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Global Foreclosure Settlement: The Success of Herding Cats

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Whether one thinks the terms of the historic federal-state civil loan servicing settlement are too much, too little or about right, two conclusions are indisputable. First, an incredible amount of good faith effort from all concerned contributed to the final settlement—simply synchronizing the differing interests of the various governmental and private parties in over a year of negotiations seemed to require a computer program. Second, while the settlement terms are likely to contribute to the future housing recovery, the federal and state governments appear intent to continue to pursue enforcement actions for prior conduct.

State and federal regulators today filed a previously announced agreement with the five largest servicers of residential mortgage loans related to redressing alleged violations of federal and state lending and servicing laws. The settlement agreement, described as the largest federal-state civil settlement ever obtained, represents the culmination of 17 months of inquiries, investigations and negotiations by and with state attorneys general ("AGs"), the U.S. Department of Housing and Urban Development ("HUD"), the U.S. Department of Justice ("DOJ"), the Office of the Comptroller of the Currency ("OCC"), the Federal Reserve Board ("FRB"), the Executive Office of the U.S. Trustees ("US Trustee"), and other federal regulators. Keeping up with press reports throughout the process about whom and what were in or out of the final settlement became its own full-time job.

To set the stage, we'll begin with the numbers:

50/8	Number of states (including the District of Columbia) that signed on to the settlement agreement, along with eight federal agencies and related entities – DOJ, HUD, the Department of Treasury ("Treasury"), Department of Agriculture ("Agriculture"), Department of Veterans Affairs ("VA"), Federal Trade Commission ("FTC"), Consumer Financial Protection Bureau ("CFPB"), and U.S. Trustee
5	Number of servicers subject to the settlement agreement – Ally Financial, Bank of America, Citigroup, JPMorgan Chase, and Wells Fargo
1	Number of states that declined to participate in the settlement (Oklahoma)
$25 billion	Amount the servicers are bound to pay in cash and in kind in connection with the agreement, representing the largest federal-civil government enforcement settlement

Global Foreclosure Settlement: The Success of Herding Cats

$17 billion	Of the $25 billion, amount slated for consumer relief, including permanent principal forgiveness, forbearance, short sales, and other assistance
$5 billion	Of the $25 billion, amount slated for state and federal governments
$1.5 billion	Of the $5 billion, amount slated for borrowers who lost their homes to foreclosure between 2008 and 2011
$12 billion	"California Commitment" – Of the $25 billion, approximate amount of relief dedicated to the State of California
$4 billion	"Florida Commitment" – Of the $25 billion, approximate amount of relief dedicated to State of Florida
$18.6 million	Amount of relief separately negotiated by the State of Oklahoma
$1,500 - 2,000	Estimated amount that reportedly 750,000 people who lost their homes in foreclosure will receive from the state fund
42	Number of single space pages of the servicing standards
3 1/2	Number of years the servicing standards will be in effect
3	Number of years to provide the consumer relief

Background – Documentation Issues and Calls For Servicing Standards

By now the story is old news and well known. Suffice it to say that the Fall 2010 press reports about document deficiencies in judicial foreclosures energized private and governmental actors to question the default servicing operations of residential loan servicers. The federal banking agencies predictably hopped into action, conducting a review of the servicing and foreclosure practices of the 14 largest servicers.[i] Without regard to the size or composition of the portfolios or operations of the servicers, the regulators' findings were surprisingly similar. They claimed that all 14 servicers had engaged in virtually the exact same "unsafe and unsound" practices by virtue of alleged weaknesses in foreclosure governance processes, document preparation processes and oversight and monitoring of third-party vendors. Nevertheless, the banking regulators stated publicly that they did not find wrongful foreclosures of borrowers who were not otherwise eligible for foreclosure. At the same time, the agencies required each of those servicers, through a formal enforcement action, to retain an independent firm to conduct a thorough review of foreclosure actions pending in 2009 and 2010, in order to identify and provide remediation, where appropriate, to borrowers who have been financially harmed. That process is ongoing.

Since 2008, state AGs had been focusing on voluntary loss mitigation alternatives to foreclosure with increasing frustration. It seemed that, no matter how quickly the servicers tried to perform, some AGs believed that the number and type of loan modifications actually implemented were insufficient. In addition, some AGs claimed that, regardless of intent, alleged poor customer service involving loan modifications was actionable as an unfair or deceptive practice. When allegations of imperfect judicial foreclosures surfaced, some AGs saw their opportunity and quickly dismissed arguments that technical violations of state judicial foreclosure laws should be treated in a "no harm/no foul" manner. Complicating their ability to act, however, was the fact that federal preemption limits the authority of the AGs to conduct reviews and investigations of federally-insured depository institutions of the same type that the federal banking agencies had performed. Absent the filing of lawsuits, the AGs needed the federal government as a portal to gain targeted access to information from the bank servicers.

