Testimony of Kurt Eggert
Professor of Law
Chapman University School of Law

Before the U.S. Senate
Committee on Banking, Housing, and Urban Affairs

At a Hearing Entitled:
"Problems in Mortgage Servicing From Modification to Foreclosure Part II."

Dirksen Senate Office Building, Washington, DC
December 1, 2010

Good morning Chairman Dodd, Ranking Member Shelby, and members of the committee. Thank you for the invitation to discuss the problems that borrowers are facing with mortgage servicers, the conflicts of interests that servicers have with investors in mortgage-backed securities, and the emerging issues of robosigners and documentation problems bedeviling the mortgage industry.

As our country slowly digs its way out of what has been termed the "Great Recession," it is notable that the housing market is one aspect of the economy that has been a dead weight. Housing prices continue to drop in many parts of the country. Foreclosures are proceeding at a fearsome pace and the large number of bank-owned houses, along with those heading toward foreclosure, may continue to drive down housing prices in many markets for some time to come.

To stop this drag on the economy, we need to focus on two tasks. The first is finding a way to resolve the problem loans that were made during the last decade before the subprime meltdown in such a way as to prevent unnecessary foreclosures and to minimize losses to investors who purchased securities backed by those loans. Investors and borrowers sometimes have conflicting goals, and we need to find a way to balance their interests when they compete. However, borrowers and investors often have merging interests, when, for example, an appropriate loan modification would prevent foreclosure and maximize investor return.

The second task we should take on is restoring the mortgage market on an on-going basis. Currently, the mortgage system depends to an enormous degree on government-sponsored or government entities, because investors have lost so much faith in private origination and securitization of loans. If the private mortgage market is to be restored, investors must be certain that buyers do not regularly fall victim to predatory loans destined for default. But investors must also be assured that servicers will not take advantage of borrowers with junk fees and inappropriate foreclosures that harm borrowers and investors alike. Currently, servicers are able to unduly enrich themselves to the detriment of both borrowers and investors.

In this testimony, I will first discuss how we find ourselves in this foreclosure crisis, with too many robosigning servicer employers and too few effective loan modifications. Then, I will briefly describe securitization and how it creates the need for mortgage servicing and then describe in more detail the ways servicers financially abuse borrowers, with junk fees, unnecessary foreclosures, and the failure to provide or agree to appropriate loan modifications. After a discussion of the Robosigner scandal and mortgage transfer problems, this testimony will address the conflicts of interests that are rampant in the servicing industry and how those interact with the representations and warranties included in a securitization deal, and then conclude with some ideas about how to reform mortgage servicing to avoid many of the problems we see today.

How We Got Here

To understand the current servicer problems, it is important to understand how we reached such dire straits. The bubble and then meltdown of the subprime and non-prime mortgage was caused in large part by the securitization of those loans, and the fact that securitization allowed market participants to drive down underwriting standards, while hiding much of the reduction of those underwriting standards from investors in the securities that were backed by those loans. During the boom years, from 2005 until the subprime market collapsed in 2007, it was as if the American mortgage market were living in an almost lawless state.[1]

Many subprime lenders were regulated only by state agencies, which did almost nothing to control the types of loans they made or the underwriting standards that they applied. Federally regulated subprime lenders migrated to whatever federal agency regulated and reined them in as little as possible. The Federal Reserve Board, which held the authority to issue regulations under the Truth in Lending Act and might have curbed the no documentation and exotic loans with multiple layers of risk, instead chose until too late to trust banks largely to self-regulate. The Federal Reserve Board's then chair seemed to disdain consumer protection, and withheld needed regulation in the belief that lenders' own self-interest would cause them to act responsibly.

With the mortgage collapse and resulting economic turmoil, it became painfully obvious that more regulation of financial institutions would be necessary. The Federal Reserve Board finally acted to curb some of the worst mortgage practices. The recent Dodd–Frank Wall Street Reform and Consumer Protection Act was designed to prevent much of the misbehavior by financial institutions that helped cause the mortgage boom and bust. An important aspect of that bill is the creation of the Bureau of Consumer Financial Protection, designed to protect consumers in the use of financial products and services. While Dodd-Frank has much to recommend it, it also leaves much of the detail work to regulatory agencies, with instructions on what to accomplish but some discretion on how to accomplish it.

One task that regulators have in implementing Dodd-Frank is to design new rules for the securitization of residential mortgages, recognizing that the system that we had until the mortgage meltdown was riddled with holes that the financial institutions running the system understood and exploited. When discussing mortgage servicing's problems, it is important to put this issue in the larger context, to see that our current system of mortgage servicing is part of a mortgage system so flawed that it came crashing to a stop because of those flaws, leaving myriad foreclosures, bankrupt companies, ravaged investors, and trashed economies in its wake.

Regulators who would fix securitization must be bold in their repairs, recognizing that the system needs far more than the pinch of transparency and dash of requiring "skin in the game" that some have proposed. But fixing securitization means more than just fixing how loans are originated and securitized. It also means fixing how residential mortgages are serviced. For many borrowers, how a loan is serviced means as much or more to them as how it was originated. Servicing is a crucial piece of the securitization industry, and so far it is being run on the cheap, half in the dark, with

[1] For an explanation of how and why the mortgage meltdown happened, see Kurt Eggert, *The Great Collapse: How Securitization Caused the Subprime Meltdown*. 41 CONNECTICUT LAW REVIEW 4 (2009), available at SSRN: http://ssrn.com/abstract=1434691

little effective regulation or oversight. Borrowers are at the mercy of their servicers, with some providing modifications, others not. Some servicers promise modifications and then at the last minute yank the rug out from under borrowers by starting foreclosures even while negotiating a modification that might have prevented that foreclosure. Some servicers push borrowers into foreclosures by the late fees, the suspense accounts, and other means to squeeze their maximum gain from borrowers, even if it hurts borrower and investor alike.

The financial industry and the federal agencies that regulate it have often viewed consumer protection for borrowers as a zero sum game, in that the more protection consumers are given in the mortgage industry, the less profit banks can make. Since banking regulators have long focused fixedly on the safety and soundness of their regulated institutions, too often protections for consumers were viewed as a threat to the financial soundness of regulated banks, and so federal regulators protected banks, rather than consumers.

With securitization, however, it is important to recognize that there are three major players at the table, banks, consumers, and investors. As banks discovered when investors pulled out of the market for non-GSE mortgage-backed securities, investors are just as important as lenders and borrowers for any mortgage industry that is dependent on securitization. However, the banks who survived the Great Collapse seem either to be missing this lesson or choosing to ignore it in the short term in order to reap short term profits. Over and over, banks have been taking steps to push losses for bad loans onto investors, despite representations and warranties of the fitness of those loans by banks. Ironically, banks are engaging in much better examination of loan files in order to avoid repurchasing bad loans than they ever conducted before making the loans.

