U.S. Banking Regulators Order Changes to Policies and Practices of Major Mortgage Servicers

April 20, 2011

On April 13, 2011, the Federal Reserve and the Office of the Comptroller of the Currency announced enforcement actions against the nation's largest mortgage servicers, including their parent bank holding companies, which collectively represent 65% of the mortgage servicing industry, or nearly $6.8 trillion in mortgage balances. In addition to actions against these servicers, the Federal Reserve and the OCC joined the Office of Thrift Supervision and the Federal Deposit Insurance Corporation in issuing orders against two prominent service providers, Lender Processing Services, Inc. ("LPS") and MERSCORP, Inc., as well as certain of their respective subsidiaries. The corrective measures to be taken under the various orders will be in addition to any monetary penalties that may be imposed by these regulators, and the Federal Reserve has already announced plans to issue such penalties.

The enforcement actions follow the fourth quarter of 2010 completion by the Federal Reserve, the OCC, the OTS and the FDIC of on-site examinations of residential mortgage loan servicing and foreclosure processing at more than a dozen federally-regulated mortgage servicers. Examiners focused on each institution's foreclosure policies and procedures; quality control and audits; organizational structure and staffing; and vendor management, including the use of third party vendors such as foreclosure attorneys and so-called "default-service" providers. Examiners also assessed the accuracy of foreclosure-related documentation and the adequacy of related controls. The findings of these on-site examinations are summarized in an interagency report, which was released in conjunction with the Federal Reserve's and the OCC's announcement of the enforcement actions. The report concluded that significant improvements need to be made with regard to, among other things, foreclosure process governance, risk management, oversight of third party vendor relationships and communications with borrowers. Importantly, however, the examinations did not appear to uncover significant instances of unjustified foreclosures and the report and enforcement proceedings do not mandate any form of principal reductions for defaulting mortgages.

This memorandum summarizes the key findings by the U.S. banking regulators, including the initial supervisory response taken against the major mortgage servicers. Although the recent enforcement actions are only with respect to individual institutions, the significance of these actions likely extends beyond these institutions. With regulators continuing to work toward a uniform set of mortgage-servicing and foreclosure processing standards, elements of the recent enforcement actions may become part of required practices at U.S. banks and mortgage servicers.

A. Critical Weaknesses Identified in Interagency Study of Major Servicers

The interagency review identified "critical weaknesses" in a variety of areas of mortgage servicers' operations and practices, resulting in "unsafe or unsound practices" and violations of applicable law. The enforcement orders that followed this interagency review generally acknowledge that the subject organizations, in consenting to the orders, were not agreeing with the findings.

Below is a summary of the significant issues that regulators found across the spectrum of servicers that they reviewed.[1]

- *Foreclosure Process Governance*—Foreclosure policies and practices at a number of the servicers were described as "either weak or needed substantial expansion to provide effective guidance, control, and ongoing monitoring." In particular, examiners found that the majority of servicers had "inadequate affidavit and notary-signing procedures that did not ensure proper attestation (or verification) of the underlying documents." Also, examiners noted inadequate risk management processes, including inadequate identification of financial, reputational and legal risks, as well as the absence of effective internal communication about those risks among boards of directors and senior management.

- *Affidavit and Notarization Practices*—The report noted that most servicers had affidavit signing protocols that expedited the processes for signing foreclosure affidavits without ensuring that the individuals who signed the affidavits personally checked the documents for accuracy.[2] Examiners also found that the majority of mortgage servicers had improper notary practices that failed to conform to state legal requirements. For example, the report noted that some foreclosure documents indicated that they were executed under oath, when no oath was actually administered.

- *Organizational Structure and Staffing*—The report concluded that, in most cases, servicers did not have enough staff to effectively review loan documentation for accuracy. In addition, inadequate training was noted as a problem, particularly for signers of affidavits, notaries and quality control staff. Examiners also cited "weak controls, undue emphasis on quantitative production and timelines, and inadequate workload monitoring."

