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Foreclosure Suspensions and Other Mortgage Disputes

By **Timothy McKenna**
and **Dr. Chudozie Okongwu***

Introduction

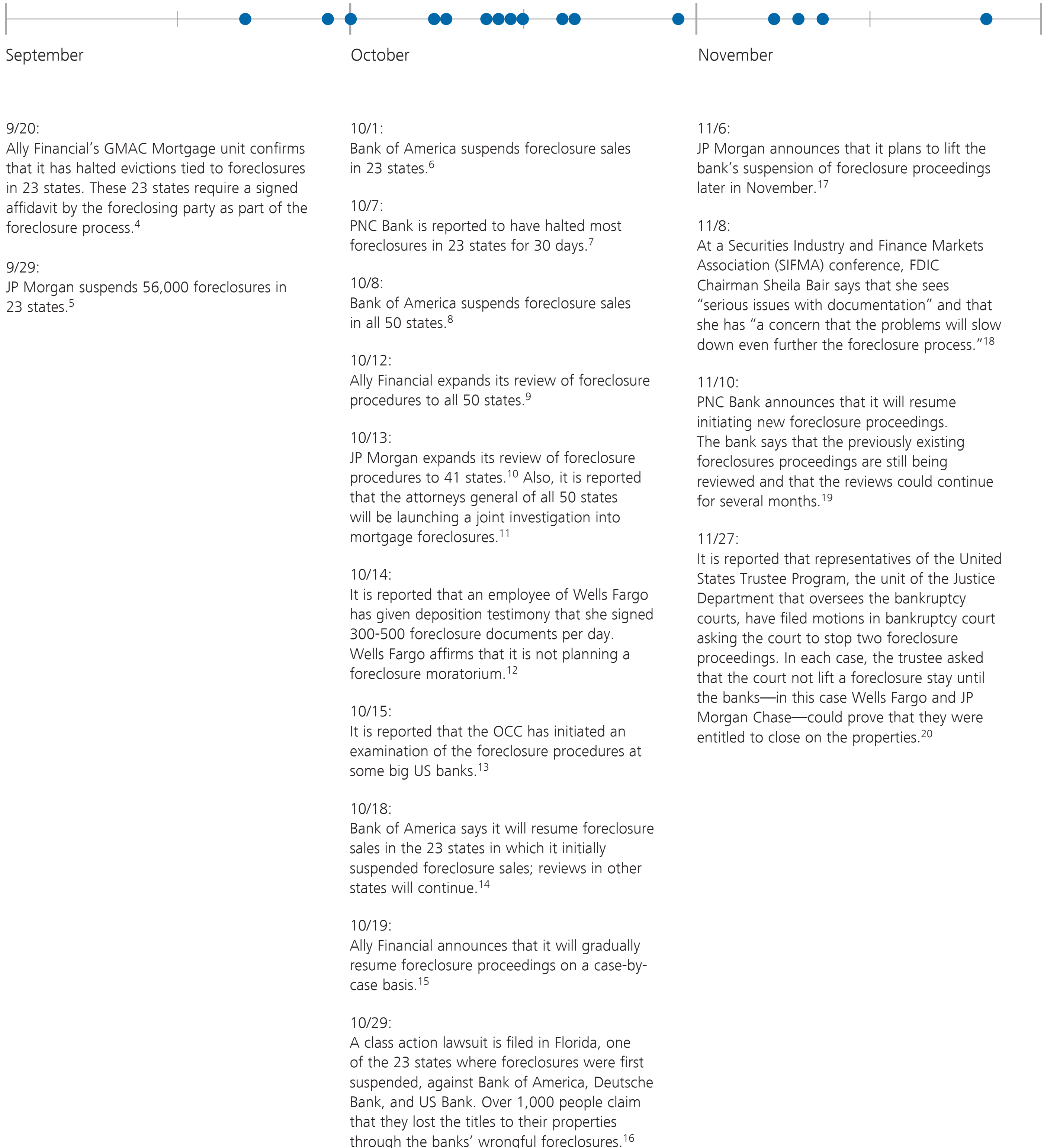
In late 2010, a number of banks with mortgage servicing operations declared moratoriums or suspensions on some aspects of foreclosure proceedings. The first announcement came on September 20th when Ally Financial confirmed that its GMAC Mortgage unit was halting evictions tied to foreclosures in 23 states.[1] By early October 2010, JP Morgan, Bank of America, and PNC Bank had all made similar announcements covering up to all 50 states.[2] In each instance the banks planned to use the time to review their practices regarding foreclosures.

