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Regulatory Actions Melding Into National Servicing Standards

The dialogue about uniform servicing standards included many voices in 2011, and patterns certainly have taken shape.

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In the last year and a half, the foreclosure-documentation crisis has triggered nationwide scrutiny of the default servicing process for residential mortgages. In the wake of these events, supervisory and enforcement actions by banking regulators have set minimum expectations for national servicing standards that are driving compliance expectations.

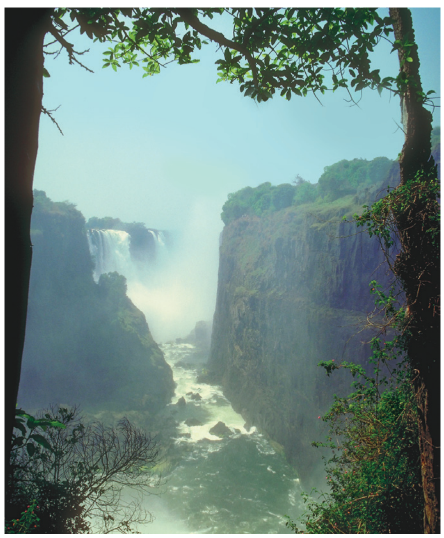
In April 2011, federal banking regulators entered into consent decrees with 14 major servicers and two third-party service providers that mandated significant changes regarding the manner in which default servicing is conducted.

Two months later, in June 2011, the Office of the Comptroller of the Currency (OCC) mandated that loan servicers under its purview conduct self-assessments that require evaluating compliance in six major areas of default servicing and undertaking look-back file reviews to identify borrowers who may have been harmed by prior practices.

More recently, in October 2011, the newest federal regulator, the Consumer Financial Protection Bureau (CFPB), announced servicing examination principles that provide a framework for testing regulated servicers' compliance with consumer protection laws.

In addition, state regulators have spent nearly a year negotiating a detailed settlement with major servicers, including a proposed order setting forth compliance expectations that state attorneys general (AGs) will seek to impose as an industry standard on other servicers.

Although these simultaneous actions by state and federal players have uncertain implications for the long term, prudent servicers are closely reviewing the changing requirements in order to determine what they need to do and what further compliance standards examiners and relevant enforcement agencies will expect them to meet. This article addresses the sources of these standards and offers practical steps for servicers seeking to implement processes that are consistent with regulatory expectations.



The multistate attack

In October 2010, all 50 state AGs and a number of state banking regulators combined to form the Mortgage Foreclosure Multi-State Group, initially focused on the verification and notarization of debt affidavits. This group has worked with several federal agencies in pursuing this investigation, including the U.S. Department of Justice, the U.S. Department of Housing and Urban Development and the then-nascent CFPB. The group's mission immediately expanded beyond the documentation issues toward a larger focus on foreclosure prevention and then to default servicing practices generally.

In March 2011, the group sent a lengthy settlement term sheet to the five largest mortgage servicers, which was a clear and novel effort to set comprehensive national servicing standards through enforcement action. The term sheet addressed a range of business functions, including foreclosure information and documentation; governance of loss mitigation functions; permissible fees; payment posting; and lender-placed insurance.

Although the original proposal was extremely aggressive (in particular, with respect to mandated principal writedowns and the scope of activities it sought to regulate), the exchange of counterproposals between the group and the five servicers has produced detailed but more modest proposals for industry reform.

As of Feb. 1, there has been no official settlement agreement. Tremendous political pressure remains for a resolution that is significant in monetary value and in the forward-looking changes that it mandates. On Nov. 1, 2011, 25 members of Congress sent a letter to U.S. Attorney General Eric Holder, urging him to ensure that "any settlement reached between the states and the mortgage servicers reflects the gravity of the harm done to American homeowners."

While there seems to be general agreement on servicing standards to be incorporated, deep disagreement remains over some issues - including the extent of any liability release to be provided to financial institutions.

Influential AGs from California, Massachusetts, New York and Nevada have severed ties with the multistate group and are moving forward with separate investigations and lawsuits. More than 30 congressional Democrats from California sent a letter to President Obama on Dec. 15, 2011, urging him to support California Attorney General Kamala Harris' investigation.

Also, AGs from New York and Delaware are working together to investigate possible "criminal acts" by financial institutions tied to the foreclosure crisis, and Nevada recently took criminal action against a number of individuals who had been employed by a widely used third-party default services provider, alleging their involvement in foreclosure-documentation improprieties.

