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RISK MANAGEMENT IN MORTGAGE LOAN SERVICING AND COLLECTION

Mortgage Lenders and Servicers Face Heightened Risk of Enforcement Actions by Government Agencies or in Private Class-Action Litigation Arising from Scrutiny of Their Practices in Billing, Collections, Credit Reporting, and Force-placed Insurance. The Authors Address the Key Areas of Concern and Outline the Components of a Risk Analysis that is Designed to Reduce Exposure.

By Andrew L. Sandler, Benjamin B. Klubes, Anand S. Raman and David B. Leland*

> If you haven't had a "litigation check-up" recently, now might be a good time to think about having internal and external attorneys take a look at your loan servicing practices. . . . News media are expanding the definition of "predatory lending" to include aggressive collection practices. And the plaintiffs counsel industry smells blood. You can bet, especially in the subprime mortgage world, that lenders will face increasing scrutiny of their customer service and collection issues.
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> — *Mortgage Servicing News, July 18, 2003 (editorial).*

Over the past year, it has become increasingly evident that federal and state regulatory and law enforcement agencies, including the Federal Trade Commission ("FTC"), as well as the federal and state bank regulatory agencies, rating agencies, investors, class action lawyers and the media, are focusing on "predatory lending" servicing and collection issues. This scrutiny is likely to increase in the wake of the settlement announced in November 2003 between the FTC and Fairbanks Capital Corporation ("Fairbanks"), in which Fairbanks agreed to pay $40 million to settle a suit alleging numerous unfair and deceptive

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servicing practices relating to, among other things, its payment posting, billing, collections, credit reporting and force-placed insurance practices.

The *Fairbanks* settlement — the first ever between the FTC and a major loan servicer — followed by one year the public announcement by senior officials at the FTC of a new focus on servicing and collections. At a conference in late 2002, an FTC Assistant Director stated that the FTC was beginning a "crack down" on "egregious" servicing problems.[1] In August 2003, the FTC's Associate Director of Division of Financial Practices reemphasized the FTC's investigative focus on servicing and collections activities of non-prime lenders by outlining a list of ten key substantive areas that the FTC was scrutinizing in the industry. Moreover, the Director indicated that this "crack down" was not restricted to whether servicing practices were, strictly speaking, "legal [or] . . . illegal," but whether they represented a policy of being "honest with borrowers," including full disclosure of charges, fees and practices.[2]

1. *National Mortgage News*, October 7, 2002 (Vol. 27 No. 3), at 17.
2. *Consumer Financial Services Law Report*, August 27, 2003, at 5 (describing statements of Joel Winston, Associate Director for Financial Practices, Federal Trade Commission Bureau of Consumer Protection at meeting of American Bar Association).

Increased law enforcement and class action litigation, as well as enhanced regulatory oversight and due diligence by rating agencies and investors, regarding servicing and collection issues presents reputational risks for non-prime lenders and servicers, as well as the potential for significant financial consequences. Under these circumstances, non-prime lenders and servicers responsibly should focus on identifying potential risks in their servicing and collections practices. The goal of such an analysis should be to ensure "best practice" servicing and collections policies that will reduce regulatory, litigation and business risks.

This article addresses the following key areas of heightened regulatory scrutiny and litigation risk in connection with servicing and collections, including those specifically identified by the Associate Director of the FTC Division of Financial Practices and covered in the *Fairbanks* settlement: (i) collection tactics; (ii) fees; (iii) payment processing; (iv) force-placed insurance; (v) credit bureau reporting; and (vi) foreclosure process. The article then discusses a recommended approach to risk analysis, including a review of policies and procedures and loan files as well as employee interviews. This analysis should focus on: (i) legal files; (ii) servicing and collections; (iii) foreclosures; (iv) credit bureau reporting; (v) employee compensation; and (vi) loan files.

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KEY AREAS OF RISK

Collections Tactics

Servicers can expect to see increased attention by regulators, enforcement agencies and class action lawyers on non-prime loan servicing techniques for aggressive or abusive collections tactics. This will extend to traditional Fair Debt Collection Practices Act ("FDCPA")[3] issues, like repeated or inconvenient telephone calls and the use of threatening or profane language.[4] Auto-dialer usage and techniques will be looked at as well to ensure that callers are not subjected to calls that are non-compliant with the FDCPA or are made prior to delinquency for purposes such as soliciting express payments.