The moratorium on foreclosures appears to have been prompted by revelations about the alleged foreclosure practices of the banks. Employees for Ally Financial and Wells Fargo testified in deposition that there were substandard reviews of foreclosure documents. By mid-October 2010, it was reported that the Office of the Comptroller of the Currency (OCC) and the attorneys general of all 50 states were launching investigations into issues surrounding the mortgage foreclosures.[3] By mid-November 2010, Ally Financial, Bank of America, and PNC had started at least a partial resumption of foreclosure activities.

The foreclosure suspensions were announced at approximately the same time that mortgage servicing was coming under increasing scrutiny by investors in mortgage-backed securities (MBS). These investors have seen a substantial decrease in the value of their MBS holdings over the last few years. There has been pressure from some quarters for the banks that sold the mortgage loans securitized in the MBS to repurchase some of the loans (this request is known as a request to “put back” a mortgage). The put-back process can be complex. There are multiple reasons why a loan may be put back to the seller of the loan. A common reason is that the loan did not satisfy the representations and warranties made by the bank selling the loan for securitization. When one of these provisions is not met for an individual loan, then the holders of the MBS may request that the bank repurchase the loan.

This paper addresses the history of this episode of foreclosure suspensions; discusses some economic implications of the suspensions; looks at some other areas where the banks are facing allegations of mortgage documentation issues; examines where put-backs may occur; and considers some potential litigation related to these issues.

Timeline of Foreclosure Suspensions in 2010

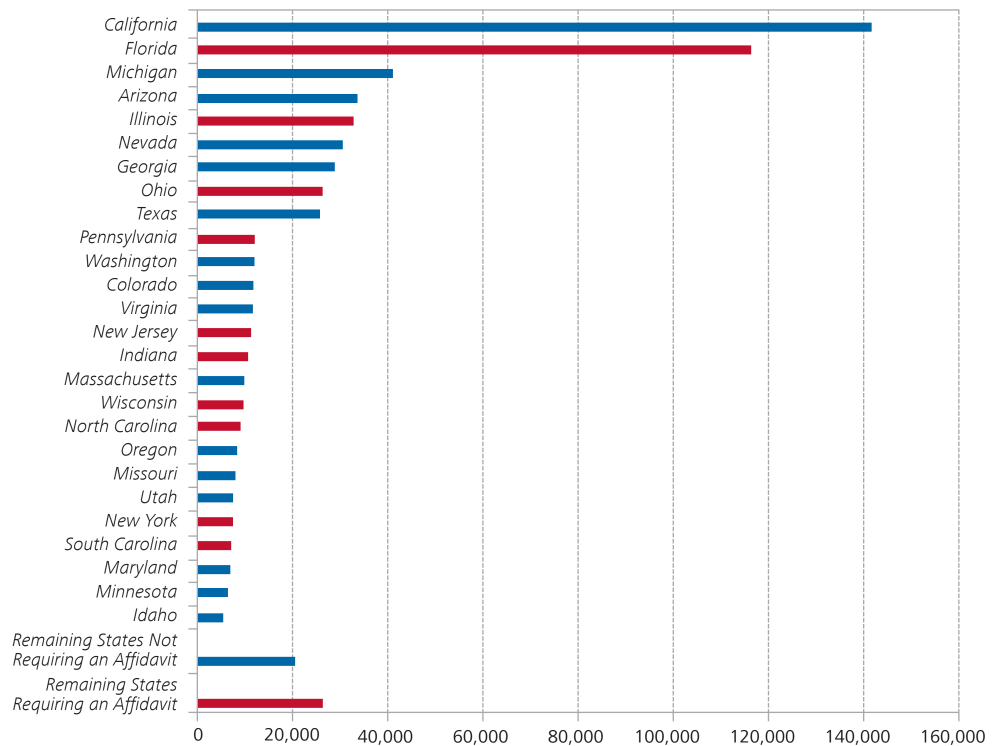


Why 23 States?