Despite fractures in the multistate group, a settlement involving a significant number of AGs remains likely. Even piecemeal resolution by enforcement action plays a role in setting servicing standards, especially in light of the market share held by the targets of the investigation. Like other standards, the multistate group standards are likely to substantially increase the costs associated with default servicing.

The CFPB's procedures

On Oct. 13, 2011, the CFPB released the first edition of its Supervision and Examination Manual. The manual incorporates many of the same examination procedures developed by the Federal Financial Institutions Examination Council with respect to laws now under the jurisdiction of the CFPB, including the Truth in Lending Act; the Real Estate Settlement Procedures Act; the Electronic Funds Transfer Act and Regulation E; the Fair Debt Collection Practices Act; the Homeowners Protection Act; the Fair Credit Reporting Act; the Gramm-Leach-Bliley Act; the Equal Credit Opportunity Act (ECOA) and Regulation B; and the Federal Trade Commission Act.

Although many of the concepts are neither novel nor surprising, they do incorporate key principles from major Federal Trade Commission actions against institutions such as Fairbanks Capital, EMC Mortgage and Countrywide.

The manual's procedures confirm that while the CFPB is charged with the enforcement of laws under its jurisdiction, the agency understands its distinct mission to be the protection of consumers from harms more diffuse across financial products. In particular, the manual makes clear that the CFPB is focused on issues of access to fair servicing for minority homeowners.

The CFPB will prioritize examinations based on an evaluation of "inherent risks" to consumers, and its first round of product reviews will focus on mortgage servicing. In particular, the manual signals the CFPB's priority on servicing relating to nonperforming loans (especially associated fees), foreclosure referrals and loan modifications, as well as the primacy of data in process and system evaluations.

The manual states that the CFPB's compliance supervision and examination process will be guided by three principles. First, the CFPB will evaluate the policies and practices of financial institutions with a focus on detecting, preventing and correcting practices that present a significant risk of violating consumer protection laws and causing consumer harm.

Second, in conducting supervisory activities, the CFPB will rely on the analysis of data pertaining to the activities of regulated entities, the markets in which regulated entities operate and the risks posed to consumers by activities of these entities in their operating markets.

Finally, the CFPB aims to apply its supervisory standards to both depository and nondepository institutions.

With respect to routine servicing and certain default servicing activities, CFPB examiners may review servicing records for evidence that loan-boarding procedures, payment systems, customer call centers, credit reporting practices, information-sharing/privacy policies and debt collection practices fail to comply with consumer protection statutes and regulations.

Additionally, with respect to foreclosure and certain default servicing activities, CFPB examiners may review servicing records for evidence that loss mitigation and foreclosure practices discriminate against protected classes in violation of anti-discrimination statutes and regulations. In this regard, the manual applies fair-lending principles traditionally understood in the context of origination to the entire life cycle of a loan.

Inside the manual

The manual establishes a comprehensive framework to test standard servicing, default servicing and foreclosure servicing practices. It is divided into nine modules, each of which establishes examination procedures for different aspects of the loan servicing cycle.

Modules 8 and 9 are of particular interest, as they expressly import disparate treatment and disparate impact analyses under ECOA into loss mitigation review. Specifically, examiner comparisons will include borrowers whose accounts are delinquent and resolved, as well as borrowers in serious delinquency and foreclosure.

Some details include the following:

• Module 1 establishes procedures for reviewing whether the servicer boards customer accounts properly (especially with respect to amounts owed, amounts charged for escrow, and loss mitigation status), as well as provides the customer with all federally mandated transfer-of-servicing disclosures.

• Module 2 creates processes for determining whether the servicer follows industry best practices for processing payments, tracking credit balances and applying suspense funds.

Additionally, the module creates processes for determining whether fees charged by servicers for optional products and default services have a reasonable relationship to the value provided and are necessary for effective servicing and maintenance of the account and property. The module also creates processes for determining whether the servicer complies with laws requiring periodic statements and disclosures.

• Module 3 institutes a framework for testing the adequacy of the servicer's customer service program, including whether the servicer maintains a sufficiently large customer service staff and effectively responds to both customer complaints and qualified written requests.