Moreover, every new complaint about loan modifications and foreclosures seemed to increase the chorus call for a uniform set of national mortgage-servicing and foreclosure-processing standards, even though foreclosure by its very nature is a local remedy. FRB Governor Sarah Bloom Raskin remarked in early 2011, for example, that the mortgage servicing industry needed to overhaul its practices. Former Chairman of the Federal Deposit Insurance Corporation ("FDIC") Sheila Bair, among others, linked the need for uniform servicing standards to the misalignment of financial incentives in the servicing industry. She called for the injection of stringent servicing standards into the Dodd-Frank Act's risk retention requirements, proposing that the definition of low-risk "Qualifying Residential Mortgages," which will be exempt from risk retention, include agreements for servicing to maximize loss mitigation and foreclosure avoidance. The Federal Housing Finance Agency ("FHFA") also directed Fannie Mae and Freddie Mac to overhaul their guidelines for servicing delinquent mortgages, including the creation of uniform servicing requirements. In addition, Treasury's Home Affordable Modification Program ("HAMP") has provided a new set of uniform standards to address loan modifications by participating servicers.

At the same time, servicers were put in a difficult situation as they were subject to conflicting expectations of various stakeholders who demanded that the servicers foreclose more quickly, more slowly or not at all. In other words, in a curious way, the 2010 crisis over foreclosure documentation and loss mitigation provided an opportunity for various governmental and private actors to come together and to try to put some of the past behind them and adopt standards for future behavior. Talk about herding cats!

Settlement Agreement

The settlement agreement is in the form of a Consent Judgment that was filed in the U.S. District Court for the District of Columbia on March 12, 2012. The Consent Judgment settles the claims specified in the Complaint, which the DOJ and the AGs simultaneously filed, and consists of several exhibits that comprise the substance of the settlement (collectively, the "Settlement Agreement"). Supplemental agreements involving the five bank servicers and Delaware, Florida, Massachusetts, New York, and California also were filed.

In exchange for a release against certain federal and state civil and administrative claims, the servicers generally agree to pay billions of dollars in consideration, to be paid through a combination of cash (i.e., "hard dollars") and in-kind contributions for consumer relief (i.e., "soft dollars"), including in the form of permanent principal forgiveness on delinquent loans and refinancings of current borrowers on "underwater loans" (for which borrowers owe more than the current value of the property). The Settlement Agreement also includes an agreement of the five servicers to adopt comprehensive servicing standards for residential mortgage loans. There are enforcement mechanisms, including the appointment of a monitor, to ensure servicer performance.

The federal and state releases of certain future liability are comprehensive, but subject to various exceptions, such as criminal claims and claims relating to securitizations. Nevertheless, the settlement in its totality offers the servicers the opportunity to extinguish several actual and/or prospective claims relating to their prior residential loan servicing and origination practices and to end some of the uncertainty that has contributed to destabilization of the housing market.

Parties to the Settlement Agreement

Federal Government

The DOJ and HUD were the principal actors on behalf of the federal government in the settlement negotiations and settlement. Other federal agencies and departments that are parties to the Settlement Agreement are Treasury, Agriculture, VA, FTC, CFPB, and the U.S. Trustee. Neither the federal banking agencies (i.e., OCC, FDIC, FRB) nor the Securities and Exchange Commission ("SEC") or the FHFA are parties to the Settlement Agreement.

State Governments

While various states like California, New York, Delaware, Massachusetts, and Nevada publicly had questioned their willingness to join, in the end, all states and the District of Columbia joined the settlement, with the sole exception of Oklahoma, which entered into a separate settlement agreement with the five servicers. Both Massachusetts and New York sued certain of the servicers prior to the announcement of the settlement based on the use of the Mortgage Electronic Registration Systems, Inc. ("MERS"), and those suits are preserved as exceptions to the state release.[ii] While the states principally were represented through their respective state attorneys general, some of the state banking departments also joined the settlement in releasing certain claims against certain state regulated entities; the New York State Department of Financial Services did not join in the settlement, even though the NYAG did sign.

Monetary Consideration

The total dollar value of the settlement among the five banks is $25 billion. There is a separate $1 billion settlement involving one of the five banks, which is why the number is often referred to as $26 billion. Some government statements indicated that this really is a $40 billion settlement; that number appears to be based on the perceived dollar value of consumer relief that may be provided as explained below.

Hard Dollars

The hard dollars are payable to both the federal government and the states. The DOJ will determine how the federal portion will be used, but a specified amount will be allocated to settlements of "qui tam" ("whistleblower") actions. A cash payment will be made to each of the participating states in an enumerated amount. A portion of the payments made to the states will be distributed to borrowers who submit claims to the states for alleged harm arising from the covered conduct. Borrowers receiving these payments from the states must agree that the payments offset and operate to reduce any other obligation that the servicer has to the borrower, with limited exceptions.

Soft Dollars

Consumer relief payments must be completed within three years on residential mortgage loans meeting specified criteria. Generally speaking, the participating servicers may elect to choose among a menu of benefits given directly to consumers on and after March 1, 2012 and receive credit against the amount due under the settlement agreements up to a specified cap per item. A minimum of 30% of the consumer relief funds must come in the form of permanent principal forgiveness on qualifying first-lien loans, with variations in the amount of credit given based on certain factors. To qualify, among other requirements, a loan must be at least 30 days delinquent, have a pre-modification loan-to-value ratio ("LTV") of at least 100%, satisfy an enumerated debt-to-income ratio ("DTI"), and at least 85% must (for occupied properties) have an outstanding principal balance prior to capitalization at or below the highest GSE conforming loan limit cap as of January 1, 2010 (the "Applicable Limits"). There also are post-modification DTI, LTV and reduction in payment requirements, subject to a net present value test for investor loans.