Ally Financial, Bank of America, and JP Morgan initially announced their suspensions of foreclosure activity in 23 states. These states have often been referred to as "judicial review" states in the popular press. Typically, judicial review refers to a foreclosure being conducted through the court system (*foreclosure by judicial sale*) rather than outside of the court system (*foreclosure by power of sale*). Some states allow both types of foreclosure, but a state usually has one type that is more commonly employed. In the set of 23 states, there are some states that allow non-judicial foreclosures (e.g., Hawaii, Nebraska, and Oklahoma), so it appears that the presence or absence of judicial review was not the determining factor used by banks to settle on the set of 23 states.[21]

Rather, it seems that the states chosen by the banks were those in which a representative of the mortgage note holder is required to sign, in the presence of a notary, an affidavit accompanying the foreclosure documents swearing that he or she has direct personal knowledge of all of the information contained in the affidavit. The 23 states contain a significant portion of the households with foreclosure proceedings against them. Figure 1 shows these 23 states in red and the other states in blue. In addition, it shows the number of households in each state that received a foreclosure notice in September and October 2010. Slightly less than 40% of all foreclosure notices in the US were in the 23 states during those months.

Figure 1. **Foreclosure Notices By State (September – October 2010)**



Foreclosure data taken from http://www.realtytrac.com.
Red indicates states where banks halted foreclosure procedures.

What is a Robo-Signer?

"Robo-signer" is a term coined by the popular press for the individuals who signed foreclosure documents allegedly without proper verification of required information. The practice became widely known in September 2010 upon news of the June 2009 deposition of Jeffrey Stephan of GMAC Mortgage.[22] Mr. Stephan testified to signing 10,000 foreclosure affidavits a month.[23]

Other examples include:

- In July 2009, Erica A. Johnson-Seck, a vice president for OneWest, testified that she and seven other colleagues signed about 6,000 foreclosure documents a week.[24]
- Renee Hertzler, a Bank of America executive, admitted in February 2010 to signing as many as 8,000 foreclosure documents a month without reviewing them.[25]
- Herman John Kennerty of Wells Fargo, deposed in March 2010, testified that he signed up to 150 foreclosure documents a day, verifying only that the dates on the documents were accurate and consistent with the date of his signature.[26]
- Beth Ann Cottrell of Chase, deposed in May 2010, said she regularly signed 18,000 foreclosure documents a month without reviewing them.[27]

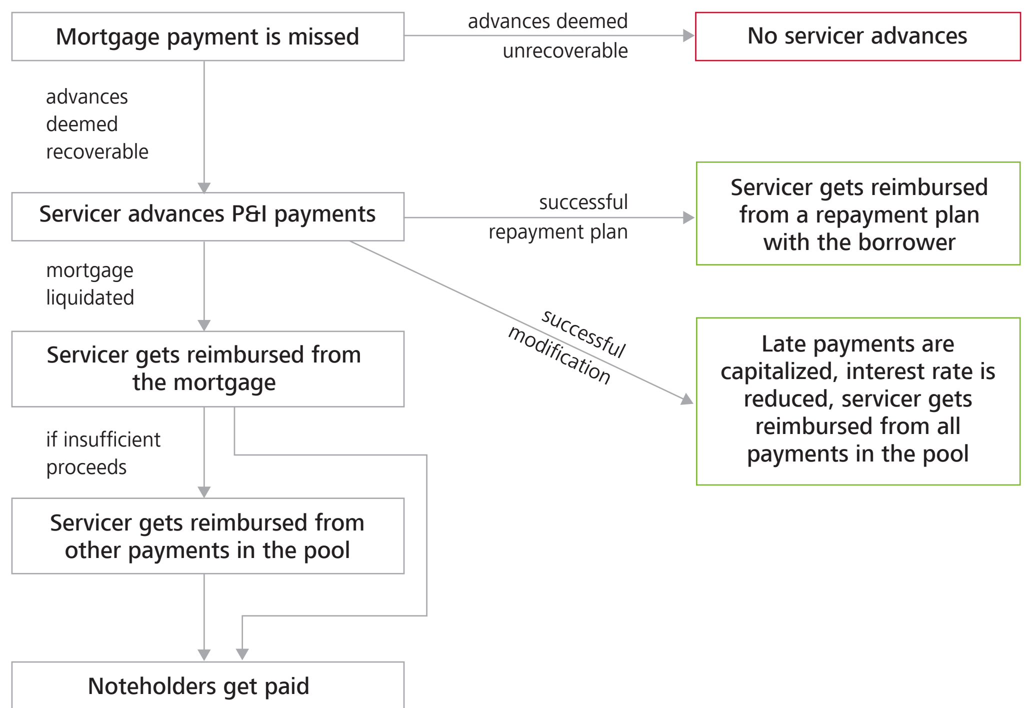
Economic Impact of the Foreclosure Suspensions

