Why People Are So Angry At Lenders and Servicers

(Part Two)

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Oregon's Trust Deed Foreclosure Law. It is widely known that during the credit/housing boom, lenders frequently sold their loans between one another. When the ownership of a loan is transferred, it is necessary to execute, in recordable form, an "Assignment of Trust Deed." ORS 86.735(1) governs what must occur before a trust deed may be foreclosed in Oregon; all such assignments must be placed on the public record. This is not a new law and it is not significantly different from the laws of many other states. Oregon's law has been on the books for decades.

The MERS Solution. In the 1990s, MERS came into existence. The primary owners were the big banks – they were also the primary beneficiaries. Its avowed purpose was to replace the time honored system of public recording for mortgage and trust deed transfers, with an electronic registry that its bank members would voluntarily use. The immediate effect of MERS was that lenders stopped publicly recording their mortgage and trust deed assignments. This deprived local governments of millions of dollars in recording fees, and took the business of the sale of loans "underground."

Although the numbers vary, it is believed that MERS comprises approximately 60% of the national lending industry. Until recently, it had *no employees*. MERS was not born from any state statute or national enabling legislation. It was the brainchild of lender owners.

When the foreclosure crisis hit, lenders realized that they needed some way to get the mortgages and trust deed into the current bank owner's hands to initiate the process. Since MERS' existence was virtual, and with no real employees, whenever it came time to assign a mortgage or trust deed, a MERS "Assistant Vice President" or "Assistant Secretary" would execute the assignment on behalf of MERS in their "official" capacity. But since MERS has no such officers, it simply created mass "Corporate Resolutions", appointing one or more low level member bank employees to "robo-sign" thousands of bogus assignments.

The recent 60 Minutes television show of Sunday, April 3, 2011 graphically showed how the robo-signing fiasco turned out. When the scandal came to light last fall, the validity of almost all foreclosures became suspect. The quality of title was now in question whenever a bank sought to re-sell a home it had foreclosed. The fallout is still not over. Local title companies are now beginning to issue exclusions in their policies, declining to insure the quality of title for any recently foreclosed home, unless the foreclosure strictly complied with Oregon law – which in most cases, they did not.

The Bank Servicing Industry. A "servicer" is a bank that does not necessarily own the loan – it merely collects the payments, ensures that the taxes and insurance are paid, and generally oversees issues related to the borrower's performance. To many people, servicers are viewed as the owners of the loans, but that is not necessarily true. This distinction has become most apparent during the foreclosure crisis, under the federal home loan modification program "HAMP," and the banks' own proprietary loan modification programs.

The last two years is replete with horror stories of lenders dragging loan modifications (and short sales) out for months. Paperwork was repeatedly "lost" two, three and four or more times. Frequently, desperate homeowners were literally "led down a path" believing that if they complied with a three-month "trial program" they would qualify for a permanent modification of their loan to a payment level they could afford. In many cases, the result was disastrous: While they paid their trial payments, homeowners' credit scores continued to decline; after months and months of lost paperwork and other delays, they were then abruptly informed by the servicer that they did not qualify. No reasons were given, or if they were, it was simply that their debt-to-income ratios were too high – a fact the lenders presumably knew at the moment the borrower's paperwork was first received. Then, 12-14 months later, homeowners were being told that they had to make up all of the deferred payments or they would be immediately foreclosed. By then, the homeowners' options were severely limited, since their credit rating had tanked, their funds were depleted, and a foreclosure became the inevitable – although long delayed – outcome.

Why would lenders do this? Didn't they want their borrowers to obtain modified loans that would permit them to stay in their homes and *avoid* foreclosure? The answer lies in the inconsistent business models of banks and servicers. Banks, *as servicers*, are in charge of the collecting the monthly payments and making the modifications. This is not the same as the business model of banks *as owners* of the loans. In other words, their financial interests are not "aligned." This is largely due to the nature of the servicers' contracts with the banks whose loans they service.

While *banks* make money originating and securitizing their loans, *servicers* make money in the following ways:

- By collecting a monthly percentage of the unpaid principal balance of the pooled loans they are servicing.
- They also receive income from the penalty fees charged to borrowers in default. The fact that the struggling borrowers cannot pay the penalties is irrelevant, since full payment ultimately comes from the banks themselves, once the home is either foreclosed, short sold, or taken back in lieu of foreclosure. These fees are paid before the owner, i.e. the "investor" of the loan, gets paid.
- Of lesser importance is the "float income" received by servicers between the time they receive payment and the time it is paid over to the owner of the loan (which is frequently the investment trust, or "REMIC," which was the final resting place for billions of dollars of securitized loans).

Thus, while the banks as "banks" make their money at the front end of the lending process, the banks as "servicers," make their money at the end, during the foreclosure process. And servicers don't want to see mortgages and trust deeds fall out of the loan pool too quickly, as it represents the end of their stream of income for that loan. Hence, delay after delay.

The upshot is that the banks and their servicers are working at cross purposes. The result is that there is a huge incentive for servicers to draw out the downward spiral of default, so that they can make as much money as possible before letting the homeowner drop into the foreclosure abyss. Lest one think that the banks should just demand that their servicers "shape up," this ignores the fact that most big banks also *own* servicer subsidiaries. In fact, some of the biggest banks in the business are also some of the biggest servicers in the business. Some banks even own their own foreclosure companies (known as foreclosure "trustees").

So while the banks' main business of making loans may be struggling today, their foreclosure business is doing quite well, thank you. In fact, there is reason to believe that during the housing downturn and tight credit market, it is the foreclosure side of the big banks' financial statement that is propping them up.

The Realtor® Take-Away. So what does all this mean for the Realtor® industry? Well first, the information provided in this article is *informational only*, and should not be considered as a basis for brokers to "advise" homeowners how to proceed in making their distressed housing decisions.

However, there is some reason to believe that the problems many banks and servicers are facing in completing their foreclosures today, may ultimately inure to the benefit of the Realtor® industry in the form of more short sales. Why? Because a short sale is a "non-foreclosure" solution to the problems many banks have brought on themselves. While foreclosure shines a bright light on the robo-signing and off-record assignments we know have been going on, short sales do not. Rather, the short sale re-introduces homes back into marketplace. There is no further question about the quality of the title, since the ugly pre-foreclosure events did not occur – or if they did, they do not become a "foreclosure defense" that calls into question the marketability of title.

Thus, banks benefit by not having to foreclose and thereby having fewer REO properties and reduced carrying costs. They also gain with enhanced lending activity to facilitate the short sales. Now we have to hope that the lending industry will only agree….

Conclusion. These are interesting times. There is no way to know how things will ultimately shake out. But one thing is clear: Until the backlog of foreclosure inventory works its way through the system and back into the marketplace, home values will continue to stagnate, and many, many, housing related industries, including employment itself, will continue to suffer.