This battle against investors shows itself in mortgage servicing as well. Investors in mortgage-backed securities are the true owners of the loans backing those securities. However, investors have few of the rights that owners of property should possess. It is difficult for investors to examine even basic documents regarding their property to see if they were defrauded when they purchased the securities. Their agent, the mortgage servicer, often is a subsidiary of the lender that may have sold them bad loans, yet has the power to deny them such basic rights of ownership. The agreement that binds their relationship with the servicer, the Pooling and Servicing Agreement (PSA), was normally drafted before investors purchased their securities, and so was offered to the investors on a “take it or leave it basis.”

Investors have a great stake in how servicers work with borrowers, what loan modifications they grant, and whether they foreclose unnecessarily. A foreclosure that could and should have been prevented costs investors dearly. And so, anyone discussing problems with mortgage servicing should not fall into the trap set by those who claim that mortgage servicing problems are mere technical defects being seized upon by deadbeat borrowers who should be losing their houses anyway. Mortgage servicer abuses have two sets of victims, the homeowners/borrowers and the investors in mortgage-backed securities.

Securitization and the Need for Mortgage Servicing

Securitization has transformed the American system of originating, funding and holding mortgage loans. While some in the financial industry portray securitization as a crucial component of the mortgage market, residential lending is conducted without securitization, or at least securitization that would be recognizable to Americans, in many parts of the world. Furthermore, many of those countries did not experience the great mortgage crash seen in the U.S., at least not first-hand.

Securitization is the process of pooling assets, such as home loans, that produces an income stream, and then selling securities that are backed by those assets, allowing investors in the securities to divide the income-stream that the assets produce. Securitizing loans is supposed to convert the fairly illiquid individual loans into much more liquid, tradable securities. In theory, securitization was supposed to benefit investors by allowing them to reduce their information-gathering costs by being able to rely on rating agencies and to reduce their risk of default by having an entire pool of loans to rely for payment on, and to benefit from other means of enhancing the stability of loan pool, such as buying insurance against the risk of default and requiring more loans in the pool than would be necessary to provide a sufficient income stream.

In practice, however, securitization of non-prime loans turned out to be a quagmire for investors, as it was difficult for them to detect the high risk of loans backing the pools, and the complexity of the resulting securities rendered their risk opaque. Such securitization was opaque in two ways, the first being that investors were not given timely and adequate information about the risks of the loans backing the securities they were purchasing. Secondly, by hiding default risk in securities with complex structures, the risks of which were again sliced and diced among CDOs, credit default swaps, insurance, repurchase agreements and other hedge attempts, securitization made it difficult to determine the amount and danger of mortgage default risk held by different financial institutions.

Securitization transformed the mortgage industry because it "atomized" it, as termed by Michael Jacobides, allowing a different entity taking over each stage of the process.[2] Rather than a single entity, such as a neighborhood bank, making and holding and collecting on a loan throughout the life of a loan, each task can be assigned to a different company. While a mortgage broker may sell the loan, a

[2] Michael G. Jacobides, *Mortgage Banking Unbundling: Structure, Automation and Profit. Mortgage Banking*, Jan. 1, 2001.

separate company may make the loan, another may fund the loan, and another may acquire it and bundle it with other loans for securitization. A Wall Street investment bank may acquire the loan pool and transfer the loans to a special purpose vehicle (SPV) such as a trust run, a rating agency normally is hired to rate the securities created that are backed by the trust assets, and then the investment bank will sell the resulting securities to investors, hold them itself, or rebundle them into a CDO for the creation of new securities. In the meantime, a trustee theoretically oversees the trust holding the loans, but actually a loan servicer, either directly or through a special servicer, collects on the loan, conducts any loss mitigation necessary if the borrower has trouble paying the loan, and determines when foreclosure is necessary.

The rights of the investors and their legal relationship between the investors, the trustee of the trust and the servicer is primarily contractual, in that the relationship and the legal rights and obligations of the parties are spelled out and determined by the Pooling and Servicing Agreement (PSA) governing that particular securitization transaction. The PSA comprises both the trust agreement between the trustee and the investors and also the agency agreement between the trustee and the primary servicer. However, the PSA is drafted and negotiated before the securities are issued, and so investors are not directly involved in the PSA's negotiation and drafting. At most, investors can participate only indirectly, by refusing to purchase securities with a PSA that is too unworkable or too unfair to investors.

Servicer Abuse of Borrowers

One of the purposes of this hearing is to determine how, why, and to what extent servicers engage in behavior that takes advantage of borrowers and increases borrowers' likelihood of foreclosure. While the mortgage industry might like to think that servicers currently have short term difficulties due to the increased number of defaulting and foreclosing loans they currently must address, in fact servicer abuse was afflicting borrowers long before the current financial and foreclosure crisis. In 2004, I documented the widespread misbehavior of mortgage servicers, and defined "servicer abuse" as follows:

> Abusive servicing occurs when a servicer, either through action or inaction, obtains or attempts to obtain unwarranted fees or other costs from borrowers, engages in unfair collection practices, or through its own improper behavior or inaction causes borrowers to be more likely to go into default or have their homes foreclosed. . . .Servicing can be abusive either intentionally, when there is intent to obtain unwarranted fees, or negligently, when, for example, a servicer's records are so

> disorganized that borrowers are regularly charged late fees even when mortgage payments were made on time.[3]

The types of servicer abuse that my 2004 article discussed are still quite present today and are the subject of many of the complaints about servicers. While we may have gained greater understanding about how and why servicers engage in this unfair and inappropriate behavior, sadly it appears that we have done little to prevent or even greatly discourage it.

Improper foreclosure or attempted foreclosure

On a regular basis, servicers attempt to foreclose on property where either the borrower is current on the note or would be but for bad behavior by servicers, or where the investors would benefit from a loan modification that the borrower would be able to afford. While many have defended aggressive foreclosure efforts by arguing that by and large the homeowners were behind on their mortgages and so foreclosure was appropriate, it is important to keep in mind that the servicer is supposed to be working for the benefit of the investors, and if the servicer forecloses when a loan modification would be more valuable to investors, the servicer has committed a wrong against the investors.

