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Hazards Of The Home Affordable Modification Program

Law360, New York (May 14, 2010) -- Mortgage loan servicers participating in the Home Affordable Modification Program (HAMP) should keep an eye on emerging enforcement and litigation risks relating to their loan modification activity.

The U.S. Department of Justice is enhancing its capabilities to investigate discrimination claims relating to loan modifications; the U.S. Treasury plans to examine servicers' compliance with HAMP requirements; and private lawsuits have emerged alleging that servicers are not living up to their HAMP obligations.

In addition, the federal bank regulatory agencies can be expected to emphasize loan servicing in their fair lending examinations. All of these activities will be aided by the availability of new, detailed HAMP data.

Created by the U.S. government in 2009, HAMP was designed to help financially struggling homeowners avoid foreclosure by modifying loans so that payments are affordable for borrowers in the near term and sustainable over the long term.

The program aims to provide consistent loan modification eligibility, underwriting and servicing guidelines for the mortgage industry, and incentives for borrowers, servicers and investors to participate.

To be eligible for a HAMP loan modification, a borrower must either be delinquent on a mortgage or face an imminent risk of default, in addition to meeting other criteria.

Once approved, the borrower must complete a three-month trial period to demonstrate an ability to meet the modified monthly loan payment. The borrower also must submit to the servicer certain required documentation before the modification becomes permanent.

As of March 2010, only about 25 percent of trial modifications had made it to permanent status (Servicer Performance Report Through March 2010, Making Home Affordable Program).

Since October 2009, servicers have been required to collect and submit to Fannie Mae — the administrator of the program — detailed data on the loans they have evaluated for HAMP modifications. The data include, among other things:

—Borrower characteristics, including race, ethnicity, sex, date of birth, credit score, income and monthly expenses;

—Delinquency, foreclosure and bankruptcy status of the borrower;

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—Property characteristics, including location and valuation;

—Loan characteristics, including product type and marked-to-market loan-to-value ratio;

—Interest rate, principal and loan payment amount prior to and after a modification;

—Net Present Value calculated for the proposed modification;

—Estimated re-default probability of the modified loan;

—Reason a trial modification was not approved; and

—Reason why a borrower failed to complete the trial period.

Stepped Up Fair Lending Enforcement In Loan Servicing

Under Assistant Attorney General for the Civil Rights Division Thomas Perez, the DOJ has increased its resources dedicated to fair lending enforcement through the creation of a new Fair Lending Unit in 2010, and has stepped up interagency cooperation.

A Non-Discrimination Working Group, co-chaired by Perez, has been formed under the Financial Fraud Enforcement Task Force to facilitate coordination and cooperation on civil rights issues among federal agencies, and with the states.

In his April 29, 2010, testimony before the House subcommittee on the Constitution, civil rights and civil liberties, Perez stated that the Fair Lending Unit will have a dedicated team of 20 staff, including both attorneys and economists.

Perez noted that the Fair Lending Unit will be using the HAMP data to identify possible servicing discrimination issues, in addition to covering such “traditional” credit discrimination issues as pricing, redlining, and reverse redlining.

He stated, “We will be getting data soon from the Home Affordable Modification Program ("HAMP"), disaggregated by race and ethnicity, and the Non-Discrimination Working Group members are collaborating on methods to analyze the HAMP data.”

We can expect that both the DOJ and the federal bank regulatory agencies will be using the HAMP data to determine whether there is evidence that servicers have treated loan modification candidates differently on the basis of their race and ethnicity, and possibly also their sex or age.

At the most basic level, this will likely include analyzing any differences in the rates at which different groups are approved for a modification, and differences in the terms of the modification (such as the amounts by which loan interest rates, principal and monthly payments were reduced).

Done properly, such analysis will need to control for differences in borrower characteristics and circumstances, loan characteristics and the investor who owns the loan, to determine whether there appear to be differences in treatment among similarly situated borrowers.

However, analysis based on the HAMP data alone may reveal apparent disparities that do not truly represent differences in treatment by servicers. This is because not all factors relevant to the servicer’s or borrower’s

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decisions in the process can be controlled for based on the reported HAMP data. For example, the reason for the borrower's financial distress and their assets are not reported, and their willingness to cure a default cannot be readily measured.

Servicers should prepare for the enhanced regulatory focus by rigorously analyzing their data for signs of fair lending risk, and by conducting in-depth loan file reviews to ensure consistency in treating similar borrowers.

The analysis should include both the HAMP-reported data and any additional internal data that may help to explain apparent inconsistencies. Servicers should also have processes in place to promptly correct issues of inconsistent execution as they are discovered.

Inconsistent execution in loan modification and other risk mitigation processes not only gives rise to fair lending risk, but also poses a risk of noncompliance with HAMP requirements and a risk of private litigation.

