in continuing with the mortgage.

[64] Andrew Haughwout, Ebiere Okah, and Joseph Tracy, *Second Chances: Subprime Mortgage Modification and Re-Default,* Federal Reserve Bank of New York Staff Report (Dec. 2009).

[65] *See, e.g.,* Amherst Study *supra* note 1; Shawn Tully, *Lewie Ranieri Wants to Fix the Mortgage Mess*, Fortune Magazine (Dec. 9, 2009); "Analysis of Mortgage Servicing Performance, Data Report No. 4, Jan. 2010, State Foreclosure Prevention Working Group, at 3.

[66] Most Pooling and Servicing Agreements require the servicer to act in the best interest of the investors as a whole, but those obligations have been honored mainly in the breach.

[67] SIGTARP, *supra* note 3.

[68] http://www.businessinsider.com/average-duration-of-unemployment-in-july-2010-8.

[69] HAMP Supplemental Directive 10-15, *available at* https://www.hmpadmin.com/portal/programs/docs/hamp_servicer/sd1015.pdf.

[70] It should be noted that other government agencies and certain outside researchers appear to have access to some or all of the data, suggesting that it is time to make it available more widely.

[71] U.S. Department of Housing and Urban Development, Mortgagee Letter 2010-04, Loss Mitigation for Imminent Default (January 22, 2010), *available at* http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/10-04ml.pdf (Loss Mitigation is critical to both borrowers and FHA because it works to fulfill the goal of helping borrowers retain homeownership while protecting the FHA Insurance Fund from unnecessary losses. By establishing early contact with the borrower to discuss the reason for the default and the available reinstatement options, the servicer increases the likelihood that the default will be cured and the borrower will be able to retain homeownership.)

[72] *E.g.*, Maryland HB 472 (2010), *available at* http://mlis.state.md.us/2010rs/bills/hb/hb0472f.pdf (Maryland homeowners deemed ineligible for relief from their lender then have the option to participate in the court-administered foreclosure mediation program.).

[73] *See, e.g.*, NYS Banking Department, Part 419 of the Superintendent's Regulations, at 419.11 (effective October 1, 2010), *available at* http://www.banking.state.ny.us/legal/adptregu.htm (Servicers shall make reasonable and good faith efforts consistent with usual and customary industry standards and paragraph (b) of this section to engage in appropriate loss mitigation options, including loan modifications, to avoid foreclosure.).

COMMITTEE ON

FINANCIAL SERVICES

Hearing - Housing and Community Opportunity

Robo-Signing, Chain of Title, Loss Mitigation and Other Issues in Mortgage Servicing

Testimony of

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Testimony of

Linda E. Fisher
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Before the Subcommittee on Housing and Community Opportunity,
House Financial Services Committee

Hearing on Robo-Signing, Chain of Title, Loss Mitigation & Other Issues

November 18, 2010

Thank you for providing me the opportunity to participate in this hearing. I am a law professor and attorney with expertise in the areas of predatory lending, foreclosure defense and other public interest litigation. I also teach civil procedure and professional responsibility. With the assistance of law students in my Civil Litigation Clinic, I have been involved in predatory lending, mortgage fraud, and foreclosure litigation for over ten years. The Clinic's clients are low and moderate income residents of urban North Jersey. In addition, I work closely with the Newark/Essex Foreclosure Task Force, a coalition of government and nonprofit agencies addressing the foreclosure crisis in the greater Newark, New Jersey area.

My testimony focuses primarily on the relationship between faulty foreclosure practices and fraud, as well as on the consequences for homeowners and neighborhoods. I describe the steps in a judicial foreclosure in which robo-signing problems can occur. I also draw links between widespread origination fraud in subprime lending, opportunistic fraud such as foreclosure rescue scams, and the assembly-line foreclosures – often involving illegalities – that are further destabilizing urban communities. I will provide examples from my own cases as well as from lawyers and housing counselors with whom I work. In many of these instances, homeowners were induced and duped into taking out loans they could not afford, or they were defrauded of title to their homes by foreclosure rescue scammers.

The current crisis is exacerbating the disparities between poor and wealthy families and neighborhoods, in part because vacant foreclosed properties depress property values and facilitate crime.[1] Widespread foreclosures invite further opportunistic fraud and increase inequality between urban minorities and the rest of the country. [2] Additional regulation and enforcement of existing law are necessary, but perhaps the most critical need is for serious mortgage modifications allowing homeowners who can make reasonable mortgage payments to remain in their homes. Absent realistic modifications, many hard-working, law-abiding homeowners --who may have been victims of fraud, illegal fee padding, or inaccurate accounting -- will lose their homes, uprooting their families in the process.

First, what is "robo-signing"? While this newly coined phrase is hardly a term of art, it generally refers to the practice of servicer employees signing high volumes of affidavits in foreclosure cases[3] with false attestations that they have personal knowledge of the facts recounted and that they have reviewed supporting documentation.[4] These affidavits can violate state false swearing and unfair and deceptive acts and practices

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[1] Studies have documented the relationship between vacant and abandoned foreclosed properties, depressed property values, and increased crime in neighborhoods with high rates of foreclosures. *See* Dan Immergluck, *Intrametropolitan Patterns of Foreclosed Homes*, Community Affairs Discussion Paper, Federal Reserve Bank of Atlanta (2009).

