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Regulatory Actions Related to Foreclosure Activities by Large Servicers and Practical Implications for Community Banks

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Special Foreclosure Edition

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This Special Foreclosure Edition describes lessons learned from an interagency review of foreclosure practices at the 14 largest residential mortgage servicers and includes examples of effective mortgage servicing practices derived from these lessons.

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Introduction

Residential mortgage foreclosure starts have increased dramatically since 2006 and are expected to continue at a brisk pace through 2011 and beyond. Most federally insured depository institutions that owned or serviced residential real estate loans during this time have been affected by this dramatic increase, but the delinquency rates on loans originated by community banks have been far lower than at the nation's largest institutions. In fact, the top fourteen servicers were responsible for processing the vast majority of foreclosures. Servicing problems also have been more common at large institutions. The volume of foreclosures and the failure to properly manage the servicing process led to numerous unsafe or unsound practices and resulted in a self-imposed moratorium on foreclosures by some of the largest servicers in the fall of 2010.

In response, in fourth quarter 2010, the federal banking agencies commenced simultaneous (or "horizontal") reviews of the foreclosure practices at these top fourteen servicers. The reviews were conducted for each of these servicers by its primary federal regulator with full and active assistance of the Federal Deposit Insurance Corporation (FDIC) in its statutory role as "back-up" regulator. In addition, the agencies jointly conducted examinations of two third-party service providers.

All fourteen servicers and both service providers recently entered into Consent Orders designed to remedy the numerous matters requiring attention, including unsafe or unsound practices identified during the examinations. These concerns included lax foreclosure documentation, ineffective controls over foreclosure procedures, and deficient loss mitigation procedures and controls. Many institutions failed to commit resources sufficient to manage responsibly the rapidly growing volume of mortgage loans in default or at risk of default. Weak governance and controls increased legal, reputational, operational, and financial risks while creating unnecessary confusion for borrowers.

Community banks fared far better than larger institutions in terms of delinquency rates on residential mortgage loans and have undertaken far fewer foreclosures. Nevertheless, community banks should be aware of the lessons learned from the horizontal review when assessing their servicing practices.

Findings from Interagency Horizontal Review of Top Fourteen Servicers

The servicers examined were:

- Eight national banks regulated by the Office of the Comptroller of the Currency (Bank of America, Citibank, HSBC, JPMorgan Chase, MetLife, PNC, US Bank, and Wells Fargo);
- Two institutions regulated by the Board of Governors of the Federal Reserve System (GMAC Mortgage, LLC, an affiliate of FDIC-regulated Ally Bank, and SunTrust); and
- Four thrifts regulated by the Office of Thrift Supervision (Aurora Bank, OneWest Bank, Sovereign Bank, and EverBank).

The federal banking agencies, including the FDIC in its role as back-up regulator for all insured depository institutions, reviewed servicing and foreclosure processes to determine their impact on the banking industry and consumers.

To ensure consistency with the scope of the review, the examiners from the participating federal banking agencies followed a standardized work program that covered the following areas: policies and procedures, organizational structure and staffing, management of third-party service providers, quality control and internal audits, compliance with applicable laws, loss mitigation, critical document control, and risk management. Servicer employees involved in the foreclosure process were interviewed, and approximately 2,800 foreclosure files, involving both judicial and nonjudicial foreclosure jurisdictions, were reviewed.

The reviews led to the identification of significant weaknesses, as described by the primary federal regulators of these institutions in the *Interagency Review of Foreclosure Policies and Practices:*

Foreclosure process governance. Foreclosure governance processes of the servicers were underdeveloped and insufficient to manage and control operational, compliance, legal, and reputational risk associated with an increasing volume of foreclosures. Weaknesses included:

- inadequate policies, procedures, and independent control infrastructure covering all aspects of the foreclosure process;
- inadequate monitoring and controls to oversee foreclosure activities conducted on behalf of servicers by external law firms or other third-party vendors;
- lack of sufficient audit trails to show how information set out in the affidavits (amount of indebtedness, fees, penalties, etc.) was linked to the servicers' internal records at the time the affidavits were executed;
- inadequate quality control and audit reviews to ensure compliance with legal requirements, policies and procedures, as well as the maintenance of sound operating environments; and
- inadequate identification of financial, reputational, and legal risks, and absence of internal communication about those risks among boards of directors and senior management.

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Organizational structure and availability of staffing. Examiners found inadequate organization and staffing of foreclosure units to address the increased volumes of foreclosures.

Affidavit and notarization practices. Individuals who signed foreclosure affidavits often did not personally check the documents for accuracy or possess the level of knowledge of the information they attested to in those affidavits. In addition, some foreclosure documents indicated they were executed under oath, when no oath was administered. Examiners also found that the majority of the servicers had improper notary practices which failed to conform to state legal requirements. These determinations were based primarily on servicers' self-assessments of their foreclosure processes and examiners' interviews of servicer staff involved in the preparation of foreclosure documents.

Documentation practices. Examiners found some — but not widespread — errors between actual fees charged and what the servicers' internal records indicated, with servicers undercharging fees as frequently as overcharging them. The dollar amount of overcharged fees compared with the servicers' internal records was generally small.

