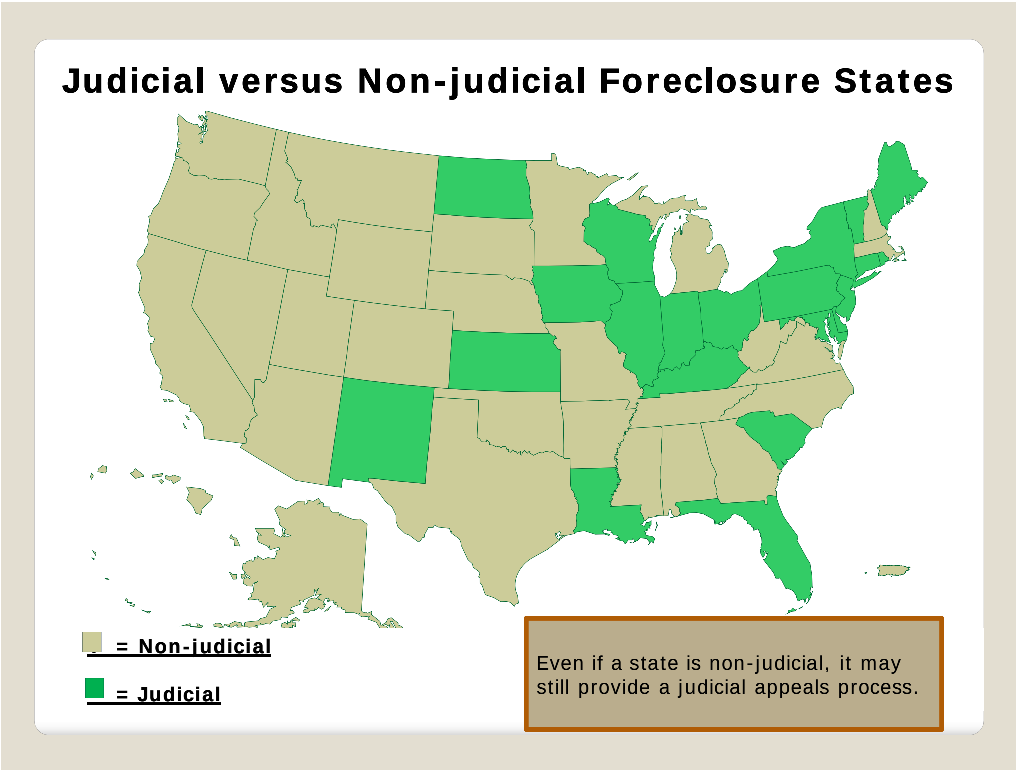
Examining Recent Mortgage Foreclosure Issues

By Robert Canova, Senior Financial Analyst, Policy & Supervisory Studies, and Madeline Marsden, Financial Analyst, Policy & Supervisory Studies, both of the Supervision and Regulation Division of the Atlanta Fed

Note: The views expressed are those of the authors' and not necessarily those of the Federal Reserve Bank of Atlanta or the Federal Reserve System.

Executive Summary

- Recent revelations about foreclosure practices have called into question the validity of foreclosures and have focused attention on longstanding problems in the mortgage servicing industry.
- Uncertainty surrounding foreclosure proceedings has slowed nationwide and has implications for consumers, the residential real estate market, and economic recovery.
- Numerous investigations are under way to determine potential violations of consumer protection laws.
- The foreclosure problems jeopardize banks' abilities to recover collateral on nonperforming real estate loans, increase costs to carry such loans, and may increase demands for put-backs from mortgage backed securities.
- Joint interagency reviews of foreclosure processes are under way in the largest servicers. A final report is expected in early 2011.
- Preliminary results of the reviews indicate significant weaknesses in risk management practices, inadequate efforts on modification, and the need for structural solutions to address problems in the industry.
- Federal regulators have called on Congress to consider developing a national standard governing mortgage servicers and are providing specific suggestions for consideration.