Other Risks From Inconsistent Servicing

U.S. Treasury Secretary Timothy Geithner has expressed concern that HAMP servicers have not been fulfilling all of their responsibilities to borrowers under the program.

In his April 29, 2010, testimony before the Senate Committee on Appropriations subcommittee on financial services and general government, Geithner stated that the Treasury Department has observed variation in loan modification performance among servicers and has received complaints from many frustrated borrowers.

He stated, "We are troubled by reports that servicers have foreclosed on potentially eligible homeowners, or that they have steered these borrowers away from HAMP and into the bank's own modification program. That they have lost documentation, or claimed to. That they are not responding to the needs of responsible and increasingly desperate homeowners ... We are committed to making sure that servicers hold up their end of the bargain. We are conducting targeted, in-depth compliance reviews. We are compelling servicers to re-review groups of mortgages — or their entire book — for eligibility. And in circumstances where servicers are not compliant we will withhold incentives or demand their repayment."

The kinds of issues noted by Geithner have also motivated class action lawsuits against HAMP loan servicers, alleging breach of contract and other claims. The claims include:

—That a servicer failed to modify loans and perform its obligations under HAMP. For example, a class action was brought against Bank of America alleging that borrowers were informed, erroneously, that they have to be in default before being eligible for a HAMP modification. The complaint alleged that Bank of America had an incentive not to modify loans, because modification might cause it to repurchase more loans, collect lower servicing fees, or assess lower default charges on its financial statements because fewer payments would be deemed late. (Kahlo et al v. Bank of America NA et al.)

—That loan servicers failed to fulfill their agreements to make trial loan modifications permanent after the borrower allegedly had met the documentation and payment requirements of the trial period. Similar class action lawsuits were brought against four loan servicers by the National Consumer Law Center. (Bosque v. Wells Fargo; Johnson v. BAC Home Loans Servicing, a subsidiary of Bank of America; Durmic v. J.P. Morgan Chase Bank; Reyes v. IndyMac Mortgage Services, a division of OneWest Bank; and Wright v. Bank of America).

—That lenders failed to provide borrowers with notice that they were denied access to HAMP loan modifications, and denied borrowers their right to contest the denials. For example, the Legal Aid Society of New York City filed suit against Aurora Loan Services alleging, among other things, that Aurora wrongfully denied Plaintiffs access to

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the benefits of HAMP by refusing to evaluate their non-GSE loans for modification, even when borrowers requested to be considered under HAMP; took foreclosure actions against borrowers who asked for a HAMP modification; offered certain borrowers forbearance agreements that violate the HAMP program guidelines; and failed to guarantee a modification even when the borrower fully complied with the terms of the forbearance agreement. The suit also names the Treasury Department, the Federal Housing Finance Agency and Fannie Mae as defendants, under the theory that the HAMP program contract Aurora signed with Fannie Mae, acting as a financial agent of the U.S. Government, denied the plaintiffs' rights to due process. (Edwards v. Aurora Loan Services et al.)

—That lenders provided unfair and deceptive loan modification agreements, and inadequate or incompetent customer service. For example, the Attorney General of Ohio filed suit alleging that servicers failed to provide borrowers with timely and affordable loan modifications to prevent foreclosures. (State of Ohio v. Barclays Capital Real Estate Inc., dba HomEq Servicing; and similar suits against American Home Mortgage Servicing Inc. and Carrington Mortgage Services).

The potential economic damages in such class actions might include borrowers' foregone benefits from reduced interest payments or principal forgiveness that may have come with a loan modification, or the costs of a foreclosure that a borrower might have avoided had their loan been modified.

However, any damage estimates would have to be discounted appropriately to account for the high rate of failure of modified loans.

According to the latest Mortgage Metrics Report from the Office of the Comptroller of the Currency and the Office of Thrift supervision (fourth quarter 2009), about 15 percent of modified mortgages became 60 days or more delinquent within three months after modification, one-third within six months, and one-half within nine months. Such high re-default rates indicate that modifications may merely defer, rather than prevent, foreclosure in many cases.

For at least the past two years, federal bank regulatory officials and examiners have been telling bankers — in private and at industry conferences — that they needed to seriously examine and address the fair lending compliance risk in their mortgage loan servicing and risk mitigation activities.

Now that the industry has been through more than a year of HAMP experience, the risks those officials warned of are clearly coming to the forefront.

Those who tightened up their operations and monitoring, are likely in good positions to defend against claims of inconsistent or unfair loan servicing. Those who didn't will have a lot of catching up to do, and possibly some consequences to reckon with.

In any case, HAMP servicers, regardless of their circumstances, would be well advised to thoroughly analyze the data they have been submitting to Fannie Mae, to ensure they understand what it shows before the DOJ and Treasury do.

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