[2] *See* Linda E. Fisher, *Reverse Redlining, Racialized Consumer Fraud and Target Marketing of Subprime Loans,* 18 Brooklyn J. of L. & Pol'y. 101 (2009).

[3] Twenty-three states, including New Jersey, have a judicial foreclosure process in which evidence must be submitted to a court, and judgment entered, before a foreclosure sale can take place.

[4] For a further description of the problem and its potential consequences, *see* the report of the Congressional Oversight Panel released this past Tuesday. *November Oversight Report: Examining the Consequences of Mortgage Irregularities for Financial Stability and Foreclosure Mitigation*, Nov. 16, 2010.

statutes, as well as the due process rights of homeowners. When an attorney is involved, court rules requiring an evidentiary basis for all filed submissions may be violated. For instance, an affidavit may falsely state that a homeowner has been served with process, that the foreclosure plaintiff is the holder of the mortgage obligation, that an assignment of a mortgage and note timely took place, or that inflated amounts are owed to the lender. When the plaintiff is not the party entitled to foreclose because the wrong party was named or because the plaintiff trust did not hold the obligation at the time of filing, it does not have standing and is not entitled to judgment.[5]

Yet every day foreclosures proceed to judgment because a court relied on a plaintiff's inaccurate attestations.[6] For the past several years, I have been involved in cases in which the wrong entity filed a foreclosure because of a documentation error, while alleging that it held the note and owned the mortgage. I have been involved in many additional cases in which plaintiffs erroneously attested that a mortgage and note were timely assigned into a trust, when the assignments and transfers actually occurred after default and after the foreclosure case was filed, depriving the plaintiff of standing. Without representation, it is unlikely that these errors would ever have been discovered, as courts frequently lack the resources to closely scrutinize all submissions. However, homeowners generally are unable to contest and raise defenses in foreclosure because they cannot afford counsel. For instance, until recently, well over 90% of New Jersey foreclosure defendants were unrepresented; that figure has declined only a little in the past year. Providers of legal services to the indigent are overwhelmed with requests for assistance and can represent only a fraction of the people seeking their assistance with foreclosures. It is likely that many of these unrepresented borrowers are losing their homes because of servicer errors.

These violations are serious in themselves and far from technical, yet robo-signing and other false attestations are only the tip of the foreclosure iceberg. The iceberg

[5] I will not go into detail concerning the various chain of title issues that can arise when a securitized trust attempts to foreclose because others have already described these issues at some length. The November Congressional Oversight Panel report provides a comprehensive and accurate description of the problems.

[6] A colleague calls these widespread practices "servicer civil disobedience."

includes the entire servicing and default servicing system, with its rampant inaccuracies, lack of verification procedures and lack of accountability. Automation, cost-cutting, and financial incentives to foreclose have combined to create a treadmill that cannot stop to rectify errors or modify mortgages so that qualified homeowners can remain in their homes and investors can continue to receive a stream of income. I have repeatedly been told by counsel for foreclosure plaintiffs that even they are unable to contact their servicer clients to request reasonable settlements in cases. I also have tried in vain to reach servicers on behalf of my clients, only to end up in a loop of endless telephone transfers to equally ineffectual employees after our paperwork was lost repeatedly. Much less are housing counselors able to stop the "left-hand, right-hand problem" in which foreclosures proceed even after mortgage modification agreements have been reached. This problem is quite common both in New Jersey and across the country.

Origination and opportunistic foreclosure fraud – frequently occurring during the peak subprime lending years of 2004 to 2007 -- are another piece of the subprime foreclosure iceberg, since fraudulent loans tend to end up in assembly-line foreclosures with little hope of redress. The securitization machine that originated so many fraudulent loans is the same machine that now forecloses even when reasonable alternatives may be available. In the rush to originate new subprime and Alt-A mortgages to distribute to securitizations – whose demand for these products was seemingly insatiable -- lenders abandoned strict underwriting standards in favor of "low-doc" and "no-doc" underwriting. The lack of verification procedures and failure to investigate telltale signs of fraud allowed many fraudulent originations to occur, particularly in wholesale lending channels involving mortgage broker originations, where fraud was known to be rampant. Myriad types of fraud occurred during this period. In my own practice, I have frequently seen false mortgage applications prepared and submitted by brokers and loan officers – with little input from the clients and sometimes with forged signatures – that vastly overstate the clients' income and assets, and sometimes list false employment.[7] Inflated appraisals have been near universal in the cases I have litigated. Where borrowers in these cases can

[7] Such practices were widespread during the peak subprime lending years. Abuses by Ameriquest, Household Finance, and Countrywide have been particularly well-documented, though many other entities were involved as well.

make reasonable monthly payments, servicers should pursue reasonable alternatives to foreclosure, even if principal writedowns are required to bring the loan into line with actual market value.