While there is no minimum amount of relief for second-lien loans, a minimum of 60% of the consumer relief funds must be in the form of permanent principal forgiveness on qualifying first- and second-lien loans, with the amount of the credit on the second liens dependent on the payment status of the loan. In both cases, the percentages can be reduced to account for excess refinancings under the program described below.

An otherwise eligible write-down of a second-lien mortgage will be creditable where such write-down facilitates either (a) a first-lien modification that involves an occupied property for which the borrower is 30 days delinquent or otherwise at imminent risk of default due to the borrower's financial situation; or (b) a second lien modification that involves an occupied property with a second lien which is at least 30 days delinquent or otherwise at imminent risk of default due to the borrower's financial situation. Servicers are required to write down second lien loans in accordance with eligibility criteria in certain circumstances until their commitment is satisfied.

Other forms of consumer relief available under the menu include waivers of deficiency balances, forgiveness of arrearages for unemployed borrowers, "cash for keys" payments to borrowers who prefer to vacate their properties, and "anti-blight" provisions designed to reduce the community impact of vacant properties. Many of these forms of consumer relief have credit caps (e.g., cash for keys-5%).

The credits given to the five servicers for various forms of consumer relief are greater for loans held for investment than for loans covered by third-party servicing agreements. For example, the credit given for writing down principal on first-lien loans held for investment that are not presently the subject of a modification is more than twice that of loans serviced for others ($1.00 versus $.45). Another example is where the servicer gets $1.00 credit if it makes a payment to an unrelated second-lien holder for release of a second lien but gets only a $.20 credit if the forgiveness is given by the investor.

In any case, the ability of any servicer to offer the relief in connection with loans held by others is dependent on the terms of the applicable servicing agreement since these provisions are expressly subject to applicable investor and insurer requirements. For example, while principal forgiveness is seen by many as a critical component of the housing market recovery, the FHFA's Acting Head, Edward DeMarco, has asserted that the agency does not have the authority or mandate to call upon Fannie Mae or Freddie Mac to offer such principal reductions. Thus, servicers may not provide permanent principal reductions on GSE loans as part of the consumer relief obligations.

The fact that a 100% credit is not given for each of the types of consumer relief explains the $40 billion number. A servicer, for example, may receive less than a dollar-for-dollar credit for a type of relief provided to the consumer, but the consumer receives 100% of the benefit. Estimates of the full economic value to borrowers of the consumer relief payments thus are greater than the $17 billion commitment of the servicers.

Refinancing Program

The Settlement Agreement also calls for a required monetary commitment upon each servicer to implement a refinancing program for current borrowers with above market rate, conventional loans that are held for investment. Eligibility criteria include that the loan to be refinanced was originated before 2009, is current with no delinquencies within the last 12 months, was not modified in the last 24 months, has a current loan-to-value ratio in excess of 100%, has an unpaid principal balance at or below the Applicable Limits and exceeds a certain interest rate. The minimum difference between the current interest rate and the offered interest rate under this program must be at least 25 basis points or there must be at least a $100 reduction in monthly payment. Dollars spent by each servicer on the program beyond its mandatory commitment will be credited against the servicer's first-lien and second-lien principal reduction obligations (25% and 75%, respectively), up to a cap. The refinancing program must be made available to all borrowers meeting the minimum eligibility criteria, regardless of whether the servicer is eligible to receive credit under the menu, but servicers are not required to solicit or refinance borrowers who do not meet the eligibility criteria. Credit against the consumer relief payments will be calculated as the difference between the current interest rate and the offered interest rate times the unpaid principal balance times a multiplier based on the remaining term of the loan.

Service Member Payments

The Settlement Agreement also includes for some of the five servicers compensation payments to military servicemembers in connection with violations of the Servicemembers Civil Relief Act's ("SCRA") foreclosure and interest rate protections that are discovered as part of a required review.

Credit for Expedited Implementation

In order to expedite consumer relief, servicers will receive additional credit against their outstanding settlement commitments for principal reductions and refinancings taken within the first 12 months of March 1, 2012. Servicers must complete 75% of the menu credits within two years of this start date. If a servicer fails to meet the requirement within three years, a servicer must pay an amount equal to 125% of the unmet commitment amount; this penalty amount increases to 140% if the servicer fails to meet both the two year and three year commitments. On the other hand, servicers shall receive an additional 25% credit against their outstanding settlement commitments for any first- or second-lien principal reduction and any amounts credited pursuant to the refinancing program within 12 months of the March 1, 2012 start date. As noted above, servicers are not required to provide consumer relief in a form or amount that is prohibited by any applicable contract or agreement to which it is subject, but their total commitment obligation may not be reduced.