The most immediate economic impact of any foreclosure suspensions is that sales and/or evictions of foreclosed homes will stop. Plainly, this lets the residents of a foreclosed home remain in the house. Individuals and families who may have been planning on buying and living in the house now must delay their transaction, possibly incurring unforeseen costs as they adjust to not having housing when they anticipated. In addition, the market for properties coming out of foreclosure may become less liquid due to any uncertainty regarding whether proper foreclosure procedures were followed. The foreclosure suspensions may even have added substantial uncertainty to mortgages not originated by banks involved in the foreclosure suspensions. This may harm both buyers and sellers of homes.

The foreclosure suspensions also have an impact on securitizations backed by the affected mortgage loans. While a loan is delinquent, the mortgage servicer will often advance the monthly principal and interest payments. A servicer is obligated to advance the monthly payment if the servicer believes that an advance is recoverable from the foreclosure proceeds and the servicer has a claim on liquidation proceeds that is senior to all certificate holders. Thus, as long as the servicer believes that the expected value of the advanced payments will be less than the expected proceeds upon foreclosure, a servicer will advance payments. If the foreclosure process on a property is suspended, then the loan is still considered to be delinquent and the mortgage servicer must advance the scheduled principal and interest payments.[28]

Figure 2 shows the choices faced by a mortgage servicer when a mortgage payment is missed.

Figure 2. **Choices Faced by Mortgage Servicers**



A delay in foreclosures and hence a change in the timing of payments related to the foreclosed loans may seem like an insignificant matter. However, these changes can have serious implications for holders of MBS. In a typical multi-tranche MBS, interest and principal payments made on the securitization's underlying mortgage loans are used to satisfy outstanding interest and prepay principal to MBS holders by tranche, in order of seniority. More junior mezzanine tranches do not get interest payments until all senior tranches are paid interest in full.

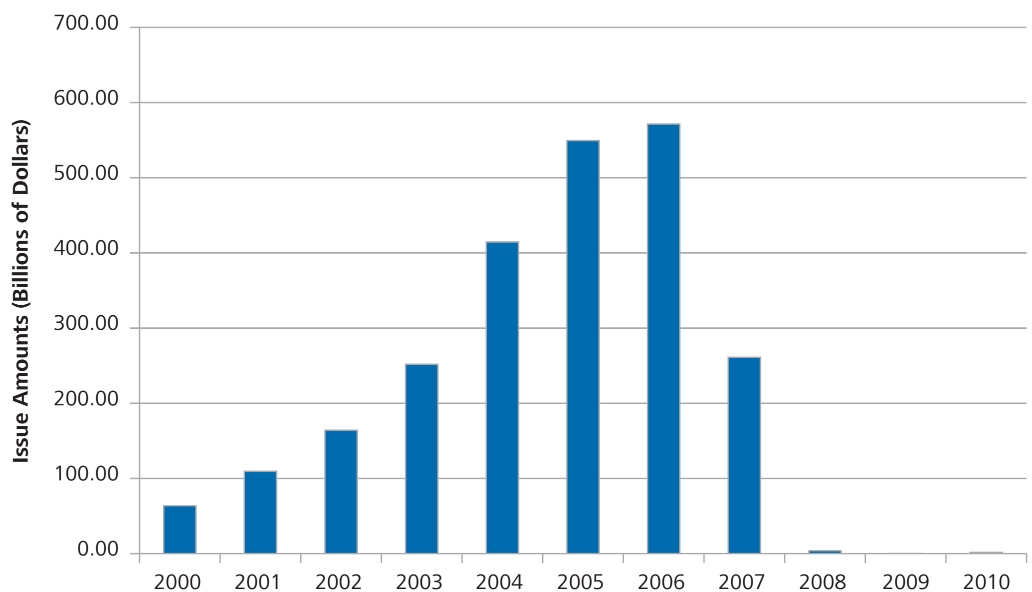
In this type of structure, senior tranches may be at a disadvantage when foreclosures are suspended. This is because a mortgage in foreclosure is only going to generate revenues equal to the price achieved at a foreclosure sale. If the foreclosure sale price is low enough, then upon a foreclosure sale the senior tranche members receive the entire value of the sale while junior tranche members receive nothing. As discussed above, under a foreclosure suspension a servicer often advances the scheduled mortgage payments until the foreclosure is lifted. These payments are distributed to both junior and senior tranche holders. However, the total amount of money that will ultimately be recovered from this mortgage is still fixed at the sale value of the house at foreclosure. Thus, upon the eventual foreclosure, the servicer will first reimburse itself for the advanced mortgage payments and then distribute the remaining proceeds to the senior tranche holders. Assuming that home prices have not appreciated materially during the foreclosure suspension, this results in the senior tranche holders receiving less than they otherwise would have received without the foreclosure suspension.