Even if the FDCPA does not apply, it is likely to be used as a benchmark for establishing unfair or deceptive trade practices; *i.e.*, a practice that violates the FDCPA will be deemed an unfair or deceptive trade practice under Section 5 of the FTC Act.[5] Thus, it is important to have a strong FDCPA compliance program in place. This includes: (i) employee training, and preferably an annual certification requirement; (ii) periodic call monitoring; and (iii) set standards addressing policy violations by individual collectors. Also, while servicers may in many instances be exempt from the FDCPA, they may, nonetheless, be subject to state debt collection laws. Because state laws are not preempted by the FDCPA if they provide greater consumer protection, servicers need to carefully evaluate which state laws apply to their conduct.

Fees

The reasonableness of servicing fees and charges also will be the subject of review and possibly litigation. This scrutiny will extend beyond the amount of the fees or charges, to the schedule by which they are assessed and the clarity of the explanation of those fees to customers. It also will include the methods by which fee-based services (*e.g.*, expedited payment methods) are offered to customers. Notably, the FTC has made it clear that it does not view Fannie Mae and Freddie Mac loan servicing standards as dispositive.

The FDCPA defines the collection of fees or charges that are not authorized by the underlying loan documents or state law as an unfair debt collection practice.[6] This raises at least two compliance concerns. First, many states have significant legal restrictions on the types and amount of fees that may be charged.[7] Servicers need to have a complete and current understanding of the various restrictions, and have systems in place to account for these restrictions when placing charges or fees on individual borrower accounts. Second, non-prime servicers in particular need to ensure that their correspondence with a borrower includes accurate information regarding the amount of a debt. This can be complicated when dealing with payoff quotes that may include projected fees. Moreover, a debt servicer should verify that information obtained from a prior servicer is accurate with respect to the loan amount and terms.

Handling of Payments

This area of potential government interest and class action litigation includes the effective date assigned to payments received from the borrower, as well as the way in which a servicer applies monies to principal and interest payments, fees and charges, and escrow or insurance advances. Servicers can mitigate risk in this area by establishing a rigorous audit process to ensure that customer payments are given an effective date as of the date they are received, rather than the date they are processed. To the extent those functions are performed by third-party vendors (*e.g.*, lock boxes), care must still be taken to ensure their accuracy. Failure to timely credit payments may be viewed by government agencies as deliberate, rather than negligent conduct, with a motive to provide the servicer with an opportunity to collect more late fees. An area of special concern is late fees — improperly applied in the first place — which are in turn used to generate additional late fees. Moreover, adequate control procedures should be put in place to ensure proper pay-

3. 15 U.S.C. § 1601 *et seq.*
4. *See generally* Federal Trade Commission Annual Report 2002: Fair Debt Collection Practices Act, *http://www.ftc.gov/os/2002/06/ftca.htm.*
5. *See* Lipsett, FTC Informal Staff Letter, Dec. 1, 1987 ("While creditors are exempt from the coverage of the FDCPA, they may be held liable for these activities under Section 5 of the Federal Trade Commission Act.").
6. 15 U.S.C. § 1692f(1).
7. *See, e.g.*, Cal. Civ. Code § 2954.4 (allowing mortgage lenders to charge a late fee of either $5 or 6% of the late installment payment, whichever is greater); Del. Code Ann. tit. 5, § 2231 (prohibiting creditors from imposing more than one late fee on any single installment payment).

ment application to principal, interest, fees and escrow, pursuant to the borrower's note. To the extent servicers have discretion to apply fees in the manner of their choosing, care should be taken to ensure that adequate disclosure is made to customers of the manner in which their payments have been applied.

Force-Placed Insurance

Non-prime loan servicers also need to be aware of the risks associated with force-placed insurance. While servicers in most instances have the obligation to ensure that collateral is adequately insured, they must give borrowers a reasonable opportunity to provide proof of insurance coverage. Servicers can achieve this by having a letter cycle that provides borrowers with several opportunities to provide proof of coverage, by supplementing the letter cycle with telephone calls, and by ensuring that they have sufficient resources (*e.g.*, fax lines and personnel) to handle the volume of declaration pages that borrowers are likely to submit.

In addition, servicers should have in place a formal set of policies governing those situations where borrowers do not timely provide proof of coverage, but later do demonstrate that they had coverage in place with no lapse. In addition to flat-canceling the policy and providing a full refund of all premiums paid, servicers should consider adopting a policy of waiving any late fees or other assessments that may have accrued on account of the force-placed insurance. Moreover, servicers should ensure that no borrower is placed into foreclosure solely as a result of not paying the premiums associated with insurance that was improperly force placed.