Various types of foreclosure rescue scams were also commonplace during the peak lending years. Lenders frequently provided funding for rescue scams in which desperate homeowners facing foreclosure were duped into "temporarily" signing over title to their homes to a straw buyer with decent credit.[8] In return, they received assurances that the buyer would obtain and pay a new mortgage, while the former owners could remain in the property and pay rent, with an option to repurchase the home once they improved their credit. Despite the existence of common red flags indicating a scam, the straw buyers were able to take out new loans, which they almost universally stopped paying before disappearing, rapidly causing a new foreclosure. Yet because the loans were securitized, existing financial incentives encouraged such behavior. The same cost-cutting, profit making system that produced robo-signing facilitated and enabled these frauds.

We currently have a case in which the former homeowners paid a straw buyer in full for a year and a half, only to have her default and disappear. They have intervened in the foreclosure action against the straw buyer to assert their own claims and defenses.[9] These clients continue to make full payments into an escrow account while the litigation proceeds. In another current case, an elderly, disabled woman who had owned her home for forty years was duped into signing it over to a rescue scammer. After two strokes, her cognitive capacities were impaired, making her easy prey. She and her family can now make reasonable mortgage payments and pay off the arrears under a reasonable installment plan if one were offered. Similar stories abound. A common feature of all is

[8] For an explanation of these scams and how a foreclosure court can address them, *see* Linda E. Fisher and Leena Khandwala, *Foreclosure Rescue Scams***,** Real Estate Financing Treatise, Matthew Bender Pub. 592, release 91 (2010), available on Lexis.

[9] Securitized trusts may be liable for the originator's actions if they are not holders in due course.

that the straw buyers were easily able to obtain new mortgages despite indications of underlying fraud. Another common feature is that these homes end up in foreclosure. [10]

Any policy solution to the foreclosure crisis must take borrowers' rights and situations into account, as well as the rights of lenders and concerns for the broader housing market and national economy. Banks should be required to engage in serious mortgage modification efforts before foreclosing, even if principal writedowns are required. Servicers must be subject to meaningful federal regulation. In the short term, independent monitors and auditors should be appointed to investigate the servicer practices that have contributed so heavily to the current crisis.

[10] Another common scam involves credit repair and mortgage modification operations that promise to assist homeowners with saving their homes, generally for an upfront fee of about $3000. Lawyers frequently are involved. After obtaining the fee, the scammers disappear, leaving the borrowers in even worse shape than they were before being scammed. As an example of how common these scams are, without my mentioning the type of work I do, a D.C. cabdriver told me last week that he was the victim of such a scam. Clients of mine have also been scammed in this fashion, as have many others in the greater Newark area and across the country. A lack of serious opportunity to modify mortgages contributes to the proliferation of these scams.

COMMITTEE ON

FINANCIAL SERVICES

Hearing - Housing and Community Opportunity

Robo-Signing, Chain of Title, Loss Mitigation and Other Issues in Mortgage Servicing

TESTIMONY OF

ANNE ANASTASI

ON BEHALF OF

THE

AMERICAN LAND

TITLE ASSOCIATION

AMERICAN
LAND TITLE
ASSOCIATION

TESTIMONY OF ANNE ANASTASI
ON BEHALF OF THE
AMERICAN LAND TITLE ASSOCIATION

"Robo-Signing, Chain of Title, Loss Mitigation, and Other Issues in Mortgage Servicing."

Thursday, November 18, 2010
10:00 a.m.

HOUSE FINANCIAL SERVICES SUBCOMMITTEE ON
HOUSING AND COMMUNITY OPPORTUNITY

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My name is Anne Anastasi and I am the President of Genesis Abstract, LLC in Hatboro, Pennsylvania. I have been in the land title insurance industry for 33 years, and I hold Pennsylvania's Certified Land Title Professional designation, which is the highest designation available in the title industry.

I am the current President of the American Land Title Association. ALTA, founded in 1907, is the national trade association and voice of the real estate settlement services, abstract and title insurance industry. ALTA's over 3,800 member companies operate in every county in the country, where we search, review and insure land titles to protect buyers and mortgage lenders who invest in real estate. ALTA members serve as independent, third-party facilitators of real estate transactions. We do not represent the borrower, lender, seller or any other party in a transaction. ALTA members include title insurance companies, title agents, independent abstracters, title searchers and attorneys, ranging from small, one-county operations, to large, national title insurers.

On behalf of ALTA, I appreciate the opportunity to appear before you today and to discuss how improper foreclosure practices by our nation's lenders affect the process of transferring real property in the United States.

The United States Real Property Transfer System

Internationally respected economist Hernando de Soto said, "Westerners take [their land ownership system] so completely for granted that they have lost all awareness of its existence." I agree with Mr. de Soto, and to help change that observation, I am going to discuss our system of land ownership so that we may better understand the effects of foreclosure irregularities and deficient documents on housing markets, mortgage finance and property rights.