• Module 4 establishes procedures for reviewing whether the servicer maintains sufficient funds in escrow; timely pays taxes and insurance bills; adequately discloses lender-placed insurance; promptly refunds insurance premiums assessed in error; and does not mark up lender-placed insurance products without creating value for the customer.

were referred to foreclosure during the prior year. If an examination identifies a problem, the CFPB has the option to take informal supervisory action or institute a formal enforcement action, depending on the type of problem found and the severity of harm to consumers.

If the CFPB opts to pursue a formal enforcement action, the agency may

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• Module 5 creates processes for determining whether the servicer accurately reports customer account information and promptly corrects reporting errors.

• Module 6 establishes procedures for reviewing whether the servicer complies with the Fair Credit Reporting Act's affiliate marketing rule and the Gramm-Leach-Bliley Act.

• Module 7 creates processes for determining whether the servicer complies with the Fair Debt Collection Practices Act and certain bankruptcy laws, when applicable.

• Module 8 institutes a framework for testing whether the servicer's loss mitigation process complies with anti-discrimination laws, adequately discloses to the customer the consequence of accepting a loss mitigation option, and meets certain customer service standards. The module emphasizes that inadequacies in a single-point-of-contact system may constitute "risk to consumers."

• Module 9 establishes procedures for assessing whether the servicer's foreclosure processes comply with anti-discrimination laws, do not erroneously or unnecessarily refer loans to foreclosure, and comply with state foreclosure laws. It also creates processes for evaluating whether the servicer's foreclosure processes adequately inform consumers about foreclosure status. Examiners are expressly directed to review dual tracking.

With the CFPB's emphasis on consumer complaints as indicative of potential harm, examiners will review all complaints of consumers whose loans launch an investigation, institute an administrative proceeding or bring a civil action in federal district court.

The agency may also refer matters outside of its jurisdiction to other government regulators. Referral authority includes the power to refer criminal violations to the Department of Justice and tax violations to the Internal Revenue Service.

Horizontal review

In late 2010, the Federal Reserve System, the OCC, the Office of Thrift Supervision and the Federal Deposit Insurance Corp. conducted a horizontal review of the mortgage servicing operations at 14 federally regulated mortgage servicers and two service providers. Approximately 2,800 loan files were examined.

The purpose of the review was "to evaluate the adequacy of controls and governance over servicers' foreclosure processes and assess servicers' authority to foreclose." The review culminated in the April 2011 execution of 16 consent orders covering foreclosure process governance; organizational structure and availability of staffing; affidavit and notarization practices; documentation practices; third-party vendor management; and quality control and audits.

Key findings in a report on the supervisory action, titled the "Interagency Review of Foreclosure Policies and Practices," included the conclusion that while there were significant process errors, all foreclosed borrowers were seriously delinquent and loan ownership documentation generally was adequate.

Nonetheless, the review identified weaknesses, including insufficient staffing; deficiencies in foreclosure policies and procedures (including processes related to affidavit execution and notarization); inaccurate assessment of fees (both undercharges and overcharges); inadequacies in quality control and audit functions; and inadequate oversight of third-party service providers (including, in particular, foreclosure counsel).

Consequently, the agencies "are currently engaged in an effort to establish national mortgage servicing standards to promote the safe and sound operation of mortgage servicing and foreclosure processing, including standards for accountability and responsiveness to borrower concerns."

As a start, the consent orders require substantial corrective action for those subject to the consent decrees, including the following:

• revised policies and procedures associated with foreclosure, including procedures in connection with legal compliance;

• independent comprehensive risk assessments, including a look back at residential foreclosure actions pending at any time from Jan. 1, 2009, through Dec. 31, 2010, intended to identify and remediate any harmed borrower;

• implementation of a single point of contact;

• elimination of dual tracking;

• heightened oversight of third-party service providers; and

• management information system improvements for foreclosure, loss mitigation and loan modification activities.

In many respects, the consent orders set a baseline for national mortgage servicing standards because they reflect concepts regulators believe to be necessary for safe and sound servicing by the nation's most prominent servicers.

These themes carried forward in the OCC's June 30, 2011, "Supervisory Guidance 2011-29," which communicates the OCC's baseline expectation that the mortgage servicers that it regulates "adhere to appropriate foreclosure management standards."

These standards include foreclosure-process governance; dual-track processing; affidavit and notarization practices; documentation practices; legal compliance; and third-party vendor management. The guidance advises banks to conduct self-assessments of foreclosure management practices to identify any weaknesses and take corrective action.