Global Foreclosure Settlement: The Success of Herding Cats

Releases of Liability

Each form of release (federal and state) has three main components:

- A detailed description of the residential mortgage loan servicing and origination activities that are covered in the release (i.e., covered conduct);
- The scope of the release (i.e., types of government claims from which the servicer and its affiliates will be immune); and
- The explicit exceptions to the release.

The covered origination and servicing conduct is roughly defined in the same comprehensive way in both the federal and state forms, but the scope of and exceptions to the release differ because of the different legal constructs and particular concerns of the government actors executing the release.

Covered Conduct

Both the federal and state releases define conduct that is covered by the release. With respect to loan servicing, the covered conduct essentially consists of virtually all activity that servicers perform for their own account and pursuant to third-party servicing agreements, including, without limitation, collecting and remitting mortgage loan payments, administering the loan documents, offering loss mitigation options to borrowers in default and imminent default, foreclosing, and managing foreclosed properties. The federal release goes one step further, however, and includes the servicing of loans of borrowers in bankruptcy, which is governed by federal law.

Covered conduct relates also to loan origination activity. Covered loan origination conduct essentially consists of activities involved in originating or purchasing single family mortgage loans, including offering, processing, underwriting, funding, closing, documenting, and pricing loans. Under both the federal and state releases, subject to exceptions as described below, the covered conduct does not depend on who performed the activity in question and extends to the servicer, its past and present affiliates, and all of their current or former officers, directors, employees, and agents.

Scope of Release

The scope of the state release extends to any civil or administrative claim of any kind that the state attorney general or state banking regulator has, or may have or assert, resulting from the covered conduct on or before the release's effective date, except for certain enumerated exceptions.

The federal release is much more complicated, based in part on the multitude of potential federal actors and laws and the difference in treatment within the release of servicing and origination. The federal release extends to any civil or administrative claims the United States may have and any civil or administrative remedies or penalties it may seek or impose arising out of or relating to the covered servicing conduct as of the effective date under an enumerated law or regulation. The laws roughly break down into three types: (i) federal consumer credit laws (e.g., the Fair Debt Collection Practices Act, Truth in Lending Act); (ii) federal statutes that provide for multiple damages based on violations of certain underlying statutes (e.g., the False Claims Act, which can be used with respect to false claims to the Federal Housing Administration ("FHA"), for example), the Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA"), SCRA, and the

Racketeer Influenced and Corrupt Organizations Act ("RICO"); and (iii) the regulation that prescribes the release authority of the Civil Division of DOJ.

HUD separately gives a full release for servicing conduct relating to FHA-insured loans, subject to an exception for mortgage guaranty claims that it does not have the statutory authority to pay based on title defects. Treasury also agrees to remit certain withheld HAMP incentive payments. The FTC and CFPB also provide a release for covered servicing conduct, and the U.S. Trustee provides a release for covered bankruptcy conduct.

The federal release for covered origination conduct is more limited and is based on the type of the loan and the law. The DOJ and CFPB release claims under federal consumer credit laws regulating loan origination activity. However, HUD's release of claims for improper origination of FHA-insured loans is very narrow, limited to claims based exclusively on false annual certification of compliance that are submitted to HUD that could serve as the foundation for FIRREA, False Claims Act, or Program Fraud Civil Remedies Act violations. HUD/FHA retains the ability to seek redress for loan-level violations of FHA rules and regulations pertaining to origination. The VA and Agriculture offer comparable limited releases related to their guaranteed loan programs. The FTC also releases claims related to origination conduct. The DOJ's release from FIRREA claims for origination of conventional (non-government insured or guaranteed) loans also is very narrow and limited to particular situations in connection with the making of a residential mortgage loan to a consumer, and the related provision of settlement services between affiliates, that did not affect or involve harm to others.

Exceptions to the Releases

Common Exceptions

Neither the federal nor the state release provides immunity from violations of criminal law; the releases are limited to civil and administrative claims. Claims for unpaid taxes are not released. Servicers also are not immune from violations of fair lending laws, although the state release applies this exception only to loan origination conduct, releasing the servicers from state fair lending claims in connection with their servicing conduct. Furthermore, the settlement agreement does not release the servicers from any claims by natural persons.

Both the federal and state releases exempt claims in connection with conduct in the securitization of residential mortgage loans (although the federal and state releases both define covered origination conduct to include loan purchases). This securitization exception is directed to the creation, issuance and sale of securities related to mortgage loans, including the proper transfer of the loans to the purchaser and the accuracy and completeness of the representations and warranties made regarding the securities, including the eligibility, characteristics or quality of the mortgage loans. The federal release, but not the state release, clarifies that pure servicing conduct does not fall within the securitization exception, such as activities related to the transfer of the loans to facilitate foreclosures in accordance with applicable state law. The securitization exception in the state release is limited to securities, but the federal release includes both securities and whole loans. This exception is not, however, limited to claims that the government could bring as an investor in a mortgage-backed or mortgage-related security, but could include claims for the benefit of investors or for conduct directed at investors.