Courts have long complained about servicers attempting to foreclose when it appears that no foreclosure is justified. In the 2002 case, *In re* Gorshtein, the court noted three examples of where servicers falsely claimed borrowers were in default and sanctioned the creditors, saying that its decision was "provoked by an apparently increasing number of motions in this Court to vacate the automatic stay filed by secured creditors often based upon attorney affidavits certifying material post petition defaults where, in fact, there were no material defaults by the debtors."[4]

Lest anyone thing that these are problems from the past, in the case from August, 2010, *In re* Cothern, the court noted how a servicer drove two borrowers into bankruptcy and attempted to foreclose, even though the borrowers had always paid their mortgage payments like clockwork. The servicer had wrongly concluded that the borrowers had failed to insure the house, and bought force-placed insurance on the property. Even when the servicer realized its mistake, however, it did not fix it, but rather began putting the borrowers' payments into a suspense account rather than applying them to principal, and in the end tried to collect foreclosure fees, attorneys fees, and other charges totaling $15,000, even though the borrowers had made timely mortgage payments and insurance payments. The court concluded, "There is no doubt that the unrelenting actions of [the servicer] drove the Cotherns into

[3] Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 HOUSING POL'Y DEBATE 753, 756 (2004), available at Available at SSRN: http://ssrn.com/abstract=992095.
[4] *In re* Gorshtein , 285 B.R. 118 (2002),

bankruptcy. [The servicer's] conduct throughout this factual scenario represents the most callous and egregious effort to collect an indebtedness that was never owed that this court has been called upon to review. Succinctly stated, [the servicer's] incompetent servicing tactics converted a loan transaction that was being paid like 'clockwork' to a loan that was virtually impossible to pay, particularly for modest income borrowers."[5]

Even when borrowers are able to stop the foreclosures eventually and with great effort, they are still damaged by the servicers' behavior. Borrowers who are the victims of unwarranted claims of default find their credit scores suffer and may find it more difficult later to buy a house or refinance their loans. They may even lose out on a new job or a promotion as a result.[6]

Servicers often have a great financial incentive pushing them toward foreclosure. For example, servicers may be attempting to recover advances or costs for a loan as they are paid first from the proceeds of the foreclosure. Also, servicers may have a conflict of interest with the investor that could encourage them to foreclose on a loan quickly, in that the servicers' parent organization may benefit from a foreclosure. These issues will be addressed in later sections.

Improper fees

At the heart of abusive servicing is the charging of inappropriate fees, late fees or other charges to which the servicer is not entitled. The temptation for servicers to charge fees is enormous, given that fees are a great percentage of their income, and that the payment system structure was designed before servicers realized how high foreclosure rates would climb and that their job would be transformed from by and large mere payment collection to active loan restructuring for a large percentage of the loans they serviced. Servicer costs were increased not only by the high default rate, but also by the exotic loans that were generated during the last decade, with

Servicer income comes from four primary sources, (1) late fees and other fees on borrowers, (2) the "float" of interest that accrues between the time that borrowers pay on their loans and when servicers pass those funds on to investors, and (3) a flat servicing fee that they charge to investors, the size of which depends on the type of loan, with prime loans carrying half the fee of subprime loans, and investment income from the servicers interests in the pool being serviced.[7] Even this greater charge for

[5] *In re* Cothern, --- B.R. ----, 2010 WL 4235864 (Bkrtcy.N.D.Miss.)
[6] For a discussion of the effect on borrowers of default, see Roberto G. Quercia and Michael A. Stegman, *Residential Mortgage Default: A Review of the Literature*. JOURNAL OF HOUSING RESEARCH 3(2):341–79 (1992).
[7] Diane E. Thompson, Nat'l Consumer Law Center, *Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior, Servicers Compensation & Its Consequences* (2009), vi, available at http://www.consumerlaw.org/issues/mortgage_servicing/content/Servicer-Report1009.pdf

subprime loans, though, does not make up for how much more expensive subprime loans are to service, and so with subprime and non-prime loans, servicers look to fees to borrowers, rather than investors, for a sizable portion of their payment. In 2006, subprime servicers were able to collect about three times the amount of late fees per loan as prime servicers.[8]

It is difficult for borrowers to fend off improper fees. They may not be certain, for example, whether a servicer received a payment late or just sat on the check for a day or two before processing it. Borrowers may not be familiar with what fees their loan agreement authorizes, and may not recognize it when a servicer charges a fee not allowed by the loan documents. Pooling and servicing agreements typically provide that the servicer, not the trustee or the investors, are entitled to these fees from borrowers, which encourages servicers to discover as many fees as possible, even if it might mean stepping over the legal or ethical line.

Just how willing servicers are to push fees on borrowers can be seen in a study of fees claimed by servicers in borrower bankruptcy proceedings, when one might think that servicers would be most cautious in trying to extract unwarranted fees. Not only do mortgage servicers consistently claim that they are owed more than borrowers have scheduled, but also a review of their claims shows, according to its author, Katherine M. Porter, "Many creditors do not comply with applicable law governing claims. Routinely, fees are not identified with specificity, making it impossible to determine if these charges are legal. In most instances, mortgagees believe the debt is greater than debtors do; these differences typically represent thousands of dollars. Yet, creditors are rarely called to task for these behaviors."[9]

The Federal Trade Commission has had some luck in suing mortgage servicers for inappropriate fees and other abusive behavior. However, the history of FTC litigation indicates that they are likely only able to target the worst offenders, while other servicers skate by without sanction. In 2003, the most notorious servicer, Fairbanks Capital, agreed to create a $40 million fund to help borrowers who had been damaged by its improper actions. Fairbanks also agreed to abide by a set of best practices for good behavior by mortgage servicers. At the time, it was hoped that the FTC could, by sanctioning Fairbanks and establishing a set of best practices, encourage good servicing practices among other servicers.[10] That hope seems to have been in vain, though, and the FTC has had to regularly seek sanctions against other servicers.

In 2008, Bear Stearns and its servicer subsidiary settled claims that they had "misrepresented the amounts borrowers owed, charged unauthorized fees, such as late fees, property inspection fees, and loan modification fees, and engaged in unlawful

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[8]Ted Cornwell, *Profit Run Might Stall*. MORTGAGE SERVICING NEWS 11(3):1 (2007).
[9] Katherine M. Porter, *Mortgage Misbehavior*, 87 TEX. L. REV. 121, 162 (2008).
[10] For a discussion of Fairbanks's actions and the FTC litigation against Fairbanks, see Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 HOUSING POL'Y DEBATE 753, 761 - 67 (2004), available at Available at SSRN: http://ssrn.com/abstract=992095.

and abusive collection practices." To settle the claims, Bear Stearns and its servicers agreed to establish a data integrity system and to pay $28 million.[11] Again, in 2010, the FTC announced yet another landmark fine and settlement against a mortgage servicer, this time Countrywide's loan servicing operation, which the FTC had accused of deceiving borrowers by using an intermediary to mark up the cost of services provided when homeowners are in default, such as property inspection, lawn care, and other services designed to protect the property value securing the loan at issue. This time, the settlement amount jumped to $108 million.[12]

While this series of settlements with servicers with an escalating pattern of payments is no doubt well-intentioned by the FTC, it is worrisomely similar to the pattern of payouts by subprime lenders before the great mortgage collapse. Rather than put an end to abusive lending, settlements of $484 million by Household Finance settlement in 2002 and for $325 million by Ameriquest in 2006 were primarily examples of how lucrative such lending could be.[13]

Failing to Engage in Appropriate Loan Modification

It has long been recognized that an important tool to deal with problem loans is for servicers to work with borrowers to agree to appropriate loan modifications instead of proceeding to foreclosures. Foreclosures clearly are damaging to borrowers, even those who are underwater and have no equity to lose in their homes. Their credit is damaged and they may have great purchasing another home. The wave of foreclosures hurts communities as well, as it lowers property values and leaves strings of empty houses in its wake. Foreclosures can also be harmful to investors, especially when the borrower owes more than the house is worth and a foreclosure sale will return only a fraction of the loan amount.