Although the time frame originally prescribed (no later than Sept. 30, 2011) was somewhat unrealistic as a practical matter, regulated servicers should endeavor to expeditiously evaluate their practices in light of the OCC's expectations and make necessary revisions.

Six compliance themes

The sources of the new servicing standards are varied, and it remains to be seen how simultaneous regulatory and enforcement actions will play out. However, six consistent themes have emerged.

These standards - and some recommendations relating to the responsive measures that might be undertaken by servicers going forward - include the following:

Foreclosure-process governance. Foreclosure policies must be well documented and contain adequate controls to manage operational, compliance, legal and reputational risk associated with foreclosure activities. Employee compliance with written policies must be monitored.

How to comply: Servicers should review and revise (or rewrite) written policies and procedures for all key functions, and install mechanisms to ensure the appropriate management, reporting and board oversight of compliance at all levels.

Servicers should take a fresh look at the substance of their monitoring efforts. For example, some may track the speed of foreclosure processes, but not the quality of their services rendered by counsel. Servicers also should make sure that staffing is appropriately keyed to increased and increasing workloads, that foreclosure training is comprehensive both in-house and for third parties, and that key computer systems are compatible and can communicate with one another to effectively transmit critical borrower information.

Dual-track processing. Foreclosures should not proceed for borrowers who have been approved for and are current on loss mitigation plans.

How to comply: Servicers under a mandate to cease dual-tracking must discontinue the practice of proceeding with foreclosures when borrowers are current on trial modification plans.

Although the concept may seem simple, it can be difficult to implement cessation of practices that involve multiple business lines and third parties, such as foreclosure counsel, bankruptcy counsel and substitute trustees. Ending dual-tracking requires significant coordination among internal groups and third-party service providers, together with the computerized systems on which they rely. Quality control and data integrity checks are paramount to ensure that aspirations are aligned with reality.

Affidavit and notarization practices. Affidavit attestations must be based on adequate personal knowledge of the affiant and supported by documentation. Notaries and signatories must comply with state notary requirements.

How to comply: Servicers should review and revise written procedures on standards for personal knowledge, use of business records and adherence to notarization formalities. Doing so requires up-to-date determinations of state law requirements.

Servicers also should create an auditable trail for attested facts and should conduct comprehensive training (and retraining) for affiants and notaries.

Documentation practices. Documents supporting foreclosure proceedings must be maintained, endorsed and assigned, and their accuracy must be verified.

How to comply: The documentation of decisions related to loss mitigation is even more important with the prohibition of dual-tracking. Servicers must implement processes sufficient to ensure the ability to locate and access all pertinent documents, to create an auditable trail of all facts asserted in the affidavit, and to prove the plaintiff's legal standing to foreclose.

Legal compliance. Lenders must comply with all laws and regulations relating to foreclosure, with a special focus on the Servicemembers Civil Relief Act (SCRA) and bankruptcy protections.

How to comply: Servicers should ensure that they have a detailed compilation and understanding of state foreclosure laws and regulations. Servicers should develop a system to actively monitor regulatory changes, a standard procedure for the timely implementation of changes, and audit processes to both ensure compliance and identify exceptions.

In a nutshell, complete reliance on foreclosure counsel is unlikely to be sufficient. Internal departments must communicate effectively with one another and with outside foreclosure counsel. They should also actively monitor a reasonable number of reliable data sources for bankruptcy filings or changes in borrowers' military status.

Third-party vendor management. Management must ensure third-party vendors are qualified to undertake the roles for which they are hired and must oversee and closely monitor vendors, including outside foreclosure counsel.

How to comply: Servicers should review their current relationships with third-party vendors to ensure that vendors comply with bank procedures, legal standards and emerging industry best practices. This includes reviewing agreements with all vendors, especially those with outside foreclosure counsel assisting with default servicing; implementing a careful due-diligence process when selecting and renewing vendors; and providing ongoing oversight, including periodic reviews. The results of these reviews, if suboptimal, should be considered in decisions about whether to retain or discontinue specific vendors.

A comprehensive due-diligence process for selecting and renewing vendors might include examination of qualifications, backgrounds and reputations of company principals; references from other clients and customers; corporate financial status; delivery capability and effectiveness; internal controls; and legal and regulatory compliance records.

Also, a review of the professional liability or errors-and-omissions insurance policies of vendors should be conducted on a regular basis, with a view to the volume of business conducted with the specific vendor and the appropriate level of liability coverage. SM

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