Credit Bureau Reporting

Servicers can expect to see some scrutiny under the Fair Credit Reporting Act ("FCRA").[8] The FCRA requirements can be complicated in the loan servicing area. For example, when a portfolio is acquired from a prior servicer, there may be issues with the accuracy of loan level information obtained in an electronic format. This can result in inaccurate reporting to a credit bureau. In addition, the FCRA imposes obligations on the servicer to report the fact that a debt is in dispute.[9] To the extent an account is reported as delinquent because of unpaid fees or charges, disputes regarding these fees or charges can give rise to the same reporting requirements. Finally, servicers should provide full file reporting, rather than only reporting negative credit information.

Foreclosure Process

Regulators are likely to focus on the foreclosure process, especially when consumers are cycled in and out of foreclosure proceedings due to repeated delinquencies. Moreover, a significant portion of litigation against servicers begins in the context of foreclosure. Servicers should ensure that loss-mitigation tools, such as forbearance, are used only in appropriate circumstances, where borrowers have the capacity to service their debt obligations, and not as a mechanism to repeatedly cycle borrowers in and out of foreclosure. They should be aware that an above-average rate of foreclosure will serve as a "red flag" to regulators and may invite further scrutiny.

Servicers also should charge fair and reasonable fees associated with foreclosure, and in particular, should be cautious in charging "re-origination" fees when a foreclosure is terminated and a borrower is reinstated to current status. To the extent borrowers are required to repay outstanding fees and other advances as part of a forbearance agreement, great care must be taken to ensure the accuracy of those fees.

RISK ANALYSIS

A review of a lender's policies and procedures with respect to servicing and collections, as well as verification that those policies and procedures are being followed "in the field," are the two fundamental aspects of an appropriate risk analysis. Such an analysis involves two types of activities: (i) review of written documents, and (ii) interviews of employees.

In conducting this analysis, a loan servicer should be mindful to ensure that the review is done in a manner that maximizes the possibility of protecting this self-analysis under the company's attorney-client privilege. Thus, careful consideration should be given at the outset of the review to the structuring of the analysis, including the retention of outside counsel. In addition, it is important that there be management "buy-in" to the process, and a commitment to address issues that are raised as part of

8. 15 U.S.C. § 1681 *et seq.*
9. *See* 15 U.S.C. § 1681s-2(a)(3); Harvey, FTC Informal Staff Letter, Dec. 23, 1997.

the review. There is little that is more devastating in government investigations and examinations and in litigation than documentation that a company was aware of a problem and yet failed to take any action to respond to it.

The following "checklist" includes categories of materials that may warrant careful review.

- Legal files, including:
  - Ongoing litigation files;
  - Government inquiries;
  - State regulatory examination summaries; and
  - Customer complaints.

- Regulatory and compliance materials, including:
  - Policies and procedures;
  - Training materials;
  - Internal audits; and
  - State audits.

- Servicing and collection policies and charges;

- Servicing and collection call scripts and letters;

- Foreclosure process policies and procedures;

- Foreclosure data;

- Credit bureau reporting policies and procedures;

- Employee compensation guidelines;

When reviewing these materials, it is important to look for patterns that may lead to future legal or regulatory problems.

As noted above, however, reviewing written policies and procedures tells only half the story. It is imperative also to understand how those policies and procedures are implemented in practice. Talking to employees, reviewing individual customer files, and conducting special audits are important ways in which this type of information can be gathered.

Legal Files

Reviewing files maintained by the legal department is often the single most important due diligence exercise in assessing potential litigation and enforcement risk. Specific focus should be placed on borrower litigation — private plaintiff or class action — and government investigations, as these proceedings generally carry the greatest potential for monetary and reputational exposure. Even actions or investigations that initially do not raise servicing and collections issues can morph into cases in which those are the central focus. It is important to evaluate individual borrower litigation matters to determine whether they reflect more systemic problems with a company's servicing and collection operations.