Mr. de Soto's research finds that systemic poverty in poor countries results from the absence of a formal property rights structure. De Soto argues that economic success in America relies on a clear system of property rights which was developed to meet land owners' needs over the course of American history. This legal system is the basis for economic activity, entrepreneurship and the creation of wealth and capital. De Soto holds,

> You are able to hold, transfer, assess and certify the value of such assets only through documents that have been legally authenticated by a global system of rules, procedures and standards. Ensuring that the relationship between those documents and each of the independent assets they represent is never debased requires a formidable system of legal property

rights. That system produces the trust that allows credit and capital to flow and markets to work[1].

The United States' property transfer system, governed by local public records, provides our economy with the legal underpinning to make homeownership possible. The land title industry fosters the trust necessary in these records so that equity in real property can be exchanged for mortgage credit. This trust, which is taken for granted in our country, is fundamental to our economy and extraordinary to the rest of the world.

For centuries, this public recording structure has provided transparency, efficiency, and security that is unimaginable in countries where numerous steps and government approval is required before real property can be conveyed from one owner to the next. Our system of land transfer has a relatively short settlement transaction time and provides individuals strong protection of their property rights, saving borrowers and sellers money. It is our system and the confidence that consumers and creditors can have in the work of land title and settlement service professionals, which allows the United States to have the strongest real property transfer system in the world.

What is Title?

The "ownership" of real estate involves the interest in a bundle of rights relating to the use of, and disposition of real property. This concept is called title, and these rights can be transferred individually or together. Prior owners may have created interests in a property or suffered liens against a property that will affect the interests acquired by a new purchaser. Potential buyers need to know which rights have been removed from or added to the bundle as this will affect the use of the land, and as a result, its value.

Some rights can be removed from the title bundle voluntarily. That is, the owner may agree to sell, give away, or otherwise forfeit a right. Rights that can be voluntarily removed from a bundle include:

1) Rights to natural resources, such as water or timber on the property;
2) Subsurface rights to other natural resources, including mineral and oil rights; and,
3) Air rights, such as the right to construct a building above a certain height.

In addition, rights that can be voluntarily granted and added to the bundle include:

1) Easements to utility companies;

[1] De Soto, Hernando. "TOXIC Paper: The Obama administration must tackle a problem that has bedeviled the emerging markets for years." Newsweek Mar 2, 2009.

2) Joint use agreements, such as common driveways and party walls;
3) Life estates, in which one party other than the owner retains the right to use and occupy a property for the rest of his or her life;
4) Reversionary rights, where title passes back to a previous owner if property ceases to be used for purposes other than those for which it was deeded;
5) Restrictive covenants, in which private parties agree to limit uses of a property – for instance, property restricted to residential use only; and,
6) The rights of consensual lien holders, those who obtain rights through other voluntary agreements, deeds of trust or mortgage for instance.

Other rights may be legally removed regardless of a property owner's wishes as ordered by local, state or the federal governmental authorities and courts. Typical involuntary removal of rights might include:

1. Continued ownership if taxes go unpaid;
2. Bankruptcy court order, forcing the owner to sell land rights to pay off debts;
3. Money judgments, awarded by the courts in civil suits that could result in a foreclosure;
4. Eminent domain, giving the government the right to take land by condemnation for official use or for use by the public;
5. Divorce, allowing courts to divide marital property between the owners or for payment of child support;
6. Mechanics liens, imposed in cases where construction or other types of work have been performed on the property and the contractor hasn't been paid;
7. Zoning laws, imposed by government to prohibit all but a single use of the property;
8. Health and environmental regulations, subdivision, or condominium regulations and flood control requirements may be imposed, forcing the owner to give up certain property rights; and,
9. Improvements from an adjacent property may encroach or intrude on real estate.

In time, a parcel of land may have a number of important rights missing from the bundle which could cause a potential buyer to reconsider the value of the property or their purchase.

How Does our System Evidence Which Rights are Included in Title?

Public records document the history of title and reveal the rights that have been removed or added. In our country, real property is conveyed by a private contract – most commonly called a deed. This document is recorded in the county land records to give notice to the public that the property's ownership rights have been transferred. Generally, under state law, courts will not enforce or protect individuals' property rights unless those rights have been recorded in the land records.

As we hear about document irregularities and question the validity and credibility of foreclosures, it is important to make the distinction that the reported problems are in areas of due process. To appreciate whether errors in foreclosure documentation extend to public records and what can be discovered in the preparation of a title insurance policy, one must understand what documents are included in the public record and what documents are not included in the public record.

When a consumer purchases a home and finances their purchase with a mortgage loan, there are three main documents that are executed to transfer title. The first document is a deed, which conveys ownership from one party to another and is recorded on the public record. The deed is a private contract, separate from the purchase contract, and it must contain certain legally-required provisions including: a legal description of the property, a statement describing the rights being sold, and the purchase price. The deed must be signed by the sellers and acknowledged by a notary public. Public recording of the deed allows consumers to protect their property rights, including the right to possess the property against challenge from a subsequent or prior unrecorded claimant to the property.