In some structured products such as cash CDOs, coverage tests, which test for sufficiency of collateral and interest proceeds, may prevent the disadvantaging of senior tranches due to suspensions by diverting interest and/or principal payments from mezzanine tranches to redeem more senior tranches. However, the effectiveness of this mechanism will depend upon whether the tests are performed before or after the mezzanine tranches are paid and, if the tests fail, whether the senior tranches or mezzanine tranches get redeemed first. In addition, there is typically an allowance for some defaults before coverage tests are triggered and the payments get diverted.[29] For these reasons, coverage tests are not sufficient to assure that junior tranche members do not benefit from a suspension of foreclosures.

Representations, Warranties, and Notes—Other Mortgage Documentation Issues

Mortgage originations and securitizations of these mortgages grew tremendously during the years leading up to 2008. Figure 3 graphs the rise in private-label MBS issuance in the last 10 years. The rise in issuance of MBS may have contributed to some issues that the banks have had with mortgage documentation that allegedly go beyond the problems surrounding the foreclosure suspensions.

Figure 3. **US Private MBS Issuances – 1 January 2000 to 31 October 2010**



Notes and Sources:
Data are from Bloomberg, L.P. Issuances include all Home Equity and Res B/C ABS issued only in the United States in USD available on Bloomberg, L.P.

For instance, numerous lawsuits have called into question the quality of the mortgages that went into the MBS issued after 2003. Notably, there have been complaints that allege that not only were the loans of poor quality, but also that the loans that went into the MBS did not meet the representations and warranties made by the seller of the loans to the MBS. While representations and warranties can vary from MBS to MBS, some common examples are that the title documents are in good order and that the loan-to-value ratio of the loan does not exceed a set threshold. If these provisions are not met, then the holders of the MBS can ask to put back the loan to the seller of the loan.

As an example, MBIA alleges in a suit against four Countrywide entities and Bank of America that there are "substantial breaches of Mortgage Loan Representations, including an extraordinarily high incidence of material deviations from the underwriting guidelines Countrywide represented it would follow. A material discrepancy from underwriting guidelines is very serious and indicates that the loan should never have been made."[30] MBIA's complaint is not that there are some mortgages that should be put back; in fact, the repurchase mechanism was put in place because it was not unusual for a few loans to warrant being put back. Instead, MBIA is arguing that the number of loans that should be repurchased is unusual and abnormally high.

The quality of basic record-keeping of documentation for the loans in MBS has been called into question in some lawsuits and there have been instances where mortgage lenders could not provide physical proof, such as the mortgage note, that they owned the rights to the loan. The mortgage note is the actual document which specifies the amount of debt, the interest rate, and when and to whom payments on the mortgage must be made. The loan note is a physical piece of paper and when a mortgage is sold the note must be endorsed by the seller and transferred to the buyer. In many jurisdictions, holders can be forced to produce the note as evidence that they are the true owners of the mortgage debt and therefore legally allowed to proceed with a foreclosure.