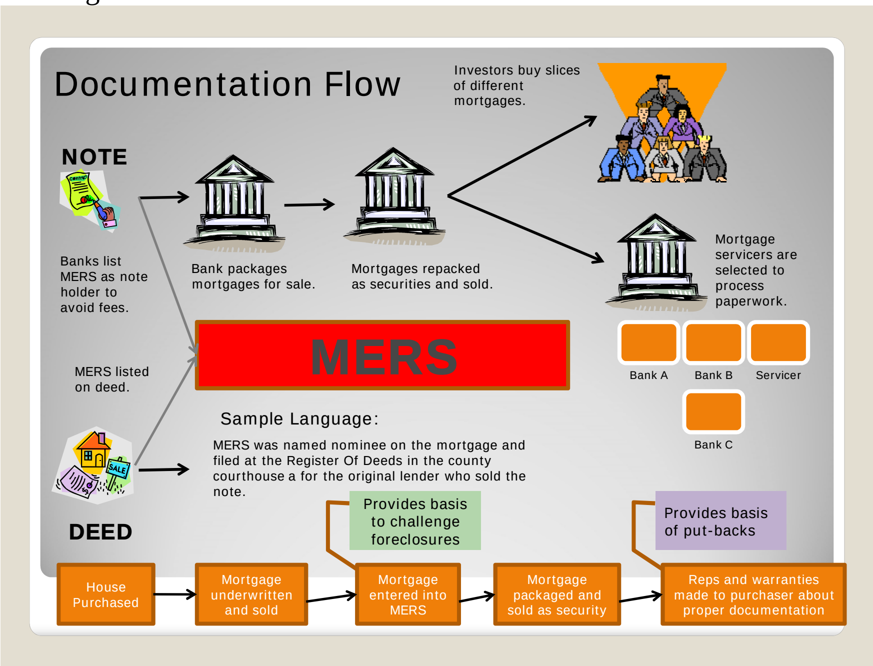


Background

The foreclosure crisis has revealed numerous problems with underwriting, recordkeeping, and other practices in the mortgage servicing industry. To date, mortgage servicers do not have the capacity to handle the record number of defaults or to offer meaningful modifications to borrowers. Substantial investments will be required to address these issues. Problems in the industry are magnified by the fact that foreclosures are governed by state law and there is no national standard.

The recent attention-getting problems with foreclosures first arose in the judicial foreclosure states, which include Florida and Louisiana, where lenders must seek court permission before foreclosing and taking possession of collateral. Judges in judicial foreclosure states rejected foreclosure actions after discovering problems with "robo-signing." Robo-signing is a practice in which banks or their servicers claimed to have verified the facts and circumstances of individual foreclosure actions, including evidence of the debt and the mortgage, when in fact, documents had not been reviewed. In depositions, employees of servicers revealed that thousands of documents were signed in bulk, without any review.[1] While issues with robo-signing practices were first revealed in the judicial foreclosure states, concerns have spread to all 50 states and have broadened to include longstanding problems in the industry.

Foreclosure actions also have been dismissed because of other problems with documents and questions regarding servicers' standing to foreclose. Some of these issues arose because recordkeeping practices at the local level were not sufficient to keep up with growth in the mortgage backed securities market. In 1996, the mortgage industry created the Mortgage Electronic Registration System (MERS) to standardize the tracking of mortgages from origination to securitization. MERS does not take into account differences in state laws regarding the recording and transfer of mortgages. MERS's "one-size-fits-all" approach to recording mortgages has, in some cases, muddled the chain of ownership of mortgages and thus proper standing to foreclose.