The second document is the mortgage, also called a deed of trust, which is also recorded into the public record. A mortgage is a lien on the property that notifies the public that there is a mortgage loan outstanding that gives the lender the right to sell the property in order to satisfy payment of a debt. Liens and lien priority are hallmarks of our property rights system. Lien priority is the legal structure that determines which creditor has the right to be paid in which order if a property must be sold to satisfy payment of a debt. This structure assures creditors of their rights when property is used as collateral for payment of a debt. Creditors lending money to finance the purchase of real property require that they will have the first right (lien priority) to foreclose upon the property in the event of default. To do this, the borrower is required to execute a mortgage (or deed of trust), which grants the creditor the right to foreclose upon and sell the property if the borrower defaults on their mortgage obligation. This mortgage is recorded in order to secure the priority of the lender's lien.

The third document is a promissory note, which identifies the principal, interest rate, repayment schedule and other terms of the loan. The note is not publicly recorded for a number of reasons – most importantly to protect the purchaser's right to privacy.

The Need for Land Title Services

Before a transaction can be completed, buyers, sellers and mortgage creditors depend on the land title industry to research the public record in order to determine which rights have been removed from the title bundle. In any real estate transaction, the buyer needs to be certain that they will ultimately be acquiring ownership of the property subject only to those liens and encumbrances that they know to exist and are willing to accept.

The seller signs the deed, which will likely contain a general or special warranty deed, in which the seller provides certain warranties of title to the buyer. Thus, the seller is contractually liable to the buyer if those title warranties are not accurate. Therefore, the seller has an interest in ensuring that the title transferred to the buyer will not be subject to any potential claims that could trigger liability under those warranties.

The mortgage lender is willing to provide financing for the transaction on the condition that the buyer, in fact, will own the property and that the mortgage lender will obtain a valid and enforceable first mortgage lien that is not subject to any other lien or claim that could adversely affect that mortgage interest. While various approaches have been used in the history of the United States to provide these assurances, since the late 19th century, the gold standard by which buyers, sellers, and lenders obtain these assurances is by purchasing a title insurance policy. To understand the reasons why this has come to be the standard, one must first understand title insurance, its value and how it satisfies important market demands.

The need for land title services has become especially acute as real estate transactions became more complex in the last half of the 20th century. In a market where land transfer is so complicated, buyers need to know exactly what interests are included in the bundle of rights that convey with the property.

The process to determine title begins when agents or abstractors search the public records for documents showing who owns the land and which rights have been removed from the bundle. By doing this, agents and abstractors build the chain of title or the specific rights the buyer is or is not receiving with the property according to the public records. The agent or abstractor uses these records to compile a title abstract, which is a condensed version of the records they have searched. The abstract lists the history of title as it appears in the public record, but does not offer an opinion or draw any conclusion as to how the rights, or lack thereof, affect title to the land. This is the “title search,” and the information collected is “title evidence.” The length of this process can take as little as a few hours to as many as a few weeks, depending upon the complexity of the title, the accessibility of the land records and available technology.

Having collected the title evidence, individuals experienced in real estate law and title insurance principles examine the title evidence to determine whether the seller has, and can convey, his or her title to the buyer. This evidence discloses the liens and other issues that must be resolved or cured, and discloses exceptions that may have to be included in the policy. It is at this “title examination” stage that the title agent performs one of the most valuable services, which is an inherent part of the title insurance underwriting function: curing defects that may exist on the public record.

The accuracy of public records is extraordinarily important for trust to exist. Land title and settlement service professionals maintain accuracy in our public records by curing defects that are found to the benefit of sellers, buyers, lenders and the public. ALTA’s research has found that curing defects in the public record was necessary in over 35% of all transactions. Curative actions include obtaining releases or pay-offs of discovered liens such as mortgage liens, child and spousal support liens, judgment liens, tax liens, homeowner’s association debts, mechanic liens as well as liens from previous owners that remain on the public record. Curative measures may also include correcting typographical recording and indexing errors in the public record, correcting misspelled names or incorrect legal descriptions.

After the thorough search and examination, a commitment to insure is then sent to the prospective policyholder. The commitment sets forth the conditions that must be met in order for a title insurance policy to be issued, such as additional documents that need to be produced. These documents may include a deed or a new mortgage in favor of the buyer’s lender. The commitment reveals the items that need to be resolved before the policy can be issued, and among others, this might include the payoff of mortgages, judgments, liens, federal and local taxes, municipal bills, and child support debts. Also included in the title commitment are the exceptions to the policy coverage that were found during the title search and examination process. These exceptions include rights that the seller cannot convey, such as the right of utility companies to maintain their lines over the land being conveyed.

If an exception poses a problem for the prospective policyholder, an attempt may be taken by the parties, with the assistance of the title agent, to eliminate those exceptions. If an exception cannot be removed, the title underwriter may be willing to insure over it, either because the title underwriter concludes that the risk of loss or financial damage is small, or because an indemnity or warranty can be obtained from the seller. If an exception cannot be removed and the buyer chooses to proceed with the purchase, the buyer may seek to modify the terms of their purchase contract with the seller or, in an extreme case, decline to proceed with the transaction. Because the title industry has been so effective over time in detecting and clearing titles errors and preserving the integrity of the public records, it is exceedingly rare that a seller's title is so defective as to be uninsurable or unmarketable, and while troubled titles may take a great deal of time and resources to cure, most issues are curable. This track record provides exceptional liquidity to U.S. real estate markets.