Servicers are supposed to maximize the value of the return of the loan to investors, to foreclose when that would give most value and to engage in other loss mitigation when that would give investors the greatest return. Making that calculation more difficult is the possibility that borrowers will redefault when provided a second chance through a loan modification, might refinance if faced with foreclosure, or

[11] See the Federal Trade Commission's press release regarding this settlement, Bear Stearns and EMC Mortgage to Pay $28 Million to Settle FTC Charges of Unlawful Mortgage Servicing and Debt Collection Practices, September 9, 2008, available at http://www.ftc.gov/opa/2008/09/emc.shtm

[12] See the Federal Trade Commission's press release regarding the Countrywide settlement, *Countrywide Will Pay $108 Million for Overcharging Struggling Homeowners; Loan Servicer Inflated Fees, Mishandled Loans of Borrowers in Bankruptcy*, June 7, 2010, available at http://www.ftc.gov/opa/2010/06/countrywide.shtm

[13] For a discussion of these settlements, see Kurt Eggert, *The Great Collapse, How Securitization Caused the Subprime Meltdown*, 41 CONN. L. REV. 1257, 1297 (2009).

might find some other way to bring the property current.[14]

Much of the response to the mortgage crisis has been a series of initiatives by both industry and government to encourage and even fund such modifications. While these programs have by and large been well-intentioned and have helped some borrowers, the overall result so far has been disappointing. New HAMP Trial starts have been leveling off, with fewer and fewer new such trial modifications, while fewer than 500,000 permanent modifications have begun since the start of this program.[15]

It is becoming increasingly clear that the process of securitization itself creates impediments to loan modifications, even those that would benefit both borrower and investor alike, though not all economists agree on this. Adelino, Gerardi, and Willen (2009) had discounted the idea that securitization reduced effective loan modification, but instead argued that servicers were failing to engage in loan modifications for economically rational motives. According to their analysis, servicers are faced with several dilemmas. Borrowers that request loan modifications may sometimes cure their loans even without that potentially costly help. Conversely, borrowers who receive loan modifications regularly redefault anyway, despite the labors and expenses by the servicers for the modification. And so waiting and hoping might be a more economically sound decision than modifying the loan.[16]

To challenge this analysis, other economists have compared how third party servicers, those servicing loans on behalf of investors, handle problem loans compared to banks servicing their own loans held in portfolio. For example, Piskorski, Seru and Vig (2010) found that securitization causes a "foreclosure bias," noting, "Controlling for contract terms and regional conditions, we find that seriously delinquent loans that are held by the bank (henceforth called 'portfolio' loans) have lower foreclosure rates than comparable securitized loans (between 3% (13%) to 7% (32%) in absolute (relative) terms)." Piskorski, et. al. also note that governmental agency reports on loan modifications also validate the idea that securitized loans exhibit a "foreclosure bias," and state, "OCC and OTS Mortgage Metrics Reports (2009b) point out that the re-default rate for renegotiated loans serviced by third parties was significantly higher than the re-default rate for loans held in the servicers' own portfolios (for example, 70% higher after six months).[17]

[14] Manuel Adelino, Kristopher S. Gerardi, and Paul Willen. 2009. "*Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization.*" Federal Reserve Bank of Boston Working Paper No. 09-4, available at SSRN: http://ssrn.com/abstract=1433777

[15] See Making Home Affordable Program, Servicer Performance Report Through September 2010, available at: http://www.financialstability.gov/docs/Sept%20MHA%20Public%202010.pdf

[16] Manuel Adelino, Kristopher S. Gerardi, and Paul Willen. 2009. "*Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization.*" Federal Reserve Bank of Boston Working Paper No. 09-4, available at SSRN: http://ssrn.com/abstract=1433777

[17] Tomasz Piskorski, Seru, Amit and Vig, Vikrant. 2010. "Securitization and Distressed Loan Renegotiation: Evidence from the Subprime Mortgage Crisis" Chicago Booth School of Business Research Paper No. 09-02; AFA 2010 Atlanta Meetings Paper. SSRN: http://ssrn.com/abstract=1321646

After reviewing the economic evidence, noted economist Christopher Mayer stated in testimony this year, "I believe there is compelling empirical evidence showing that third party servicers have undertaken more foreclosures than would otherwise have taken place if all mortgages had been made by portfolio lenders."[18]

This "foreclosure bias" by third party servicers has several causes, but the primary ones are the direct financial incentives to servicers that encourage foreclosure over loan modification, the conflict of interest that some servicers have, given that they are often subsidiaries of the bank that originated the loan or currently holds a second loan secured by the same property, and the fear of "tranche warfare" whereby the servicer may face litigation by other investors should the servicer modify the loan in ways that help some tranches of the investors while harming others.[19]

Robosigners and False Affidavits

Three years after the non-prime mortgage market essentially shut down after investors finally recognized how shoddy subprime underwriting had become and how much risk came with their non-prime mortgage securities, a new example of the perfidy of the mortgage industry came to light. Robosigners had been signing the affidavits used in judicial foreclosure states to justify foreclosures. In states that require judicial foreclosures, servicers had long relied on affidavits to prove up their cases, to show the payment history of the borrowers, the amount owed and what payments were in default, in order to demonstrate that the entity foreclosing on the note was legally entitled to do so.[20]

Robosigners are employees of servicers or law firms employed by servicers who sign affidavits attesting to facts justifying a foreclosure even though the robosigner has no personal knowledge of those facts, has not reviewed the business files that contain those facts and/or often has not even read the affidavit that he or she is signing under penalty of perjury.[21] The existence of robosigners was discovered by borrowers' attorneys who deposed the servicer employees who signed affidavits for the

[18] Christopher Mayer, *Housing, Subprime Mortgages, and Securitization: How did we go wrong and what can we learn so this doesn't happen again?*, testimony before the Federal Crisis Inquiry Commission, February 27, 2010, available at: http://fcic.gov/hearings/pdfs/2010-0227-Mayer.pdf

[19] For a discussion of these causes and why loan modifications have not been forthcoming, see Kurt Eggert, Comment on Michael A. Stegman et al.'s "Preventive Servicing Is Good for Business and Affordable Homeownership Policy": What Prevents Loan Modifications?, 18 HOUSING POL'Y DEBATE 279 (2007), available at SSRN: http://ssrn.com/abstract=1081479

[20] See Katherine Porter, Testimony Before the Congressional Oversight Panel, Hearing on the TARP Foreclosure Mitigation Program, October 27, 2010.