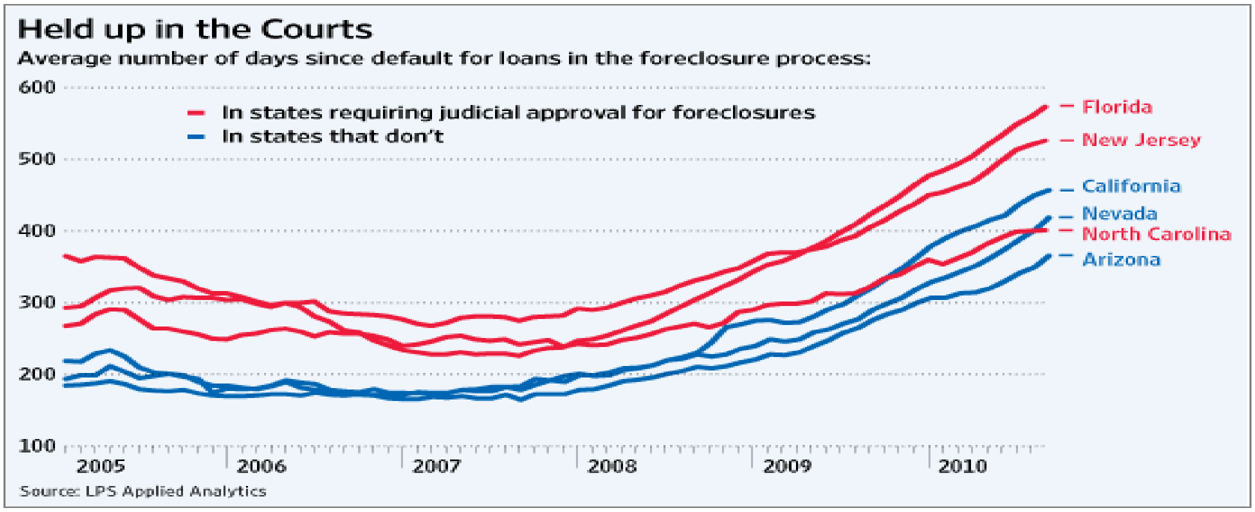
In addition to problems and costs associated with robo-signing and foreclosure documentation issues, banks face increased demands for repurchase of nonperforming loans by investors in mortgage backed securities. In recent years, Fannie Mae and Freddie Mac have used issues with underwriting to force originators to buy back bad loans that did not conform to representations and warranties offered to investors in sales contracts. If problems with mortgage documentation conflict with representations in sales contracts, a forced repurchase could be triggered.

---

[1] Sworn testimony, Jeff Stephan, 6/7/2010, Federal National Mortgage Association v. Nicole Bradbury, et al, Maine District Court, District 9, Division of North Cumberland, Docket # BRI-RE-09-65

Implications

Uncertainty surrounding foreclosure proceedings has slowed the process nationwide. Numerous lawsuits have been filed on behalf of consumers alleging a lack of due process in foreclosure actions. Foreclosure hearings have been suspended as servicers scramble to verify documents. As lenders resume foreclosure proceedings, judges do not know whether to trust new documents. Growing concern over the abuse of the judicial foreclosure process by lenders and servicers has led to increased scrutiny of filings at the federal, state, and local levels.



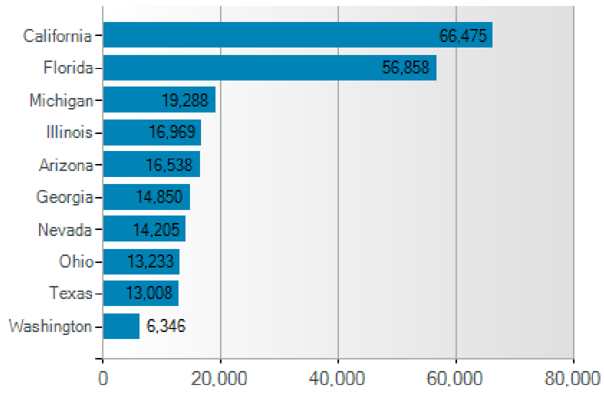
Numerous investigations are under way to determine potential violations of consumer protection laws. The 50 state attorneys general have joined forces to investigate mortgage practices and ensure consumer protections. The investigation is complicated by the competing laws of each state. Servicers must respond to each state's concerns individually, which makes reaching a national consensus resolving foreclosure issues difficult to achieve. The resulting uncertainty further hampers recovery in the real estate market.