Third-party vendor management. Examiners generally found adequate evidence of physical control and possession of original notes and mortgages. Examiners also found, with limited exceptions, that notes appeared to be properly endorsed and mortgages and deeds of trust appeared properly assigned. The review did find, in some cases, that the third-party law firms hired by the servicers were nonetheless filing mortgage foreclosure complaints or lost-note affidavits even though proper documentation existed.

Quality control and audit. Examiners found weaknesses in quality control and internal auditing procedures at all servicers included in the review.[1]

These inadequate management practices led, in turn, to widespread unsafe or unsound operational practices, including missing documents, execution of documents by unauthorized persons, failure to notarize documents in accordance with local law, inaccurate affidavits, and affidavits signed by persons lacking sufficient knowledge of the underlying mortgage loan transaction. Consent Orders were issued to all fourteen servicers by their primary regulators.

The interagency horizontal review and resulting Consent Orders did not encompass issues beyond the foreclosure process. As a result, the review did not review allegations of improper servicing or loss mitigation, such as misapplied payments, unreasonable fees, inappropriate force-placing of insurance, failure to consider adequately a borrower for a loan modification, or requiring a borrower to be delinquent to qualify for a loan modification.[2] The Orders require the servicers to undertake a comprehensive third-party review of risk in servicing operations and reimburse borrowers injured by servicer

[1] *Interagency Review of Foreclosure Policies and Practices,* Federal Reserve System, Office of the Comptroller of the Currency, and Office of Thrift Supervision, pages 3-4.

[2] *Ibid.* See also "Problems in Mortgage Servicing from Modification to Foreclosure," November 16, 2010 hearing at the U.S. Senate Committee on Banking, Housing, and Urban Affairs.

errors. Furthermore, investigations by state and federal law enforcement agencies related to these allegations are ongoing.

Findings from Interagency Examinations of the Third-Party Service Providers

The federal banking agencies additionally examined the Mortgage Electronic Registration Systems, Inc. ("MERS") (as well as its parent company MERSCORP, Inc.) (together, the "MERS Entities"), and Lender Processing Services, Inc. ("LPS"). MERS acts as the nominee of original lenders on mortgages and the lenders' successors, and MERSCORP tracks electronically which institution owns residential loans and which institution owns the servicing rights. LPS provides a variety of services, including foreclosure document services, to foreclosing servicers.

The review at both service providers led to the execution of Consent Orders based on their engaging in unsafe or unsound practices that exposed the member institutions to unacceptable operational, compliance, legal, and reputational risks. The MERS Entities failed to devote adequate financial, staffing, training, and legal resources to ensure proper administration and delivery of services to MERSCORP's members and failed to establish and maintain adequate internal controls, policies and procedures, compliance risk management, and internal audit and reporting requirements with respect to the administration and delivery of services to member institutions. Similarly, LPS failed to establish and maintain adequate internal controls, policies and procedures, compliance risk management, and internal audit and reporting requirements. In addition, LPS executed and recorded numerous affidavits, assignments of mortgages, and other mortgage-related documents that contained inaccurate information or were not properly notarized or based on personal knowledge.

Findings from FDIC Examinations of State Nonmember Banks

In its role as the primary federal regulator of a large number of state nonmember banks, which collectively service less than four percent of residential mortgages, the FDIC has been reviewing and conducting targeted exams to determine whether any of these institutions have engaged in the types of practices identified at the major servicers. To date, the review has not identified "robo-signing" or any other deficiencies that would warrant formal enforcement actions. The FDIC will continue to monitor these servicers, as well as the performance of institutions servicing loans through FDIC securitizations or resolution programs.

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Best Practices for State Nonmember Banks

Though the FDIC has not identified serious industry wide problems among state nonmember banks, the well-publicized problems of large servicers, combined with growing litigation over "robo-signing" and other processing deficiencies have created heightened public and judicial scrutiny of servicing and foreclosure practices. This context indicates that community banks should promptly review their servicing practices to guard against intensifying reputation and legal risk in the servicing of residential mortgages.[3]

Loss Mitigation Activities and Communication Efforts

As we have stated in previous guidance, institutions should avoid unnecessary foreclosures and consider mortgage loan modifications or other workout strategies that are affordable and sustainable.[4] When a borrower is at risk of default, early and frequent customer contact may increase the likelihood of successful foreclosure mitigation. Loan modifications should be pursued when the borrower's ability to make modified payments is reasonably assured and the net present value of those payments exceed the expected recovery that would result from a foreclosure. For larger banks where multiple divisions may be involved in handling the loan, a single point of contact should be named to manage the bank's relationship and communications with the borrower. This single point of contact should be referenced on all communications to borrowers related to collections, loss mitigation, or foreclosure.

Staffing and Training

Staff assigned to collections, loss mitigation, collateral management, and foreclosure activity should be sufficient to ensure compliance with state and federal laws, regulations, policies, and servicing guidelines. Front-line employees working with borrowers, especially those who are candidates for modification, should receive sufficient training to ensure communications with borrowers are accurate and consistent. In particular, banks participating in the Home Affordable Modification Program (HAMP) should maintain systems, processes, and training to ensure adherence to program guidelines and directives.