[21] Paul Tharp, *Bank of America suspends foreclosure sales nationwide* 10/8/10 N.C. Law. Wkly. 2010 WLNR 21011587

borrowers' judicial foreclosure cases. When they began questioning the servicer employees charged with supplying testimony about the mortgages, they found that the servicer employees were woefully unprepared even to understand what they were signing, with some not knowing even what an "affidavit" or a "mortgage" was, some admitting they were lying in their affidavits, or that they signed the affidavits without reading or seeing their contents. One bank employee admitted that she signed up to 8,000 foreclosure documents a month, but rarely reads any of them[22] One servicer supervisor charged with signing affidavits admitted she could not define even a basic term like "promissory note" and that she did not know what conditions were required before a bank could foreclose or would was the holder of the mortgage note, explaining "I don't know the ins and outs of the loan, I just sign documents."[23]

This extensive use of robosigners allows banks and servicers to foreclose on borrowers without regard to whether such foreclosure is proper and to hide from courts flaws in the banks and servicers documentation for the loans, be it bad records regarding mortgage payments or loan modifications or missing documents that would show whether the foreclosing entity even owns the loan it is trying to foreclose. On a massive scale, servicers seemed to have been committing fraud on the court, submitting testimony from witnesses who had little idea of the contents of the affidavits they signed, let alone whether the affidavits were in fact true.

Servicers responded to the robosigning in various ways, including engaging in foreclosure moratoriums generally in the 23 judicial foreclosure states pending review of the problem. The use of robosigners was widely reported and caused a significant drop in the stock prices of banks caught up in this scandal. Investors too weighed in, pressuring banks and servicers to resolve the problem quickly so that investors would not be harmed either by legal claims against the trusts holding the loans or by long delays in foreclosures. However, at least some banks and servicers fairly quickly announced that they had completed their reviews and that foreclosures would recommence, though it appears that recommencing foreclosures may take longer and be more challenging than the banks and servicers have let on.[24]

Servicers and their defenders argue that the robosigning scandal was a set of mere technical defects, and ones that the bank can correct on move on with processing these same foreclosures. They claim that the borrowers deserve to be foreclosed and it should not matter greatly whether the affidavit was the product of a robosigner,

[22] Jenifer B. McKim, *Lenders on autopilot: Using robo-signers to process thousands of foreclosures opens banks up to legal risks* 11/2/10 Boston Globe 7

[23] Michelle Conlin, *Robo-signers: Mortgage experience not necessary* 10/13/10 AP General Fin./Bus. News 01:21:31, October 13, 2010.

[24] Dan Fitzpatrick and Ruth Simon, *Foreclosure Restarts Limp Out Of The Gate*, Wall Street Journal, , November 27, 2010, available At: http://online.wsj.com/article/SB10001424052748704008704575638943432734062.html

since the servicer's staff had already determined that foreclosure is appropriate. Such an argument completely undermines the judicial process that some states have set up to oversee foreclosures. States that require judicial foreclosure do so in order to provide a venue for a borrower to contest the foreclosure, to challenge the servicer's claims about how much money is owed and whether the claimed holder of the note has the right to foreclose. Robosigning of affidavits short-circuits this process, as the foreclosure could proceed without valid evidence that the borrower was even in default or that the foreclosure even owned the note.

One important question, given the great cost to banks of the robosigning scandal and the accompanying foreclosure moratorium is why the banks and servicers employed robosigners to begin with. The potential cost savings to be gained by having servicer employees speed through affidavits without reading them seems small compared to the losses banks and investors have suffered as a consequence.

Borrower advocates have questioned whether the purpose of employing robosigners is more nefarious than mere cost-cutting. Perhaps, the advocates query, servicers use robosigners to hide defects in the loan records, either in the payment and mortgage fee history or in the documentation of the ownership of the loan to begin with. Currently, the servicing industry is haunted with the specter that the robosigning controversy may only be an early symptom of a much greater, industry-threatening problem. Just as the rise in early mortgage defaults in 2006 presaged the mortgage meltdown a year later, some argue that the robosigning scandal is an early warning of greater problems ahead.

Mortgage Transfer Problems

One of the largest of the potential problems facing the mortgage and servicing industry stems from the realization that, during the scramble of the boom mortgage years from 2004 until mid-2007, lenders and securitizers cut corners in many regards. Clearly, lenders cut underwriting standards and Wall Street houses reduced their diligence in trying to weed out bad loans from being securitized. The great worry some have is that this shoddy work extended to whether lenders and securitizers also cut corners in transferring notes to the trusts that hold them for investors. Wall Street may have fallen down, the theory goes, in transferring not only ownership of the notes but also the right to enforce them to the trusts holding the notes on behalf of investors in mortgage-backed insurance. The investors may be holding securities backed by far fewer loans than they anticipated, or may have a theoretical ownership right in the notes, but lack the power to enforce to enforce the notes through foreclosure.

Borrowers have seized on this issue and have regularly challenged servicers to "show the note" and prove the right to foreclose. Servicers have fought back against the "show the note" defense by various means. In some non-judicial foreclosure states, courts have ruled that state foreclosure law does not require that the beneficiary of a deed of trust even to possess the note in order to enforce it, as the state law governing non-judicial foreclosure does not require possession of the note.[25] Even in states where a party attempting to foreclose must prove up the right to foreclose, including possession of the note, as needed, servicers have widely used and even abused the lost note affidavit to finesse this requirement.[26] However, as Professor Whitman observes, "By its literal terms, the person who seeks to enforce the note must have been in possession of it when the loss occurred. Under this view, the 'lost note' provisions do nothing to assist a party who claims to own a note but who never had possession of it to begin with, either because it was lost by a predecessor holder or because the predecessor never delivered it to the present claimant."[27] While a revision of the UCC and some courts would allow a party who lost a note in essence to transfer the benefits of a lost note affidavit to transferees, this rule is not universal.[28] Worse yet, as Professor Levitin notes, many signing lost note affidavits have no personal knowledge that the note is in fact lost, as it may well be held by a document custodian who only requires notice and payment to retrieve it.[29]

Lenders have disparaged the "Show the Note" defense. However, it is grounded in a central element of the negotiable instrument law that governs negotiable notes. According to that law, the debt of the borrower is not just evidenced by the note; it is reified in it, in that the note constitutes the law and is proof of title of the debt. As Professor James Steven Rogers noted, negotiability is a title recognition system, and possession of the note indicates who is entitled to enforce the note. Rogers stated, "The key element of the negotiability transfer system is that the liabilities of the parties to negotiable instruments are 'reified' in the pieces of paper, that is, the writings become the indispensable embodiments of the liabilities of the parties. Accordingly, the appropriate way of transferring the rights embodied in the writings is by transferring the writings themselves."[30]

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[25] See, for example, *Chilton v. Federal Nat. Mortg. Ass'n*, Slip Copy, 2009 WL 5197869, E.D.Cal.,2009. December 23, 2009, and the cases cited therein for the proposition that under California law, "It is well-established that non-judicial foreclosures can be commenced without producing the original promissory note." This holding is based on the theory that foreclosure in California the Civil Code provisions specifically concerning foreclosure "cover every aspect" of the foreclosure process, citing *I.E. Assoc. v. Safeco Title Ins. Co.,* 39 Cal.3d 281, 285, 216 Cal.Rptr. 438, 702 P.2d 596 (1985), and also are "intended to be exhaustive," citing *Moeller v. Lien,* 25 Cal.App.4th 822, 834, 30 Cal.Rptr.2d 777 (1994). However, these decisions fail to note that the right to enforce notes in California is governed by the U.C.C. provisions regarding the transfer of notes, as adopted by California, and that specific foreclosure provisions should be read in tandem with the U.C.C. provisions' requirements for such enforcement.