The last step in the process involves the closing of the transaction and services conducted after the closing. At the closing or settlement, the relevant deeds, mortgage instruments, and other documents are executed and funds are exchanged through escrow. After the closing, the new deed and mortgage lien are recorded, and then the title insurance policy is issued to the lender and the new owner, if an owner's policy is purchased. Between the time the new deed and mortgage are signed and the time that the new deed and mortgage lien are entered into the index of the public records, a gap may occur. The length of this gap period depends on the efficiency of local jurisdiction's recording office, and if another document is recorded "in the gap," a title agent will simply not have the ability to discover the document. For example, in Fairfax County, Virginia, the gap is almost non-existent. However, at one point in my home state of Pennsylvania, the gap in one locality was over 11 months in length. This is particularly troubling to the title insurance industry because the gap in the time between the closing of the transaction and the recording of documents represents an opportunity for fraudulent activity. The fraud risk arises because a dishonest party could convey the same interest in the property a number of times to different people during this gap period, similar to selling the same widget on eBay to multiple bidders. Title insurance provides coverage against this risk. We protect borrowers, sellers and lenders during this vulnerable period of time in order to ensure that the transaction can go through quickly, safely and efficiently.

An owner's policy insures the purchaser against financial loss or damage that may arise from defects in the title as it is insured, including the assertion of liens and claims against the property that are not otherwise excepted from policy coverage. The policy includes protection against title defects that may be found in public records but were not discovered during the search of those records and against those non-record defects that even the most comprehensive search of the records would not reveal. These risks include, among others:

- fraud or forgery in the execution of documents in the chain of title (in deeds, mortgages, mortgage satisfaction pieces, etc);

- mistakes in interpretation of wills, divorce decrees, bankruptcy court directives and other legal documents;
- the execution of documents by minors or incompetent persons who could not legally convey property interests;
- the existence of undisclosed heirs who did not consent to a prior transfer;
- deeds executed under an expired power of attorney or on behalf of someone who has died; and,
- errors.

The title policy is issued for a one-time fee, paid at the closing, and there are no renewal premiums. The protection of an owner's title insurance policy continues so long as the policyholder or his or her heirs own the insured property, and can protect the policyholder even after they sell the property if the buyer later asserts claims under a warranty deed with regard to matters covered by the policy.

A loan policy insures the lender: 1) that it will have a valid, enforceable lien on the property in accordance with the mortgage interest created by the loan, 2) that the person borrowing the money has title to the property being mortgaged, and 3) that no other claimant, other than those specifically noted in the policy has a prior, superior claim. The policy is in force so long as there is a balance due on the loan and is assignable to a purchaser of the loan in the secondary mortgage market.

Under both policies, the title insurer is obligated to pay for the costs of defending the title as insured against any covered claim. In virtually all areas of the country, if an owner's policy is issued in the transaction, the cost of a loan policy that is "simultaneously issued" with the owner's policy involves a relatively small additional charge to the cost of the owner's policy.

The single most important aspect of the title insurance industry that cannot be overlooked is that we are the independent third party to the transaction whose only interest is to the integrity of the transaction and the protection of our customers. We are the people who handle the funds that come from the borrower and the lender and disburse it to the appropriate parties in the transaction. Our job is to close the transaction equitably, honestly and in accordance with the agreed-upon instructions, and to get the funds into the appropriate hands.

How a Foreclosure Affects the Title Process

The presence of a foreclosure in the chain of title does not alter the title industry's duty to provide title assurance to parties involved in the transaction. However, the ability of the industry to provide that assurance becomes more challenging when the credibility of the foreclosure process is damaged by process and documentation deficiencies. Allegations of affidavit issues, robo-signing, notary irregularities, or incorrectly endorsed or assigned promissory notes are serious, but stakeholders can work together to resolve any uncertainty and restore credibility to the system equitably. After all, everyone has a stake in the outcome.

Regardless of any deficiency in the foreclosure process, fundamental to our understanding of how foreclosure affects title, we must remember that foreclosure in a judicial foreclosure process results from a court issuing a binding order allowing the foreclosure sale to proceed. A court order by a judge has the force of law. The judgment can only be vacated or corrected if one of the parties to the proceeding makes an appeal or other motion. It is not appropriate for, nor does the land title industry have the power to challenge these judgments or act as a check and balance on the court system.

A foreclosure appears in the title search and evidencing process in three ways. First, when the mortgage creditor institutes a foreclosure suit, they file a *lis pendens* in the public records. This gives the public notice that a foreclosure action is pending against the property. Second, the court docket in the foreclosure action, including the final judgment of foreclosure is available for examination. Third, after the foreclosure sale either the sheriff will issue a sheriff's deed to transfer property to the successful bidder at the foreclosure sale or the court clerk will issue a certificate of title. Whichever form of document the evidence of the foreclosure sale takes, the document is entered into the public record. The three documents discussed above give notice to the world that a foreclosure action was instituted, that a sale was ordered by the court and that the sale occurred. What these documents do not show is any problem with the evidence used to secure that foreclosure order.