Administration of Third-Party Relationships

Many community bank servicers engage in third-party relationships with data processing and other service providers to carry out their mortgage lending activities. These institutions should maintain adequate oversight of third-party activities and adequate

[3] Guidance previously issued by the FDIC also provides useful information. Part 365, Appendix A of the *FDIC Rules and Regulations, Interagency Guidelines for Real Estate Lending Policies,* may be found at http://www.fdic.gov/regulations/laws/rules/2000-8700.html#fdic2000appendixatopart365. FDIC rules also require institutions to identify problem assets and prevent further deterioration in those assets. Appendix A to Part 364 http://www.fdic.gov/regulations/laws/rules/2000-8630.html#fdic2000appendixatopart364; FIL-62-2008 http://www.fdic.gov/news/news/financial/2008/fil08062.html. Management of vendor relationships should reflect consideration of the guidance issued through FIL-44-2008, *Guidance for Managing Third-Party Risk* http://www.fdic.gov/news/news/financial/2008/fil08044.html.

[4] FIL-35-2007, *Working With Residential Borrowers: FDIC Encourages Institutions to Consider Workout Arrangements for Borrowers Unable to Make Mortgage Payments,* http://www.fdic.gov/news/news/financial/2007/fil07035.html; FIL-76-2007, *Servicing for Mortgage Loans: Loss Mitigation Strategies* http://www.fdic.gov/news/news/financial/2007/fil07076.html.

quality control over those products and services provided through third-party arrangements to minimize the exposure to potential significant financial loss, reputation damage, and supervisory action. The FDIC evaluates activities conducted through third-party relationships as though the activities were performed by the institution itself. Institutions should conduct meaningful due diligence before engaging vendors rather than relying exclusively on lists of vendors approved by government-sponsored entities. It is incumbent upon financial institutions to analyze the ability of subservicers to fulfill their contractual obligations, and manage the risks associated with obtaining services from, or outsourcing processing to, subservicers. For instance, banks should make sure that third- party software programs allocate payments in compliance with legal and contractual requirements. In addition, if banks use third-party law firms to conduct their foreclosures, they should always retain copies of foreclosure documentation and monitor third-party management of the foreclosure process as described below.

Compliance with Servicemembers Civil Relief Act

Financial institutions' quality control and other programs must ensure full compliance with all laws and regulations related to mortgage foreclosures. In particular, it is essential for institutions, including mortgage servicers and third-party vendors, to have systems and controls in place to identify borrowers protected by the Servicemembers Civil Relief Act ("SCRA") to preclude overcharging or improper foreclosure.[5] Written confirmation of SCRA status checks with the Department of Defense should be obtained before initiating a foreclosure action.[6] Borrowers denied SCRA protection should be able to request an independent review of the decision.

Foreclosure Practices

Foreclosures of defaulted loans should be consistent with all applicable laws and follow best practices, including the following items:[7]

- Foreclosures should be brought in the name of the holder of the note or the party entitled to enforce the note.
- A foreclosing entity should have possession of the original note and either a recorded mortgage or a recorded valid assignment of the mortgage before initiating the foreclosure process.
- Lost-note affidavits should be used only after a good faith effort to locate the note, should attach a copy of the note, and should comply with Uniform Commercial Code § 3-309.
- The attestations in a foreclosure affidavit should comply with applicable local substantive, evidentiary, and procedural law and should

[5] SCRA extends rights and safeguards to military personnel, including a six percent reduced interest rate for mortgages and deeds of trust that continues throughout the term of military service and for an additional year thereafter; and stays judicial procedures, such as foreclosures, during military service and for nine months thereafter. The nine-month stay is slated to expire on December 31, 2012; after that date, the stay period is to revert to the SCRA's original ninety days.

[6] To obtain certificates of service or non-service under SCRA, institutions may access this Web site: https://www.dmdc.osd.mil/appj/scra/scraHome.do.

[7] Most of these practices are applicable directly to foreclosures in the twenty-three judicial foreclosure states. In non-judicial foreclosure jurisdictions, these practices should be followed to the extent applicable and in the event the borrower seeks judicial intervention.

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contain: (a) facts explaining the basis for the personal knowledge of the affiant (e.g., job title, job position, job duties, how an affiant became familiar with the facts in the affidavit, etc.); and (b) assurances the affiant has reviewed supporting documents and records to ensure all necessary and proper documents for foreclosure in that jurisdiction are included.

- A complaint and foreclosure affidavit should address the following subjects: (a) the specific amount due under the note, including an itemization of all fees and penalties; (b) the payment history sufficient to demonstrate servicing of the loan (a best practice would be to provide the complete payment history whenever available); (c) a description of the applicable quality control procedures governing the foreclosure process that are operative and effective as of the date the loan became more than 30-days delinquent; and (d) where applicable, the authorization under which the mortgage is validly assigned to the foreclosing note-holder. Documents that support the statements in an affidavit should be attached as exhibits.
- To the extent an institution has a practice of paying law firms, servicers, and employees bonus incentives to process high volumes of foreclosures, the practice should be discontinued.

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