[26] For a discussion of the use of lost note affidavits, see Dale Whitman, *How Negotiability Has Fouled Up The Secondary Mortgage Market, And What To Do About It* 37 Pepp. L. Rev. 737, 758 - 62 (2010).

[27] Id., at 759

[28] Id.

[29] See Adam Levitin's Testimony before the House Financial Services Committee Subcommittee on Housing and Community Opportunity "Robo-Singing, Chain of Title, Loss Mitigation, and Other Issues in Mortgage Servicing" November 18, 2010.

[30] James Steven Rogers, Negotiability as a System of Title Recognition, 48 Ohio St. L.J. 197, 200 (1987).

The rules regarding negotiability were created when bills and notes circulated widely in the economy, acting as currency in the days before government-issued notes took over that function. To make bills and notes circulate as currency, it was important that one receiving the bills and notes be able easily to determine whether they were acquiring both good title and the right to enforce the note. From this need came the system of negotiation, so that from the note itself, a purchaser could determine whether he was receiving good title by examining the indorsements on the note. If there was an unbroken chain of indorsements up to the purchaser, or if the note was indorsed in blank after an unbroken chain of indorsements, then the purchaser would take over title to the note by gaining possession of it.[31]

While this title recognition system benefited buyers of notes, it also includes an important protection for borrowers. Requiring possession of a note in order to enforce it ensures that a borrower who pays off a creditor, either directly, through a refinance, or through a foreclosure, will not face another creditor claiming ownership of a note and demanding payment even after the borrower has paid off the note once. Borrowers have the right to be certain that they are paying off the party with the actual right to enforce the note. Negotiability works as a title recognition system because a note has only one physical presence, and so only one party can hold the note at a time.

This protection for borrowers has been recognized by the courts. In a notable recent case, *Kemp v. Countrywide,* which will be discussed at greater length later in this testimony, the court noted how a previous court had "explained that the maker of the note must have certainty regarding the party who is entitled to enforce the note" and quoted at length:

> From the maker's standpoint, therefore, it becomes essential to establish that the person who demands payment of a negotiable note, or to whom the payment is made, is the duly qualified holder. Otherwise, the obliger is exposed to the risk of double payment, or at least to the expense of litigation incurred to prevent duplicative satisfaction of the instrument. These risks provide makers with a recognizable interest in demanding proof of the chain of title. Consequently, plaintiffs here, as makers of the notes, may properly press defendant to establish its holder status.[32]

UCC Section 3-301, which governs what party can enforce a note, recognizes this central importance of possession, stating, ""Person entitled to enforce" an instrument

[31] There are some exceptions, of course, where the person gaining possession of a note would not obtain title, for example where he or she obtains possession as an agent or document custodian for the true owner.
[32] *In re* Kemp, Slip Copy, 2010 WL 4777625, Bkrtcy.D.N.J.,2010. (November 16, 2010), quoting *Adams v. Madison Realty & Dev. Inc.,* 853 F.2d 163, 166 (3d Cir.1988)

means (i) the holder of the instrument, (ii) a nonholder in possession of the instrument who has the rights of a holder, or (iii) a person not in possession of the instrument who is entitled to enforce the instrument pursuant to Section 3-309 or 3-418(d). A person may be a person entitled to enforce the instrument even though the person is not the owner of the instrument or is in wrongful possession of the instrument."

The importance of the transfer of possession of a note is underscored by UCC Section 3-203, regarding transfer of a note, and its comment which describes how even the owner of a note may not have the power to enforce it until the note is transferred to the owner, that ownership and the power to enforce can be separated:

> "The right to enforce an instrument and ownership of the instrument are two different concepts. . . Ownership rights in instruments may be determined by principles of the law of property, independent of Article 3, which do not depend upon whether the instrument was transferred under Section 3-203. Moreover, a person who has an ownership right in an instrument might not be a person entitled to enforce the instrument. For example, suppose X is the owner and holder of an instrument payable to X. X sells the instrument to Y but is unable to deliver immediate possession to Y. Instead, X signs a document conveying all of X's right, title, and interest in the instrument to Y. Although the document may be effective to give Y a claim to ownership of the instrument, Y is not a person entitled to enforce the instrument until Y obtains possession of the instrument. No transfer of the instrument occurs under Section 3-203(a) until it is delivered to Y."

Thus, under the UCC, if the loan originator does not transfer the physical instrument (the note) up the securitization and ultimately to the trustee on behalf of the securitization trust, that trust does not have the right to enforce the note even if it may contractually be the note's owner.

Have Originators Failed to Transfer the Notes They Originated?

Given the importance of the transfer of physical possession of notes to transfer the right to enforce them, it is easy to understand why many have wondered whether the originators of notes failed to transfer them during the securitization process, thus denying the trusts that supposedly hold them and the servicers who are agents of those trusts the power to enforce them. Anecdotal evidence indicates that, on a wide scale basis, these transfers were not made.[33] Even such a luminary as Dale A. Whitman, co-

[33] See Gretchen Mortgenstern, Guess What Got Lost in the Loan Pool, NY Times, February 28, 2009, available at: http://www.nytimes.com/2009/03/01/business/01gret.html

author of the standard hornbook on real estate finance law, considers this an enormous concern, stating:

> While delivery of the note might seem a simple matter of compliance, experience during the past several years has shown that, probably in countless thousands of cases, promissory notes were never delivered to secondary market investors or securitizers, and, in many cases, cannot presently be located at all. The issue is extremely widespread, and, in many cases, appears to have been the result of a conscious policy on the part of mortgage sellers to retain, rather than transfer, the notes representing the loans they were selling. (Footnotes omitted.)[34]

There has been considerable anecdotal evidence that originators have, on a regular basis, failed to deliver notes to the trusts that are intended to hold them. One noted foreclosure defense attorney, April Charney has noted the extreme frequency in which she has encountered lost note declarations in her cases, indicating that many notes were never delivered up the securitization chain. She estimated that eighty percent of the 300-some foreclosures she defended during 2008 in her Florida practice involved lost-note affidavits, and commented, “Lost-note affidavits are pattern and practice in the industry. They are not exceptions. They are the rule.”[35]

More evidence of how broadly notes may never have been transferred to the trust may be found in a recent, widely reported bankruptcy case, *In re* Kemp.[36] Countrywide filed a proof of claim for a loan in arrears as a servicer for the Bank of New York for a loan that Countrywide had originated. However, the court found that the “note in question was never been indorsed in blank or delivered to the Bank of New York, as required by the Pooling and Servicing Agreement,” even though the mortgage securing the note had been assigned to the Bank of New York. Though Countrywide had previously submitted an affidavit of lost note, it produced at trial an undated allonge purporting to transfer the note to the Bank of New York as trustee and its witness testified that the allonge had been created in anticipation of the instant litigation.