In addition to ongoing governmental inquiries and litigation, legal department files may also be reviewed for sources of potential litigation. For example, it is important to review customer complaint files for both substance and volume. A company with a high percentage of legitimate customer complaints is more likely to end up in litigation or with regulatory problems, while an entity with a low volume of complaints or an effective complaint resolution process may be better able to address troublesome problems before investigations are commenced or legal actions are filed. It is also often instructive to review consumer web sites on which disgruntled consumers post complaints about particular lenders or servicers.

As *Mortgage Servicing News* noted, "[i]t's not easy managing a loan portfolio in an environment of rapid portfolio churning and increasing regulatory scrutiny . . . . Small wonder some borrowers are unsatisfied with the customer service they have been getting. But customer satisfaction is about more than just paving the way for increased portfolio retention when homeowners refinance. Bad decisions in the call center lead to lawsuits down the line."[10] One of the most effective risk management tools available to non-prime servicers is a process to address customer complaints promptly and professionally, with an appropriate audit oversight to review and improve the process.

Servicing and Collections

A review of servicing and collections policies and procedures is important to understand whether a company is vulnerable to claims of abusive servicing or collection tactics. In understanding actual practices, it is often useful to

10. *Mortgage Servicing News*, July 18, 2003 (Vol. 7 No. 6) (editorial).

review training materials to assess how new employees are trained and whether existing employees are consistently kept abreast of legal developments and changes to company policies.

In addition, much useful information can be obtained from a careful review of internal audit and regulatory reports. These audit files can be an invaluable source of information about past problems and also provide insight into the company's commitment to addressing problems as they arise. To the extent a servicer has a compliance program that involves either random phone monitoring or total call recording, review of customer service, collections and other loss mitigation calls can provide valuable information concerning FDCPA and state collections law compliance.

A review of materials related to fees charged to borrowers for late payments and other infractions can reveal whether excessive fees are imposed, which may subject the institution to government or consumer litigation. Finally, a review of materials related to the imposition of force-placed insurance will help to determine whether force-placed insurance is improperly placed or inappropriately results in late fees being charged to customers, and to ensure that customer complaints regarding force-placed insurance are dealt with properly.

Foreclosures

In reviewing foreclosure materials, care should be taken to assess whether information is provided to customers in an understandable format. In addition, fee schedules should be evaluated, and any documentation of commercial reasonableness should be noted. Where ancillary services are obtained in connection with foreclosure proceedings (*e.g.*, broker price opinions or attorney services), special care should be taken to ensure that fees are reasonable, particularly if such services are performed by an affiliate of the servicer.

Credit Bureau Reporting

Mortgage lenders and loan servicers should have procedures in place for ensuring that accurate credit information about the customer is furnished to credit reporting agencies. To mitigate the risk of FCRA violations, loan servicers should consider taking the following steps:

- providing a special address for customers to notify the loan servicer that it has provided inaccurate information to a credit reporting agency;

- establishing formal procedures for notifying credit reporting agencies that a customer's credit information is incomplete or inaccurate and for correcting the information;

- ensuring that when a customer indicates that certain credit information is incomplete or inaccurate, the servicer notifies the credit reporting agency that the information is in dispute;

- notifying credit reporting agencies when a customer closes an account voluntarily; and

- within 90 days of reporting any delinquent loan that has been charged off or placed for collection, informing credit reporting agencies of the month and year of the preceding delinquency.

Employee Compensation

The way in which employees, particularly collection employees, are compensated, can motivate them — or at least be viewed as motivating them — to act in ways that could create litigation exposure. Where, for example, collections employees are compensated for the amount they collect, without adequate compliance and audit control, there is a risk that they may be considered incentivized to disregard the mandates of the FDCPA, which would expose the institution to enhanced scrutiny. Performance-based compensation incentives are not per se problematic, so long as they reflect reasoned objectives and compensation amounts, and are counter-balanced by appropriate and effective compliance training and systems, including an effective internal audit function.

Loan Files

A review of a random sample of loan files can help assess whether a lender implements its policies and procedures and follows relevant legal requirements. Particular attention should be paid to how servicing and collection issues were handled, and to any foreclosure process initiated with respect to that customer. Sometimes a statistical analysis of a sample of loan files can provide useful data.

CONCLUSION

A comprehensive risk analysis focused on servicing and collections is an essential element of a strong corporate risk management program, given current levels of scrutiny by government agencies, rating agencies, investors, the media, and plaintiffs' class action lawyers. Accordingly, mortgage loan servicers are well advised to undertake a meaningful risk analysis and make policy and practice modifications necessary to ensure fair dealing with loan customers. ■