- *Documentation Practices*—For most servicers, examiners cited a lack of a clear auditable trail to show how information set out in affidavits (*e.g.*, amount of indebtedness, fees, penalties) was linked to the servicers' internal records at the time the affidavits were executed. Errors between actual fees charged and what these

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1 This summary does not necessarily reflect findings at any specific institution that recently became subject to an enforcement action by the Federal Reserve, the OCC or another regulator, as applicable. In addition, the orders generally noted that the recipient organizations were not admitting or denying any of the regulators' findings set out in the orders. Copies of the enforcement actions announced on April 13, 2011 are publicly accessible on the Federal Reserve's and the OCC's websites:

Federal Reserve: www.federalreserve.gov/newsevents/press/enforcement/20110413a.htm
OCC: www.occ.treas.gov/news-issuances/news-releases/2011/nr-occ-2011-47.html

2 The basic affidavit of indebtedness typically sets forth the name of the party that owns the loan, the default status and the amounts due for principal, interest, penalties (such as late charges) and fees. This affidavit frequently is the principal basis upon which a court is permitted to order a foreclosure without requiring in-person testimony. Similar documentation may be required in bankruptcy proceedings.

internal records indicated (with servicers undercharging fees as frequently as overcharging them) were also identified. Significantly, examiners also found that servicers generally had possession and control over critical loan documents (*e.g.*, original promissory notes and mortgages), giving them "sufficient documentation available to demonstrate authority to foreclose." Examiners also found evidence that, prior to initiating the foreclosure process, servicers generally attempted to contact distressed borrowers about participating in loan modification and other loss-mitigation alternatives.

- *Oversight of Third Party Vendors*—Examiners found that servicers generally did not properly structure, carefully conduct or prudently manage their third party vendor relationships with outside law firms and other service providers, such as "default-service" providers like LPS, which provide significant services to support mortgage servicing and foreclosure processing. Among other things, examiners cited a lack of formal contractual arrangements, an overreliance on law firms to retain originals and copies of critical documents related to foreclosures and lax oversight of third party vendors to ensure compliance with servicers' standards.
- *Quality Control and Internal Auditing*—Examiners found deficiencies in quality control and internal auditing procedures. Quality control weaknesses included failures to satisfactorily ensure accurate foreclosure documentation; incorporate mortgage-servicing activities into the servicers' loan-level monitoring, testing and validation programs; evaluate and test compliance with applicable laws and regulations, court orders, pooling and servicing agreements and similar contractual arrangements; and ensure proper controls to prevent or stop foreclosures in cases in which bankruptcy proceedings had been commenced, where the borrower was covered under the Servicemembers Civil Relief Act or where the borrower was qualified for or paying in accordance with a loan modification program. Regarding internal auditing, examiners found that servicers' failure to perform internal audits impeded their ability to effectively communicate foreclosure processing risks internally. Lack of comprehensive audits also resulted in servicers not taking sufficient corrective action to strengthen policy and procedural gaps, increase staffing levels, improve training in response to sharply rising foreclosure volumes or improve processes relating to custody and control of documents and oversight of third parties managing foreclosure activities on their behalf.

B. Corrective Measures Required Under Recent Formal Enforcement Actions

The orders require mortgage servicers to take a number of corrective measures, subject to certain prescribed deadlines, to address deficiencies in their servicing and foreclosure practices. While the scope of the orders varies somewhat among the different mortgage servicers, the core sections are generally consistent. Below is summary of some of the key requirements imposed under the orders:

- *Compliance Program*—Servicers will be required to submit acceptable compliance programs to ensure mortgage servicing and foreclosure operations (including loss mitigation and loan modification functions) comply with all applicable legal requirements and supervisory guidance. In particular, servicers must implement a number of processes to ensure: (i) the proper execution and notarization of affidavits and properly documented ownership of loan documents; (ii) that a clear and auditable trail exists for all factual information contained in an affidavit; (iii) the ability to locate and secure all loan documents necessary to perform servicing, loss mitigation or foreclosure functions; and (iv) that staffing levels and workloads, training, oversight and quality control are appropriate.