In a set of 14 foreclosure cases involving Deutsche Bank National Trust Company, Judge Christopher Boyko dismissed the foreclosure proceedings against the defendants as the judge held that the mortgage lenders could not prove that they were the holders and owners of the mortgage notes at the time of the complaint. The court had requested that the plaintiffs provide physical copies of the assignment documents indicating that ownership of the mortgage had been transferred to them prior to the date the complaint was filed. When the plaintiffs were unable to produce such documents, the judge dismissed their foreclosure complaints, stating:

> This Court acknowledges the right of banks, holding valid mortgages, to receive timely payments. And, if they do not receive timely payments, banks have the right to properly file actions on the defaulted notes—seeking foreclosure on the property securing the notes. Yet, this Court possesses the independent obligations to preserve the judicial integrity of the federal court and to jealously guard federal jurisdiction. Neither the fluidity of the secondary mortgage market, nor monetary or economic considerations of the parties, nor the convenience of the litigants supersede those obligations.[31]

The problem of inadequate legal documentation of the transfer of mortgages may be widespread. In a comment before the Florida Supreme Court on a proposed rule change, the Florida Banker's Association asserted that some paper loan notes were purposely destroyed upon the note being converted to an electronic file.[32] Linda DeMartini, an employee of Bank of America's BAC Home Loans Servicing L.P., testified in a recent case that it was customary for Countrywide to maintain physical possession of the mortgage note even after the mortgage had been sold into a securitized product such as a MBS. The case, *Kemp vs. Countrywide Home Loans Inc*., involved a property purchased with a mortgage from Countrywide. The mortgage was eventually placed in a MBS. The owner of the property subsequently declared bankruptcy and Countrywide, as servicer, filed a proof of claim against the property on behalf of the trustee of the MBS, Bank of New York. Bank of New York never took physical possession of the note and as a consequence the court ruled that the claim on the property by Countrywide (on behalf of Bank of New York) "must be disallowed."[33]

Given the massive growth in the securitized mortgage markets over the past two decades, and the huge number of mortgage transfers underlying the securitizations, motions by courts to require physical proof of mortgage transfers have the potential to slow or stop a large number of foreclosure proceedings.

Mortgage Put-Backs

Mortgages securitized in MBS issued by government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac as well as private label MBS can be put back to the banks that sold the loans. There are multiple reasons why a loan may be put back to the seller of the loans. As discussed above, a typical reason is that the loan did not satisfy the representations and warranties made by the bank selling the loan at the sale. A complication for an entity wishing to ask for a put-back is that it can be difficult to verify whether an individual loan did not satisfy the representations and warranties. Often the party will be dealing with many loans and the truth of the representations and warranties can be hard to determine without access to more detailed files that are generally held by the banks that sold the loans.

In addition to the informational hurdles faced by holders of the mortgages, investors in private-label MBS have an additional problem. If investors request a put-back of certain mortgages in a MBS, it is possible that the servicer will not take action on this request. The exact procedures may differ, but generally speaking, investors making up 25% of the voting rights in the MBS, or the trustee, need to provide written notice to the master servicer of a breach of representations and warranties. After the written notice, the procedures provide a number of days to cure the breach as specified in the Pooling and Servicing Agreement—usually 60 days. If the breach is not rectified, an Event of Default occurs and the trustee may take control of the servicing rights from the master servicer in order to appoint a successor.

In an August 2010 filing, Bank of America said that put-back requests from holders of private-label MBS account for only $33 million of the approximately $11.1 billion in unresolved mortgage put-back requests received by the bank.[34] Both JPMorgan Chase and Wells Fargo noted in their recently filed 3Q financials that repurchase demands received to date have been predominantly related to loans sold to GSEs and that private-label repurchase demands have been limited.[35]

An Attempt to Put Back Mortgages in Private-Label MBS

A recent example of an attempt to put back loans is found in a letter sent by a group of holders of MBS including the New York Federal Reserve, Blackrock, and PIMCO.[36] The letter was sent to Countrywide Home Loans Servicing LP, the servicer of the MBS, and The Bank of New York, the trustee of the MBS, and it detailed a series of alleged failings by Countrywide Home Loans Servicing LP. The letter alleges that Countrywide Home Loans Servicing LP, as Master Servicer, had failed to abide by the terms of the Pooling and Servicing Agreements (PSAs) that cover the MBS held by the writers of the letter. An excerpt of the letter is below:

> a. Although it regularly modifies loans, and in the process of doing so has discovered that specific loans violated the required representations and warranties at the time the Seller sold them to the Trusts, the Master Servicer has not notified the other parties of this breach;
>
> b. Although it has been specifically notified by MBIA, Ambac, FGIC, Assured Guaranty, and other mortgage and mono-line insurers of specific loans that violated the required representations and warranties, the Master Servicer has not notified any other parties of these breaches of representations and warranties;
>
> c. Although aware of loans that specifically violate the required Seller representations and warranties, the Master Servicer has failed to enforce the Sellers' repurchase obligations, as is required by Section 2.03; ….