Countrywide’s witness’s additional testimony has created consternation across the country. She testified on behalf of Countrywide that the original note never left the possession of Countrywide and that it apparently was transferred directly to Countrywide’s foreclosure unit, while the new allonge had not been attached to the note. Furthermore, she testified that Countrywide customarily maintained possession of original notes and related loan documents. As a result, the court ruled that the

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[34] Dale Whitman, *How Negotiability Has Fouled Up The Secondary Mortgage Market, And What To Do About It*, 37 PEPP. L. REV. 737, 758 (2010).
[35] Bob Ivry, *Banks Lose to Deadbeat Homeowners as Loans Sold in Bonds Vanish*, Feb. 22, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aejJZdqodTCM
[36] *In re* Kemp, Slip Copy, 2010 WL 4777625, Bkrtcy.D.N.J.,2010. (November 16, 2010).

Bank of New York could not, through its servicer Countrywide, enforce the note because the Bank of New York had never obtained possession of the note and so can not qualify as the holder of the note even though it might have a valid claim of ownership.

If this witness's testimony is true, Bank of America could have a monstrous problem on its hands.[37] If Countrywide never delivered the notes as required by the PSAs, it was in violation of those in a manner that would leave the servicers of the undelivered loans unable to foreclose on them pursuant to rulings such as that in *In re* Kemp. Worse yet, this may not be a problem that Bank of America can solve merely by finding all of the notes and delivering them to the appropriate trustee for each respective trust. PSAs have strict time requirements for when actions should be taken, and while the terms of PSAs may vary, no doubt such delivery should occur in most cases before years have passed, as they have here since the shut-down of the subprime market. Furthermore, it is not clear that the trustees for the loans could accept the notes at this point without endangering the status of the securities they are supervising. Securitized mortgage trusts are supposed to be static creatures, with the mortgages delivered at or near the creation of the securities and changes in those mortgages only pursuant to specific rules.

Moreover, if the trustee is adequately representing the interests of the securities investors, it may be that the trustees should not even accept the delivery of the late-arriving mortgage notes. Instead, it may be that the trustee and servicer should refuse such delivery and instead demand repayment for those undelivered notes, forcing Bank of America to take them back pursuant to the terms of the PSA and the representations and warranties contained therein. Whether the trustee and servicer could do so would depend on the terms of the PSA, but this is a legitimate concern.

Bank of America has attempted to walk back this witness's testimony, claiming that she was "not comfortable testifying about the circumstances under which original loan documents would move, or whether and to what extent they ever are moved." A spokesperson for Bank of America has since provided a less than complete denial, stating, "Countrywide's policy and practice has been and remains to fully comply with the pooling and servicing agreements, including forwarding any necessary documents to the trustee."[38] This denial does not fully answer the question, however, as it is not clear whether Countrywide delivered the notes or instead has some argument that the underlying notes are not "necessary documents" to deliver to the trustee.

[37] For a different and perhaps more alarming analysis on Bank of America's potential problems, see Adam Levitin, The Big Fail, posted on Credit Slips, November 22, 2010, at http://www.creditslips.org/creditslips/2010/11/securitization-fail.html.

[38] Abigail Field, *Countrywide's Mortgage Document Errors May Doom Bank of America*, Daily Finance, 11/22/10, available at: http://www.dailyfinance.com/story/credit/bank-of-america-mortgage-document-errors-trouble-countrywide/19728402/

Servicers' Conflicts of Interest

Servicers of mortgage loans appear to be plagued by conflicts of interest, some they try to resolve, others they do not appear even to address. A primary conflict of interest they have is that should they try to modify loans, they run the risk of falling prey to "tranche warfare," whereby one tranche of investors could claim that the servicer's actions benefited another class to the first class's detriment. The industry may claim that servicers act for the good of the investors as a totality. However, servicers may have their own interest in which securities benefit or lose. In order to give loan originators "skin in the game," in some deals they service the resulting loan pools and also retain a portion of the resulting securities. The idea was that originators would do more careful underwriting if they held some of the resulting securities. Similarly, if originators held the servicing rights, they would be penalized for making loans likely to default, as those loans would be more expensive to service.[39] Instead of having that effect, however, where servicers in essence hold an investment piece in the securitization, they have a motive to conduct loan modifications or foreclosures that benefit them rather than investors has a whole.

Another conflict of interest, already discussed, is that servicer profits may be dependent on taking advantage of the passivity of investors. When servicers gauge excess fees from borrowers, especially borrowers in bankruptcy and facing foreclosure, they are often taking money not from the borrower, who will often lose the house anyway, but from the investors whose main hope of repayment is from the foreclosure and resale of the house. To the extent that servicers add junk fees to the amount they are owed by borrowers and recoup those fees during the foreclosure, they are taking that money directly from the investors in many cases. Another conflict stems from the fact that many of the servicers are subsidiaries of other entities in the mortgage chain, either originators or investment banks. For example, Countrywide was purchased by Bank of America and Litton by Goldman Sachs.

During the course of securitizing the loans, securitization entities made various representations and warranties that are included in the pooling and servicing agreements, including representations and warranties about the qualities of the loan and about the loan transfers. It is difficult for investors to act directly on those representations and warranties, and so often must depend on servicers to prosecute any actions to seek recompense from the sponsors for violations of those representations and warranties.[40] Servicers are loathe to seek putbacks of loans, however, when the putbacks would come from their parent companies.[41] Trustees are

[39] Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2064 (2007).
[40] See Adam Levitin's Testimony before the House Financial Services Committee Subcommittee on Housing and Community Opportunity "Robo-Singing, Chain of Title, Loss Mitigation, and Other Issues in Mortgage Servicing" November 18, 2010.
[41] Nora Colomer, *Conflicts Arise from Servicer's Dual Role*, 11/8/10 Nat'l Mortgage News 15, 35(8), 2010 WLNR 22307700.

not much help for investors either, because they would be unlikely to notice the violation of the representations and warranties unless it was pointed out to them by the Servicer,[42] and because a trustee may derive much of its income from a single lender. For example, according to Professors Tara Twomey and Adam Levitin, Deutsche Bank derives nearly two-thirds of its RMBS trustee business from Bank of America/Countrywide.[43]

Servicers that are subsidiaries of banks have an even greater conflict of interest if the bank also holds a second lien on property secured by a loan serviced by the subsidiary. In that case, the servicer's own parent organization may refuse to allow a loan modification unless the parent bank is paid more than the second loan is currently worth. This conflict is rampant in the servicing industry given that banks own servicers and second liens, while the loans in first position are owned by investors but managed by servicers. According to a recent trade article on servicer conflicts, "As of the second quarter, the four largest banks-JPMorgan Chase, Wells Fargo, Citigroup and Bank of America-own 56.2% of one-to-four family loan servicing industry, said Laurie Goodman, senior managing director at Amherst Securities Group. . . She said that these banks also own $433 billion of the roughly $1 trillion HELOC and second-lien markets, essentially owning about 43% of the outstanding."[44] Owning most of the servicing industry and almost half of the second-lien market puts these four largest banks in continual conflicts between the needs of the investors in the first liens and the banks' own interests in the second liens, with the borrower often stuck in the middle.