Global Foreclosure Settlement: The Success of Herding Cats

Unique Aspects of the State Releases

The state release has certain unique exceptions. It does not release claims against MERS or MERSCORP, Inc., other than claims against the servicers for their use of MERS. Similarly, the releases do not apply to claims of county recorders for fees relating to the recordation or registration process, such as claims for lost revenues attributable to the use of MERS.

The servicers may also remain liable for particular existing state claims that were carved out of the Settlement Agreement, including recent lawsuits by Massachusetts and New York against certain of the servicers for their use of MERS. A separate supplemental agreement filed simultaneously with the Consent Judgment limits the remedies available to those states in connection with such suits and permits Delaware to file a MERS suit subject to the same limitations. In addition, the release does not protect the servicers from claims of county and local governments and of state regulatory agencies (other than state banking departments) with regulatory and enforcement jurisdiction that is separate and independent of the state attorney general, or from claims seeking injunctive or declaratory relief to clear a cloud on title on real property under applicable state law resulting from the covered conduct.

Unique Aspects of the Federal Release

Notwithstanding the blanket exception to the release for any criminal liability, there is a separate exception for any criminal liability of individuals (including current or former directors, officers, and employees) based on the covered conduct. In addition, HUD retains the right to undertake administrative claims, proceedings or action for suspension, debarment or exclusion from any HUD program against any current or former director, officer or employee.

The federal release for conduct regulated under federal consumer credit laws carved out claims by the CFPB for violations of the Real Estate Settlement Procedures Act ("RESPA") related to private mortgage insurance (e.g., whether certain captive reinsurance arrangements with private mortgage companies violate the anti-kickback requirements of RESPA). The release for violations of federal privacy laws excludes violations of the information security provisions of such laws, such as for data breaches. Environmental laws are also excluded.

The Settlement Agreement highlights the continuing rights of other federal agencies and instrumentalities to bring claims. In addition to the continuing authority of the SEC and federal banking agencies, mentioned above, exceptions apply to any potential claims of the FHFA (the conservator of Fannie Mae and Freddie Mae), as well as Fannie Mae, Freddie Mac, Ginnie Mae, any Federal Home Loan Bank, and the Commodity Futures Trading Commission. For example, the existing securities lawsuits brought by FHFA are not released, nor are outstanding GSE loan repurchase demands. The CFPB's release applies only to activities prior to July 21, 2011, the date that authority was transferred to the CFPB from other federal agencies.

Global Foreclosure Settlement: The Success of Herding Cats

Servicing Standards

General

A key consideration for the release of claims is the adoption of national servicing standards. In certain respects, these standards go beyond those imposed in the "14 largest servicers" consent orders with the federal banking agencies and the FRB's orders against certain holding companies, beyond the explicit provisions of existing federal and state laws pertaining to residential mortgage loan servicing, and well beyond the foreclosure documentation issues that initially sparked the dispute. They address virtually all interactions with mortgagors from the time the mortgagors either fail to make a regularly scheduled payment (or make an insufficient payment) through foreclosure. The servicing standards will be phased in over a 180-day period depending on the importance of the standard to consumers and the difficulty in implementing the standards and will last for 3 ½ years.

While the standards are more expansive, they pose precious few issues that are not otherwise part of the national servicing debate under HAMP, GSE default servicing standards, proposed and newly enacted state and federal servicing laws, and prior government enforcement actions, including the FTC. Concerns may be expressed over the scope, wording or even content of certain of the provisions, but the debate is likely to be more of a line drawing exercise than a wholesale rejection of the concepts baked into the standards.

It is important to remember that no one other than the five servicers and their affiliates that are parties to the Settlement Agreement are bound by the servicing standards. The standards are expressly subject to applicable laws, the terms of the mortgage loan documents and any servicing agreement or related agreement or requirements to which the servicer is a party. For example, the requirements, binding direction, or investor guidelines of the applicable investor, insurer or credit enhancer are not superseded but may be supplemented by the servicing standards. Those provisions in the servicing standards that exceed existing law may become accepted servicing practices as a matter of conduct, but they are not yet legal requirements for the rest of the industry. Moreover, routine servicing transfers may be made by the five participants without generally subjecting the transferees to these standards. Transferees must be obligated in the transfer document to accept and continue processing pending loan modification requests, as well as to honor trial and permanent loan modification agreements entered into by a prior servicer.

Nevertheless, one should assume that these standards will be the baseline for consideration of national servicing standards that apply to the whole industry. Indeed, we understand that there is an inter-agency task force within the federal government that is charged with proposing national servicing standards, which we assume begin with these standards. Depending on the method of proposed enactment, true national standards at a federal level likely will be subject to notice and comment rulemaking or legislative hearings in which relevant stakeholders will be entitled to their say. Rulemaking, for example, cannot circumvent the statutory requirement to assess impact on small businesses.

These standards also could be a starting point for state initiatives. The New York Department of Financial Services, for example, already has promulgated "voluntary" servicing standards that it strongly encourages servicers to adopt. The California Attorney General has proposed state legislation that effectively would codify several of these standards, but couple the standards with strict enforcement mechanisms.