James J. Saccacio, chief executive officer of RealtyTrac, commented about the mortgage documentation issue in a recent press release that reported foreclosure sales in third quarter of 2010. In his comments, Saccacio said that "the foreclosure-processing controversy, which was brought to light at the very end of the third quarter, could chill demand even further — particularly for foreclosure properties." According to RealtyTrac, sales of properties in some stage of foreclosure decreased 25 percent in the third quarter of 2010 versus the second quarter and decreased nearly 31 percent from the third quarter of 2009.

The delay in foreclosures has a potentially negative effect on home values. For example, it will take longer to clear the market of shadow inventory and thus may lengthen the time for home prices to stabilize and begin to appreciate. Potential title issues could impact the marketability of Other Real Estate Owned (OREO) properties and homes with loans that have been previously securitized. In the Sixth District, these problems could be particularly acute, given the large supply of foreclosed properties. Florida, Georgia, Mississippi, and Louisiana have some of the highest inventories of foreclosed properties in the country. Florida has been an epicenter of the real estate collapse and of judicial action on foreclosure problems.

The recovery of the market for residential mortgage-backed securities could be hampered by investors' concerns over the value of the underlying assets and the ability to take possession in the event of default. Uncertainty regarding the value of this type of investment will cause investors to demand a higher rate of return, which will push down prices.

States With the Most New Foreclosures Nov 2010



Soure: RealtyTrac

Issues with foreclosures pose several challenges to financial institutions. When foreclosures are delayed, banks face higher costs to carry properties and potential losses on OREO properties. Continued sluggishness in the residential housing market prolongs recovery for the banking industry. Additional capital may be needed to cover losses on investments in mortgage-backed securities and increased repurchase demands.

Actions

In recent remarks, Federal Reserve Board Chairman Ben Bernanke and FDIC Chairwoman Sheila Bair expressed concern over the impact problems with foreclosures could have on the economy. Chairwoman Bair has stated that regulators should have looked more closely at servicers' activities. During congressional testimony, Federal Reserve governors have been asked to defend the supervisory record with regard to foreclosure practices.

In the Fed's risk-focused supervisory process, foreclosure practices fall under operational, legal and compliance risks. In the past, mortgage-related examination work has focused on credit management controls, underwriting, and loan modification efforts, not specifically the foreclosure process.

Joint interagency horizontal reviews of foreclosure processes are under way at the largest servicers to determine the adequacy of governance of the foreclosure process, which would ensure compliance with applicable laws. Loan modification practices and consumer complaints related to foreclosures are being scrutinized. Data also are being gathered on the amount and nature of any put-backs from mortgage-backed securities. Overall results of the interagency review will be published in early 2011.

In recent Congressional testimony, Federal Reserve Gov. Daniel K. Tarullo commented on the preliminary findings of the horizontal reviews in which numerous deficiencies have been noted and called for creating a national set of standards for mortgage servicers. "Significant weaknesses in risk-management, quality control, audit, and compliance practices" have contributed to the problems associated with mortgage documentation and foreclosures. He noted that these findings "raise significant legal and reputation risk to the major mortgage servicers" and "require immediate remedial action." Tarullo said the Federal Reserve plans to address these weaknesses through additional attention to internal control processes and procedures, and he indicated that more examinations of nonbank affiliates will be conducted under Dodd-Frank authority. Tarullo also acknowledged that structural solutions may be necessary to solve problems in the industry and encourage meaningful modifications. The Senate Banking Committee has asked the federal regulators to provide specific suggestions for legislative action to develop a national standard for mortgage servicers.

Conclusion

Issues with foreclosures prolong the recovery of the residential real estate market and the banking industry. Uncertainties surrounding the legitimacy of foreclosures inhibit real estate market stabilization. The mortgage servicing industry must adjust its business model to meet the demands of record foreclosure filings and to remedy long standing deficiencies in its dealings with consumers. The supervisory process is evolving quickly to address deficiencies found in the interagency reviews of the largest servicers. While regulators will require remedial actions to correct problems noted in individual institutions, systematic changes may be necessary to fix problems in the servicing industry and improve modification efforts overall.