As we hear about document irregularities and question the validity and credibility of foreclosures, we need to remember that these are due process issues. They are fundamentally about the fairness of the process, but also its outcome. The question raised by recent media reports is whether the foreclosing party properly evidenced their standing to obtain a foreclosure judgment by a court. Standing is an important due process protection, akin to proving one's identity, as it ensures that the party asking a court to take away another party's legal rights actually has the legal authority to assert a valid claim. Intrinsic problems with the underlying foreclosure documents, whether they are affidavit issues, robo-signing or notary irregularities, are not themselves a title defect; however when these issues are not identified during court proceedings, they allow the credibility of a court order to be called into question, and by extension, they become a title defect. Because these problems are part of the court process, they are properly the responsibility of the judicial system to resolve.

The title industry has no way to discover foreclosure irregularities that are not included in court proceedings or documented in the public record. As such, unlike the curative work to correct errors in the public record that occurs before a title insurance policy is issued, the title insurer or agent cannot cure foreclosure defects. Unlike property and casualty insurance lines, title insurance protects against risks that exist at the time the policy is issued. The underwriting of title insurance operates almost entirely on the basis of identifying, evaluating, and addressing title problems before a policy is issued. It is theoretically possible, through a thorough search and examination of the title, to identify all the record defects (but, of course, not the off-record defects) that may exist and then to address them and either eliminate them, insure over them, or exclude them from coverage. Defects in the foreclosure process, while underpinning the documents that are on the record, are in fact similar to other off-record title defects in that they cannot be discerned until someone appears before a court and challenges title after the policy is issued. Therefore it is impossible to eliminate the defect. Each title insurer must decide whether to exclude foreclosure problems from coverage or insure over them.

Differing risk tolerances in the industry will determine how each insurer chooses to handle transactions involving foreclosure. ALTA believes that an increased risk of losses for title insurers' due to litigation or other costs is minimal because: 1) servicers are undertaking appropriate remedial work at the direction of federal and state regulators; 2) to our knowledge, no foreclosure irregularities have resulted in a claim under a title policy; and 3) there are legal protections for purchasers of REO properties that which I will discuss in detail. Although it is possible that insurer costs could increase through additional litigation costs associated with defending a homeowner's title under their owner's policy, we believe that title insurers will be able to obtain recourse from parties responsible for any deficiency. For these reasons and the strong reserving policies of our prudential regulators and our members, state insurance departments have not required title insurers to take additional steps, and discussion of additional capital reserving is premature.

Legal Protections for Purchasers of REO Properties

There are three main protections for consumers who purchase a previously foreclosed property, also called a Real Estate-Owned (REO) property: 1) an owner's title insurance policy, 2) bona fide purchaser for value status, and 3) equitable rights should a court rescind the foreclosure that in all likelihood would result in the homeowner keeping their home and the person who was foreclosed upon being compensated by their lender for their loss.

Under an owner's title insurance policy, a consumer will be protected from challenges against title by a previously foreclosed upon owner of the property. This protection is two-fold. First, the policy covers cost of defense. Thus under the terms of the policy, even if a title challenge is meritless, the title company will step in and assume the cost of litigation, protecting the consumer's right to title until the matter is resolved.

Second, if a title challenge is successful, the policy will cover a claim and make the insured whole up to the insured amount (typically the purchase price). As a note, a consumer can purchase an owner's policy at any time after closing. If a consumer makes substantial improvements to the property which increase its value (as is frequent when a purchasing an REO), they can purchase an updated owner's policy to protect themselves for the new appraised value.

Bona fide purchaser protection, which is codified in state statutes and common law, allows a consumer to take good title despite competing claims if they record their conveyance first and there is no notice of the claims. The triggers for this protection are recordation and notice. Once a consumer purchases the property, their deed is recorded by the settlement agent, meeting the recordation requirement. Under the notice requirement, a consumer must have actual or constructive notice of a specific claim. Actual notice is met when the purchaser knows that the foreclosed upon owner is planning to sue to re-obtain title. Constructive notice is met when notice of a challenge is filed in the public or court records. Media speculation or newspaper articles about a foreclosure deficiency are not sufficient to defeat bona fide purchaser protections.

Should a court decide that the circumstances of a particular case require the foreclosed upon borrower to re-obtain title the property, the traditional court remedy is rescission of the entire foreclosure. When rescinding the foreclosure, the court seeks to place all the affected parties in the same position they were in before the foreclosure occurred. Thus, in theory, the foreclosed upon owner would receive title, the mortgage creditor would have their mortgage reinstated and the innocent consumer who purchased the REO property, would be refunded all the monies that they put into the property. While the innocent homeowner would be harmed by losing title to the property and having to move out of the home, they will not suffer financially, either because the title policy or the court will make them whole. We do not believe that a court would take these steps as it is likely that the previously foreclosed upon borrower, if his or her title is reinstated, will not be able to meet the obligations of the mortgage and would simply face a second foreclosure proceeding shortly thereafter. Rather, the purchaser would keep their home and the person who was foreclosed upon would be compensated by their lender for their loss.