Generally speaking, the servicing standards can be divided into 4 basic categories. First are the "blocking and tackling" operational issues, consisting of staffing, systems and quality control/internal audit. Second are inbound and outbound communications with borrowers. Third are general servicing requirements relating to payment administration, fee income and forced place insurance. Last are default servicing requirements pertaining to loss mitigation, foreclosure and bankruptcy documentation and the special protections afforded borrowers in active military service.

Blocking and Tackling Issues

The standards require the servicer to hire, train and supervise sufficient trained staff to handle the current and projected workload. The obligation specifically arises in connection with working with consumers (including counseling on SCRA), handling loss mitigation and preparing foreclosure documents and handling bankruptcy matters. Lawyers usually think of staffing as an operational issue, not a legal one. But the OCC addressed sufficient staffing in its horizontal reviews. The Servicer Participation Agreement under HAMP imposes substantive staffing obligations and reserves the right to require that participating servicers increase their call center capability as a remedy. Servicers must establish an easily accessible single point of contact ("SPOC") assigned to each homeowner who reaches out to the servicer regarding difficulty making loan payments.

Servicers may not pay volume-based or other incentives to employees or third-party providers or trustees that encourage undue haste, or lack of due diligence over quality, nor may they adopt compensation arrangements for their employees that encourage foreclosure over loss mitigation alternatives.

Maintaining viable servicing systems is another requirement. For example, servicers must have systems that properly record account information (including posting of payments and imposition of fees), make relevant records relating to a borrower's account promptly available to the SPOC, receive documents, track information for inquiries and complaints, document electronically key actions taken on foreclosure/loan modifications/bankruptcy, and enable consumers to check the updated status of their loan modification applications through an online portal.

Another general operational issue pertains to quality control, audit, oversight, and independent review. Taking a page out of the banking agency requirements, the standards generally require servicers to review and assess the adequacy of their internal controls and procedures and implement procedures to address deficiencies in compliance. Similarly, servicers must adopt policies and procedures to oversee and manage foreclosure firms, law firms, trustees, subservicers and other contractors retained by or on behalf of the servicer and that provide foreclosure, bankruptcy, loss mitigation, and other services. Consumer complaints must be evaluated to identify systemic problems. And there are a variety of requirements relating to independent reviews such as regular reviews of a statistically valid sample of affidavits, sworn statements, proof of claims, default notices, account summaries, among other documents, to ensure accuracy and compliance with law. Independent reviews of loan modification denials also are required. Servicers must have their systems independently reviewed to determine the accuracy and completeness of such systems' ability to record account information.

Global Foreclosure Settlement: The Success of Herding Cats

Communications with Borrowers

At the same time that the CFPB has undertaken initiatives to streamline and synchronize borrower disclosures in order to minimize confusion, new requirements relating to borrower communications are sprinkled throughout the document without regard to whether they conflict with existing legal requirements. One common theme is the method of communication, including the requirement to provide toll free numbers, web based portals, websites, hard copy notices, and a SPOC.

The content and timing of communications is a material issue. The standards obligate certain types of generic information to be provided to consumers, such as loss mitigation options, dispute procedures and SCRA rights. Loan specific information also is addressed in great detail, such as notices of who owns the loan (beyond Section 404 requirements), regular monthly account statements, and notices about borrower rights and options. Notices about the status of the borrower's loan are plentiful, including when a late fee has been imposed, when an application for a modification has been received, a description of missing documents accompanying such an application, decisions on and reasoning behind modification requests, and very detailed pre- and post-referral to foreclosure notices.

The servicers are required to establish and maintain procedures to address complaints by borrowers, their authorized representatives and government officials, and must provide an avenue for escalating disputes and adopt enhanced billing dispute procedures.

General Servicing

Payment administration is addressed in the servicing standards. Servicers must promptly accept and apply all borrower conforming payments, including cure payments (where authorized by law or the loan documents), as of the business day received in the order specified in the loan documents unless such application conflicts with the loan documents or prevailing law; this standard does not explicitly include the qualifier adopted by the FRB in its servicing regulations that except situations where a delay would not result in a late charge, additional interest or negative reporting; presumably, the enforcement mechanism for the standards would get to the same place.

Subject to certain exceptions, servicers are required to accept and apply at least two non-conforming payments from the borrower, when the payment, whether on its own or when combined with a payment made by another source, comes within $50.00 of the scheduled payment. At its discretion, the servicer may post partial payments to a suspense or unapplied funds account, as long as it (a) discloses to the borrower the existence of and any activity in the suspense or unapplied funds account, (b) credits the borrower's account with a full payment as of the date that the funds in the suspense or unapplied funds account are sufficient to cover such full payment, and (c) applies payments as required by the terms of the loan documents.

There are several restrictions on fees charged to borrowers for servicing-related activity, including late fees, property inspection, property preservation, valuation, attorneys, default, foreclosure and bankruptcy-related fees. These limitations address the authority to charge the fees and the maximum amount of such fees and reflect some of the provisions of earlier FTC settlements. For example, where permitted, default, foreclosure, and bankruptcy-related fees must be bona fide, reasonable in amount, for services actually rendered and disclosed to the borrower in detail.

