Our Perspectives:
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Barnett Sivon & Natter P.C.
ATTORNEYS at LAW
WASHINGTON, DC

Mortgage Servicing: Today's Story Should Be Tomorrow's Non-Story*

Robert Barnett

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Three years from now the concerns of CFPB will have moved on from residential mortgage servicing to other fields of consumer relationships with creditors. Mortgage servicing will no longer have front page attention, although there probably will be some legacy litigation hanging around, as well as some old REO hampering balance sheets. Mortgage servicing, however, will not be front page news.

The major reason is that newly originated loans, certainly after January 2014, will be well-underwritten.

The current debate concerning servicing revolves around the foreclosure process and the techniques used to process non-performing loans in the foreclosure process through completion of the foreclosure sale. The servicing standards that have been published in the proposed regulations on risk retention, the standards that have been included in the enforcement actions by the OCC and other federal regulators, and the standards (should they actually be adopted) that will accompany a settlement of real or potential disputes between some Attorneys General and some servicers all share one overriding idea - make the foreclosure process for non-performing loans transparent and accountable.

This debate is only necessary because so many loans have become nonperforming in the last few years. Some of that is attributable to the downturn in the economy, but much of it is attributable to the fact that borrowers took on more debt than they could expect to service. Lenders, of course, made loans they should not have made, as it turns out, and did so through lax underwriting and poor decisions on risk management.

Making such loans will not be common in the future. By January 21,

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2014, and probably earlier, regulations will have been promulgated as a result of Title XIV of the Dodd-Frank Act and will be in effect. All regulations in Title XIV must be finalized within 18 months following the Designated Transfer Date (July 21, 2011) and must become effective no later than 12 months after final adoption. Among those regulations, the CFPB will promulgate regulations relating to the definition of a Qualified Mortgage to provide a rebuttable presumption of compliance with the requirement that lenders must have a reasonable basis to repay a loan. See “Beware the QM!,” by Raymond Natter in the February issue of Our Perspectives.

In addition, CFPB has the authority to promulgate regulations to prohibit, or condition terms, acts or practices relating to residential mortgage loans that the Bureau finds to be abusive, unfair, deceptive, predatory, necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers in a manner consistent with the purposes of section 129B of TILA. It has authority to promulgate regulations to implement the High-Cost Mortgage sections in the Act.

Of course, in addition to the rules the Bureau and the other regulators promulgate, and any rules that flow from the enforcement actions currently underway, lenders and regulators will carry an institutional history of the poor risk management practices that were followed in the late ’90s and early ’00s, and both will have changed practices to ensure they don’t happen again.

Based on all of that, it is not at all a stretch to say, with some confidence, that residential mortgage loans will be well-underwritten, at least by early January 2014, and probably earlier. In fact, assuming that the CFPB does nothing other than promulgate regulations that implement the Qualified Mortgage statutory definition as it is written (it may, of course, make it tougher and also - highly unlikely - more lenient), the major cause of the housing crisis that we are still going through will have been eradicated.

If this is so, then servicing issues, if any, should be those that relate to servicing performing loans, not those relating to servicing non-performing loans. Yet, it is the servicing provided to non-performing loans that has been the focus of recent attention and over which so much angst has been spilt.

Can an over-enthusiastic establishment of rules relating to foreclosure issues adversely impact future servicing of performing loans?

Certainly the 27 page Term Sheet is resplendent with controversial requirements that would do so. That approach, most likely, will not be the basis for a settlement, however.

More concerning than that term sheet is the conflict between the general need for additional well-trained staff available now to deal with the current large number of non-performing loans and the absence of a need for such staff in the future once non-performing loans shrink dramatically in number. It is not easy to modify a loan, and employees must be well-trained to be capable of doing so. There is a lead time and a substantial investment required to produce the necessary numbers to deal with the current problem. Can the industry easily and smoothly ratchet up those numbers and then trim them quickly when they are no longer needed?

Similarly, a single point of contact is currently a very high priority in the demands of regulators and advocacy groups. Too often there are stories of individuals that have been passed from person to person with the result that discussions and documents get lost to the detriment of the borrower. To solve that, some advocates and regulators have urged that servicers establish a single point of contact with which the borrower can always be in contact, and many servicers have already done so. These, of course, generally are implemented when a loan becomes non-performing. Some suggestions have been made, however, that they be available for every loan as soon as it is made, or even at the time that an application for a loan is submitted.

If servicing standards are imposed that would require staffing patterns more suitable for loan modification than for servicing performing loans, or those that would require a single point of contact for every borrower, then an unnecessary and substantial financial burden will be added to the costs of servicing performing loans, and inevitably adding to the price of loans.

While any standards should not engage themselves with pricing services, the appropriate way to price mortgage servicing, be it for performing or non-performing loans, is a question that has been exposed by this recent crisis. Fortunately, FHFA and HUD have now commenced a review of that question, and while pricing servicing for the GSE and FHA loans only covers a part of the market, historically, it has been a guide to the entire market. Many regulators and advocates, however, have been persistent in their suggestions that the servicing contracts should be standardized, perhaps by rule, in a way that will align the interest of borrowers, lenders and investors.

That probably is a mistake.

The key to good servicing standards three years out is in part based upon avoidance of prescriptive and detailed rules imposed on the servicing industry in the current environment of many non-performing loans that will effect servicing for performing loans in an entirely different environment.

Robert Barnett is a partner with the law firm of Barnett Sivon & Natter, P.C.