Electronic Recordkeeping

Title information found in the title search of the public record and subsequent examination is discovered not by simply finding a document, but also through the tedious study and review of the relevant documents. Each of these documents requires close scrutiny by a trained professional. The signatures, notarizations, and legal descriptions must be reviewed. Often, a right included within the bundle of rights discussed above, is buried in the middle of a paragraph in a document.

Technology can help people to retrieve a document more quickly, but trained professionals must still read and examine each document that is retrieved. Even where documents are found electronically, which are available in 406 of the roughly 3,600 local record-keeping jurisdictions in the country, these documents must still be read, word-by-word to understand the rights that they convey and any limits to these rights.

In addition to electronic public records, the Mortgage Electronic Recording System (MERS) is a valuable tool for our system of property rights that brings efficiency and surety to public records. MERS was created in the 1990’s as a response to the time and the cost required to record mortgage assignments in local jurisdictions. As I discussed earlier, the gap between when a document is executed and presented for recordation and when it actually appears in the public record, is the time when mortgage fraud occurs, and this increases the costs and risks for all stakeholders. MERS was created to help reduce the burden on the system and bridge the gap by giving stakeholders the surety to know who owns the mortgage lien.

Title professionals interact with MERS in two ways. First, when conducting the settlement, a title agent receives the mortgage from the lender listing MERS as the nominee for the mortgagee. After the closing, the agent records that mortgage into the public record, thus protecting the mortgagee’s rights. A mortgage listing MERS as the mortgagee includes the MERS Mortgage Identification Number on the front page giving the public notice that they can conduct further investigation through the MERS system to identify the mortgagee.

Second, the title agent encounters MERS when they conduct a title search for a sale or refinance transaction. When an agent discovers a MERS mortgage in the chain of title, they know that they need to contact MERS, either through the MERS website or through its toll-free phone number. Using the MERS Mortgage Identification Number, the title agent determines the contact information for the servicer, and then can order the payoff information.

Reports suggest that MERS creates a defect in the securitization process. A potential defect in the securitization process does not create a title claim as a lender's policy is effective as of the policy date. It protects the lender's interest against actions that occurred prior to and including the policy date. Any problems with the securitization occur after the policy date and thus are outside the scope of coverage of a lender's policy.

ALTA's Response to Recent Controversy

Soon after initial media reports were published about foreclosure deficiencies, ALTA reached out to industry stakeholders, including Fannie Mae, Freddie Mac and their regulator, the Federal Housing Finance Agency (FHFA) in an effort to restore certainty and confidence in the REO market. On October 1, FHFA announced that Fannie Mae and Freddie Mac were "working with their respective servicers to identify foreclosure process deficiencies and that where deficiencies are identified, would work together with FHFA to develop a consistent approach to address the problems." On that same date, ALTA indicated that it would be "asking lenders to acknowledge that all appropriate procedures have been followed by the lending community before foreclosed properties are resold on the market."

Staff held individual discussions with ALTA members to discuss whether any additional steps should be taken by servicers to ensure that title insurance policies would continue to be issued to buyers of REO properties and their lenders. On October 13, FHFA directed Fannie and Freddie to "implement a four-point policy framework, including guidance for consistent remediation of identified foreclosure process deficiencies. This framework envisions an orderly and expeditious resolution of foreclosure process issues that will provide greater certainty to homeowners, lenders, investors, and communities alike." This direction required servicers to, "take actions as may be required to ensure that title insurance is available to the purchaser for the subject property in light of the facts surrounding the foreclosure actions." On that same date, ALTA indicated that, "Title insurers are looking to lenders to provide appropriate indemnities," and that "we will continue to work with federal and state regulators, Fannie Mae, Freddie Mac and lenders to bring certainty to the marketplace."

ALTA drafted a model indemnity agreement with Fannie and Freddie that acknowledged the insurer's obligation to defend its policyholders in the event of a court challenge to the property's title, and required the servicer to reimburse the title insurer for any costs of defending the title of the purchaser of an REO property. Since that time, because of the remedial work that servicers have undertaken at the direction of federal and state regulators, that to our knowledge no claim under a title policy has yet occurred due to foreclosure irregularities and the legal protections discussed above, parties on all sides have walked away from the concept of special indemnity agreements.

Conclusion

ALTA appreciates the opportunity to discuss public records, the land title industry and the effect of the foreclosure crisis on real estate transactions. Bringing stability back to the market for REO properties is essential not just for the title and settlement services industry, but for the nation’s economy as a whole. Our country will not see strong economic recovery until we also have a robust housing recovery, and delays in selling REO properties will only add to the already fragile housing market.

Actions like the ones taken by FHFA in its October 13 guidance, servicers in reviewing their foreclosure processes and the courts in scrutinizing servicer practices, are essential for bringing stability back to the market. Transparency protects the integrity of real estate transactions. ALTA is eager to serve as a resource to the Subcommittee and other stakeholders, and I am happy to answer any questions. Thank you.