- *Third Party Management*—Policies and procedures for outsourcing foreclosure or related functions to third parties will need to be adopted by each servicer to ensure appropriate oversight and that such activities comply with all applicable legal requirements, supervisory guidance and the policies and procedures of the servicer. Servicers will be required to perform appropriate due diligence on potential and current third party service providers (*e.g.*, outside legal counsel, consultants, independent contractors, property management firms), including with regard to their qualifications, expertise, capacity, reputation, compliance, information security and document custody practices, as well as to ensure the adequacy of such providers' staffing levels, training, work quality and workload balance.

- *Independent Foreclosure Review*—Servicers will be required to retain an independent consultant, acceptable to regulators, to review residential foreclosure actions or proceedings that were pending at any time from January 1, 2009 to December 31, 2010, as well as residential foreclosure sales that occurred during this time period. The purpose of this independent foreclosure review is to determine, among other things, whether any errors, misrepresentations or other deficiencies identified in such review "resulted in financial injury to the borrower or the mortgagee." Following the preparation of a written report by the consultant detailing the findings of the foreclosure review, servicers will be required to submit a remediation plan to regulators and, where appropriate, provide compensation to borrowers who suffered financial injury as a result of wrongful foreclosures or other deficiencies identified in the review.

- *Management Information Systems*—Servicers will also be expected to improve their information systems used in foreclosure, loss mitigation and loan modification activities. Regulators will expect that appropriate changes or upgrades be made to ensure that staff has sufficient and timely access to information provided by the borrower to facilitate effective decision making. Any changes or upgrades should also ensure the ongoing accuracy of records for all serviced mortgages, including records necessary to establish ownership and the right to foreclose by the appropriate party for all serviced mortgages, outstanding balances and fees assessed to the borrower.

- *Communication Improvements*—A number of communication-related improvements will be required of servicers with respect to both their internal operations and their communications with borrowers. Servicers will be required to ensure that staff handling loss mitigation and loan modification requests routinely communicate and coordinate with staff processing the foreclosure on the borrower's property. Also, servicers will be required to ensure that, with regard to borrowers, communications are designed to avoid borrower confusion and ensure continuity in the handling of borrower cases, and that decisions with regard to loss mitigation options or programs be made and communicated in a timely fashion. In particular, servicers will be required to identify a "single point of contact" for each borrower so that the borrower has access to an employee to obtain information throughout the loss mitigation, loan modification and foreclosure processes. Written communications with a borrower must specifically identify the employee, as well as one or more "direct means" of reaching this person.

- *Risk Assessment*—Servicers must also have a written, comprehensive assessment of their risks in servicing operations, particularly in the areas of foreclosure, loss mitigation and the administration and disposition of other real estate owned. This assessment must take into account the various operational, compliance, transaction, legal and reputational risks attendant to such operations.

The Federal Reserve has also issued orders against 10 parent bank holding companies of mortgage servicers. These orders generally require a bank holding company's board of directors to improve oversight over the institution's enterprise-wide risk management, internal audit and compliance programs concerning the residential mortgage loan servicing, loss mitigation and foreclosure activities conducted within the organization.

C. Looking Ahead

The leading mortgage servicers are now engaged in settlement negotiations with the 50 state attorneys general and certain of the findings by the banking regulators (including the finding that servicers generally had sufficient documentation to demonstrate authority to foreclose on borrowers' mortgages) may provide some leverage to servicers in those negotiations. Furthermore, these recent actions may shed light on some of the key areas of concern that regulators will address as they develop national mortgage-servicing and foreclosure processing standards, which will be of critical importance to the mortgage servicing industry once adopted.

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