Global Foreclosure Settlement: The Success of Herding Cats

While the amount of the fee may be restricted, there is no outright prohibition on fees charged by affiliates. There is, however, a ban on giving or accepting referral fees in relation to third-party default- or foreclosure-related services.

Force-placed insurance is another topic. Servicers are prohibited from obtaining force-placed insurance without a reasonable cause to believe a homeowner has not paid for property insurance, and must continue to advance payments to an insurer if a homeowner pays into an escrow account, regardless of whether the homeowner has made payments. Many of these provisions are similar in many respects to the provisions in the Dodd-Frank Act.

Servicers also have responsibilities to implement policies to ensure that foreclosure and acquired properties do not become blighted.

Default Servicing

What gave rise to the settlement in the first place was alleged defective default servicing, and the standards are quite detailed on this topic.

Loss mitigation is a major element of these standards, virtually none of which would be a surprise to those participating in HAMP or agency loan programs. Servicers are required to make reasonable and good faith efforts to engage in available loss mitigation activities and foreclosure prevention for delinquent loans, including consideration of a modification, forbearance, short sale, and deed-in-lieu of foreclosure, where appropriate, and make publicly available information on its related qualification processes and requirements. For example, they must design proprietary first-lien loan modification programs that are intended to produce sustainable modifications according to investor guidelines and previous results, and track outcomes and maintain records regarding characteristics and performance of proprietary first-lien loan modifications. This includes an obligation to offer and facilitate loan modifications for borrowers when such loan modifications for which they are eligible are net present value (NPV) positive and meet other applicable requirements. Second-lien modification programs are expected to be designed with the intent of providing affordable payments for borrowers needing longer term or permanent assistance. Servicers may not deny any loss mitigation option to eligible borrowers simply because the borrower is a debtor in bankruptcy.

As noted above, servicers are required to establish a SPOC to ensure that the borrower has access to an employee (or, upon request, to a supervisor) to obtain information throughout the loss mitigation, loan modification and foreclosure processes after a potentially eligible borrower requests loss mitigation assistance. The SPOC must have primary responsibility for (a) communicating with the borrower regarding loss mitigation options and requirements and account status specific to the borrower, (b) coordinating receipt of relevant documents, (c) being knowledgeable about the borrower’s situation, and (d) considering the borrower for applicable loss mitigation options. The SPOC must remain assigned to a borrower’s account and available to borrower until the servicer determines in good faith that all loss mitigation options have been exhausted, the borrower’s account becomes current or, in the case of a borrower in bankruptcy, the borrower has exhausted all loss mitigation options for which the borrower is potentially eligible and has applied.

In order to minimize the risk of borrowers submitting multiple loss mitigation requests for the purpose of delay, servicers will not be obligated to evaluate requests for loss mitigation options from (a) borrowers who have already been evaluated or afforded a fair opportunity to be evaluated consistent with the requirements of HAMP or proprietary modification programs, or (b) borrowers who were evaluated after the date of implementation of the Settlement Agreement, unless there has been a material change in the borrower's financial circumstances that is documented by borrower and submitted to servicer.

Servicers may not, in the ordinary course, require a borrower to waive or release claims and defenses as a condition of approval for a loan modification program or other loss mitigation relief. They, however, may require a waiver or release of claims and defenses with respect to a loan modification offered in connection with the resolution of a contested claim, when the borrower would not otherwise be qualified for the loan modification under existing servicer programs.

If a borrower does not qualify for modification, then the servicer is required to develop a cooperative short sale process which allows the borrower the opportunity to engage with the servicer to pursue a short sale evaluation prior to putting the home on the market, including consideration of appropriate monetary incentives to underwater borrowers to facilitate short sale options.

These provisions also provide very detailed time rules for evaluating borrowers' requests for loan modifications, including the obligation to offer appeals to denials and very tight time frames within which actions must be taken. There are strict prohibitions and conditions on when a loan may be referred to foreclosure and when a referred loan may proceed to a foreclosure sale or move for a foreclosure judgment. The anti-dual track provisions are extraordinarily rules-based and designed to give the borrower every conceivable benefit of the doubt before proceeding to or finalizing foreclosure.

Not surprisingly, foreclosure and bankruptcy-related documentation is a major component of the servicing standards. Servicers must implement processes to ensure that the servicer or the foreclosing entity has a documented enforceable interest in the note and security instrument under applicable state law or otherwise is a proper party to the foreclosure action. With respect to documentation, servicers must ensure that factual assertions made in pleadings, bankruptcy proofs of claim, declarations, affidavits, and sworn statements filed by or on behalf of the servicer in judicial foreclosures or bankruptcy proceedings and notices of default, notices of sale and similar notices submitted by or on behalf of the servicer in non-judicial foreclosures are accurate and complete and are supported by competent and reliable evidence. Servicer's affiants that are used to initiate or advance foreclosure proceedings or bankruptcy proceedings must be natural persons, confirm that they have reviewed competent and reliable evidence to substantiate the borrower's default and the servicer's right to foreclose, including the borrower's loan status and required loan ownership information, and must execute by hand signature (except for permitted electronic filings) and not by signature stamps and any other means of electronic or mechanical signature. Similarly, before a loan is referred to non-judicial foreclosure, the servicer must ensure that it has reviewed competent and reliable evidence to substantiate the borrower's default and the right to foreclosure. Servicers must maintain records that identify all notarizations of the servicer documents executed by each notary employed by the servicer.