Sections a. and b. allege that Countrywide became aware that certain loans violated the representations and warranties made upon issuance of the MBS. Section c. asks that the Master Servicer—Countrywide Home Loans Servicing LP—put back the loans to their originator. In this case that happens also to be Countrywide, although it is likely to be a different specific legal entity than Countrywide Home Loans Servicing LP.

The letter highlights some issues that may have hindered other attempts to put back mortgages from private label MBS. First, by assembling such a large and diverse group of parties, the letter writers claim to represent 25% of the voting rights. Also, it can be difficult to find specific information about which loans failed to meet the representations and warranties made by the seller. Here the letter writers are calling attention to loans that came to light either in the mortgage loan modification process or that were identified by one of the monoline insurers. Identifying loans this way obviates the need for the firms to identify the loans themselves.

Potential Avenues of Litigation

Litigation Related to the Foreclosure Suspensions

On 29 October 2010, a class action lawsuit was filed against Bank of America, Deutsche Bank, and US Bank in Florida. Over 1,000 people claim that they lost the titles to their properties through the banks' wrongful foreclosures. In particular, the suit alleges that the banks' employees signed affidavits without direct knowledge of the information contained therein, and without a proper notarization process.[37] It appears that robo-signers were active in many other states in the country and it is possible that litigation of this type could appear in those states as well.

As discussed above, a suspension of mortgage foreclosure sales can disadvantage holders of senior tranches in a MBS and benefit the holders of the junior tranches. It is possible that senior tranche holders may file lawsuits against the parties responsible for the foreclosure suspensions to restore themselves to the position they allegedly would have been in but for the foreclosure suspensions.

Put-Back-Related Litigation

Litigation may result if an attempt to force a mortgage servicer to put back loans does not result in the loans actually being put back. For example, as previously discussed, the New York Federal Reserve and others have requested that Countrywide Home Loans Servicing LP put back loans to their originator. If the originator refuses to repurchase the loans this could result in litigation.

Another example of an attempt to put back a large pool of mortgages comes in the previously discussed lawsuit filed by MBIA against Countrywide and Bank of America Corp. In that litigation, MBIA is demanding the repurchase of 4,689 loans with an unpaid principal balance of $396.9 million. MBIA has also filed lawsuits against Residential Funding Company, LLC and Credit Suisse with similar allegations relating to the representations and warranties made by the sellers of the loans.[38]

Additional litigation has been filed by other parties such as the Federal Home Loan Banks and Cambridge Place Investment Management. Generally, the allegations are that the banks provided inadequate disclosure about the nature of the loans being packaged into MBS.[39] The suit by the Federal Home Loan Bank of Chicago alleges that the defendants should be required to repurchase the securities because they "did not tell the bank the truth about the loans that comprised the mortgage pools." In these cases, the plaintiffs are asking that the defendants repurchase the entire MBS, not just individual loans securitized in the MBS.

Conclusion

The recent controversies in the mortgage industry have the potential for significant economic and legal consequences. These concerns can be seen in the report released on November 16th by the Congressional Oversight Panel, "Examining the Consequences of Mortgage Irregularities for Financial Stability and Foreclosure Mitigation."[40] The report states that "Allegations of 'robo-signing' are deeply disturbing" and that robo-signing "may have concealed much deeper problems in the mortgage market." The report also notes that repurchase requests related to representations and warranties may result in "extensive capital losses" for the banks. It remains to be seen how much of an impact the foreclosure suspensions and the repurchase requests will ultimately have on the various stakeholders in the mortgage marketplace.

End Notes

* Mr. McKenna is a Senior Consultant and Dr. Okongwu is a Senior Vice President with NERA Economic Consulting. The authors would like to thank James Jordan and Oksana Kitaychik for helpful comments and Ekaterina Jager and Benjamin Berman for helpful research assistance.

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Contact Information

For further information and questions, please contact the authors:

Chudozie Okongwu, PhD
Senior Vice President
+1 212 345 5003
+44 20 7659 8568
chudozie.okongwu@nera.com

Timothy McKenna, MA, MBA
Vice President
+1 212 345 5503
timothy.mckenna@nera.com

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