The pooling and servicing agreements are typically drafted to make it difficult for investors to act to protect their own interests. Ownership of the securities is often widely dispersed, with many investors who do not know each others' identities, and so collective action by investors has been difficult and scarce. For investors to challenge the actions of servicers, such as their failure to seek putbacks because of violations of representations and warranties or to give investors good information to prove such violations, investors need to accumulate a percentage of investors in a cohesive group, 25% of investors according to many PSAs, to make such a demand.[45] Getting this many investors together has long been thought virtually impossible, leaving servicers free to act without investor control.

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

[43] See Adam Levitin's Testimony before the House Financial Services Committee Subcommittee on Housing and Community Opportunity "Robo-Singing, Chain of Title, Loss Mitigation, and Other Issues in Mortgage Servicing" November 18, 2010, citing Adam J. Levitin & Tara Twomey, *Mortgage* Servicing, 28 YALE J. ON REG. (forthcoming 2011).

[44] Nora Colomer, *Conflicts Arise from Servicer's Dual Role*, 11/8/10 Nat'l Mortgage News 15, 35(8), 2010 WLNR 22307700.

[45] Nora Colomer, *Beyond Foreclosures, Buybacks are the Real Issue*, 11/1/10 Asset Securitization Rep. 10(11), 2010 WLNR 21818979.

However, recently investors and attorneys aiding them have found a method for investor collective action. Attorneys have been gathering pools of investors to overcome this limitation and have recently announced a collection of investors large enough to make demands on servicers and trustees. One clearinghouse for collective action now apparently has gathered investors holding at least 25% in over than 3,000 securitization deals, as well as investors holding more than 50% of 1,325 deals, and its participants are said to include such heavy-hitting investors as "BlackRock, PIMCO, Fortress Investment Group, Fannie Mae and Federal Home Loan Banks, among others."[46]

A group of such investors with over 25% of the voting rights for more than $47 billion worth of RMBS issued by Countrywide (before it was acquired by Bank of America) wrote the Countrywide, the servicer, and Bank of New York, the trustee, complaining that Countrywide had not been servicing the loans backed by the securities properly, and asked that the Bank of New York demand that loans be repurchased pursuant to the representations and warranties in the PSA.[47] The purpose of this letter could be to attempt to switch the servicer to one that would be more amenable to representations and warranties claims or to providing documentation that would buttress such claims, or to pressure Bank of America to accept more putbacks directly.[48]

With such collective action, investors may be able to enforce the representations and warranties and force sponsors of securitizations to repurchase loans that do not meet the underwriting criteria for the loan pool. If this happens, this could be a huge blow to the banking system, with JPMorgan analysts estimating "that put-back risk will be approximately $23 billion to $35 billion for agency mortgages, $40 billion to $80 billion in non-agency and roughly $20 billion to $30 billion for second liens and HELOCs." [49]

While these putbacks could be extremely expensive for banks, they could actually help some borrowers. Instead of being trapped in a securitized loan pool, with the barriers to modifications and the foreclosure bias that entails, the borrower could be back with the originator of the loan. The originator could be more able and willing to provide borrowers with effective loan modifications, while eliminating the conflicts of interest that the servicers may have had with investors. So even while a massive set of putbacks could cause a great deal of harm to banks, it may help borrowers at the same time.

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[46] *RMBS Investor Group's Clout Grows*, 11/12/10 Total Securitization & Credit Inv., 2010 WLNR 23711881

[47] Ronald D. Orol, Second *round of bank stress tests advocated*, 11/5/10 Marketwatch 20:54:02

[48] Bill Berliner, *Behind the Mortgage Market Headlines*. 11/1/10 Asset Securitization Rep. 18, 10(11), 2010 WLNR 21818971

[49] Nora Colomer, *Beyond Foreclosures, Buybacks are the Real Issue*, 11/1/10 Asset Securitization Rep. 10(11), 2010 WLNR 21818979.

Where To Go From Here

Policy makers have tried several programs to encourage servicers to make reasonable loan modifications. They have tried begging them and bullying them and even paying them. The FTC has tried to saddle the worst servicers with large fines. None of this seems to have worked. What is needed now is a thorough investigation of servicer behavior by someone with the power to demand to see their books, to review their processes and their fee structure, to see why they are failing to modify loans that could help investors, and to demand specific changes. One part of such an investigatory effort is that of 50 attorneys general who have begun an investigation of mortgage servicers' practices, spurred on by the robosigning scandal.[50] While they are in talks with servicers, in an effort to spur servicers into making more loan modifications, it is important that they also release the results of their investigations so that Americans are still not in the dark as to why there are so few effective loan modifications.

We also need to follow through on the promise of the Dodd Frank bill and the coming Bureau of Consumer Financial Protection. This bureau would be a natural for the regulation of servicers, something that has only been done piecemeal by other regulators, as it would focus on the protection of consumers in the servicing process and so work on fixes of many of the problems that bedevil the servicing industry. Sheila Bair, head of the FDIC, noted that the agencies currently regulating servicers (to the extent they even do so), were essentially asleep at the switch when it came to the rise in problem foreclosures and the robosigning scandal, saying in October of this year, "In retrospect, there were warning signs that servicing standards were eroding. Those signs should have caused market participants and regulators alike to question current practices. . . We should have been asking how servicers were able to achieve such efficiencies without sacrificing quality. Sadly, those types of questions were not asked."[51]

A consumer protection agency with the ability to write regulations would be tasked with asking those questions, demanding the answers, and finally reining in servicer abuse. Such an agency could finally obtain some real leverage over servicers, as servicers should be nationally licensed, regularly audited, and required to explain and document their fee system, their loan modifications and their foreclosure process. Such a consumer protection agency could threaten to strip servicers of their license to

[50] See Stephanie Armour, *Hearing: Foreclosures Hit Homeowners Not In Default*, USA TODAY, 11/17/2010, available at: http://www.usatoday.com/money/economy/housing/2010-11-17-foreclosures17_ST_N.htm
[51] Donna Borak, *Bair Says Regulators Share Blame*, 10/26/10 Am. Banker 1
2010 WLNR 21345594

service mortgages should they misbehave, and threaten them with lesser sanctions as needed. Having hands-on regulation by an agency dedicated to protecting consumers from unfair practices is the best plan to turn the servicing industry around.

By fixing these problems, we will not just be helping borrowers who might otherwise be loaded with junk fees or face unnecessary foreclosures. We will also be helping investors in their struggles against servicers. Doing so will not only help us deal with the problem loans of the past, but can also lay the groundwork for a more workable mortgage market in the future.