The Settlement Agreement provided detailed document requirements relating to proofs of claim and motions for relief from stay in bankruptcy proceedings, including the obligation to attach properly completed primary credit documents. Where lost note affidavits are used in accordance with applicable law, servicers must use good faith efforts to obtain or locate the note or assignment in accordance with its procedures.

The obligations of servicers to comply with the requirements of SCRA are restated in the servicing standards. Clarifications or new requirements are detailed including those regarding eligible documentation, required review processes, timing and content of notices, and assessment of financial hardship in terms of eligibility for loss mitigation without being in default or imminent default.

Compliance Monitoring

The Settlement Agreement calls for the establishment of a monitoring committee for compliance with the agreement's standards. The monitoring committee will comprise representatives of certain of the government signatories to the Settlement Agreement. Joseph Smith, the Commissioner of the North Carolina Banking Department, will be appointed as the head of the committee, which will likely be assisted by an independent professional accounting firm. The servicers are responsible for the committee's fees and expenses.

The servicers are obligated to designate an internal quality control group that is independent from the line of business whose performance is being measured to perform compliance reviews each calendar quarter in accordance with the terms of a work plan. Compliance with the servicing standards under the work plan will be assessed through the quarterly application of defined metrics, each of which will specify a threshold non-cured error rate beyond which the servicer will be deemed in violation of the standards. The monitor may impose additional metrics in certain circumstances. Compliance with the financial terms identified in the menu for consumer relief also will be assessed.

The servicers must report to the monitor on the compliance metrics and other additional information. These reporting obligations include regularly prepared business reports analyzing executive office servicing complaints, that are supported by reliable information and of which the servicer becomes aware, related to significant patterns or practices of noncompliance with a material aspect of the servicing standards and access to work papers prepared by the internal review group. The servicers must respond to monitor requests for relevant information, and the monitor agrees to provide strict confidentiality to the information it receives and generates, although certain confidential information may be shared with the monitoring committee or a participating state or federal agency whose claims are released through the settlement subject to a confidentiality provision.

The monitor also has reporting obligations. He must report quarterly on servicer compliance to the government parties to the agreement, after conferring with the servicers. If the monitor finds that, for example, a servicer violated the threshold error rate for a particular metric, a potential violation will be deemed to have occurred, subject to the servicer's right to cure and obligation to remediate any material harm to identified borrowers. While the monitor may identify violations, only a party to the agreement or the monitoring committee may bring an enforcement action, in the U.S. District Court for the District of Columbia, with respect to the violation. The sole relief available will be non-monetary equitable relief and civil penalties awarded by the court in a maximum amount per uncured violation dependent on the metric at issue.

The Settlement Agreement remains in effect for 3½ years after it is entered, subject to a trailing 6-month review period.

Conclusion

As indicated throughout this client alert, the Settlement Agreement with the five largest servicers does not close the door on further review of the past. The fact that the newly created Residential Mortgage-Backed Securities Group (chaired by New York Attorney General Eric Schneiderman) within the existing Financial Fraud Enforcement Task Force recently issued 11 subpoenas to financial institutions suggests that the securitization carve out from the federal and state releases will be widely utilized.

The government's announcements regarding the Settlement Agreement described the consumer benefits in high numbers, focusing on the total value to consumers of the hard and soft dollars, while many consumer advocates bemoan that the servicers are providing only minimal assistance to a small number of troubled homeowners. However, the Settlement Agreement represents a major resolution of mortgage issues lingering since the financial crisis, establishes what will likely be seen as global servicing standards, and helps the mortgage and housing industries to begin moving forward.

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[i] The 14 servicers subject to the federal agencies' review are Ally Bank/GMAC, Aurora Bank, Bank of America, Citibank, EverBank, HSBC, JPMorgan Chase, MetLife, OneWest, PNC, Sovereign Bank, SunTrust, U.S. Bank, and Wells Fargo. The federal agencies involved were the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision. The agencies reported that the five largest mortgage servicers by activity volume—included among the 14 servicers subject to the reviews and that are now subject to the Settlement Agreement—account for 60 percent of the industry's total servicing volume.

[ii] MERS® is the Mortgage Electronic Registration Systems, Inc., a wholly-owned subsidiary of MERSCORP, with the purpose of serving as mortgagee in the land records for loans registered on the MERS System.

Consumer Financial Services Practice Contact List

K&L Gates' Consumer Financial Services practice provides a comprehensive range of transactional, regulatory compliance, enforcement and litigation services to the lending and settlement service industry. Our focus includes first- and subordinate-lien, open- and closed-end residential mortgage loans, as well as multi-family and commercial mortgage loans. We also advise clients on direct and indirect automobile, and manufactured housing finance relationships. In addition, we handle unsecured consumer and commercial lending. In all areas, our practice includes traditional and e-commerce applications of current law governing the fields of mortgage banking and consumer finance.

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