"A Foreclosure Crisis"

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A Foreclosure Crisis

Problems with mortgage foreclosures have been in the headlines during the past several months. The media attention arises from several concerns. One concern relates to whether lending institutions have followed proper foreclosure procedure. Another reflects a popular misconception among many that a mortgage can become separated from the note it secures. Yet another concern arises out of the complexity of some of the structured transactions involving the mortgages.

Often there is no infirmity in the applicable foreclosure procedures themselves, but the volume of business is so great that certain procedures are ignored or circumvented as a shortcut. There is no excuse for this, especially when such procedures are a safeguard that might prevent an inappropriate separation of a family from a home. In other cases there may be a failure to comply with the proper foreclosure procedures because of training deficiencies with respect to the people who conduct the operations. That difficulty in turn may stem from (1) the complexity, and the outdated nature of the relevant law, (2) the complexity of the transactions themselves, and (3) the vast amount of paper that must be managed by market participants who are geographically distant from one another. Little can be done about the second cause, as modern financial transactions are simply complex and usually for good reasons. But something can be done about the first cause and perhaps even about the last cause.

Years ago, mortgage loans were done locally and the transaction documentation did not travel. That meant the lender and the borrower were in the same locality, and the lender kept the mortgage until it was paid off. The parties could talk to each other and work out difficulties and one set of familiar laws applied. Commercial practice changed some years ago, when banks transformed from an “originate the loan and hold it” model to an “originate the loan and distribute it” model. Today, the initial lender will often sell the note and the mortgage that secures it to a buyer (such as another lender). That buyer will engage someone to “service” the mortgage (the service of collecting payments and other interaction with the borrower). The servicer is acting as an agent of the buyer of the mortgage and note, which now owns the rights to both. The servicer may be the initial lender who sold the mortgage and note, or it may be a company that provides this service for many lenders, and perhaps is located far away from the location of the borrower.

The note, which is evidence of a promise to repay that a layperson would call a “loan,” and the mortgage securing the loan may be transferred more than once. Ultimately the loan and the mortgage may end up being owned by an entity created for the purpose of owning many loans with their accompanying mortgages (often called pooling). That entity will then issue rights (investment securities) in the pool of loans and mortgages, to investors, who become owners with many other investors in the stream of payments generated by the pool of the loans and mortgages (but do not become the owners of those loans and mortgages). This process of selling the loans and mortgages to an entity, which then issues rights (securities) in the payment stream from the pool, is called securitization. This process of selling loans and mortgages enables the initial lender to replenish its supply of capital to make new loans, instead of being restricted to making new loans only as the old loans get repaid, or from local resources, which limits the new loans that may be made.

The process of selling loans and mortgages requires that there be some method of determining the current owner of each particular loan and mortgage. In fact, that is a necessary component of the foreclosure process. The loan and mortgage owner, or a servicer who is acting as the owner's agent, must determine whether it is appropriate to exercise foreclosure rights. When a loan and mortgage securing the loan is created, the initial lender will ensure that the mortgage is recorded in the correct real estate records based upon the location of the real property. However, when the loan and mortgage are sold, the manner of transferring the right to realize on the security for the loan does not typically require that an assignment of the mortgage be recorded in the real estate records. In many cases the loan and mortgage will be registered with an entity called MERS, which is a tracking system, so that interests in it can be followed when the loan and mortgage are transferred. In some cases, MERS also is listed as the mortgagee in the mortgage as an agent of the initial lender and all of the initial lender's subsequent assignees (buyers of the loan and mortgage).

This division and fractionalization whereby there are entities that are owners of the loan and mortgage (or some part of the loan and mortgage), a servicer for the loan and mortgage, and a named mortgagee that is not necessarily the owner of the loan and mortgage has caused significant confusion. Mark Kaufman, Commissioner of the Maryland Office of Financial Regulation (OFR) testified about the remarkable changes in securitization and third-party servicing before a Congressional legislative committee, noting that these developments "forever changed the mortgage landscape." Today, he said community banks only hold a fraction of mortgage loans in Maryland and account for next to none of the foreclosure complaints received. "The unbundling process may have facilitated the flow of cheap capital, but it has also fragmented roles, distorted market incentives, and severely complicated the task of modifying loans to avoid preventable foreclosures." Moreover, Kaufman continued, the same economies of scale drove consolidation in the mortgage servicing business line, so that today the top five mortgage servicers are responsible for over 60% of the mortgages serviced. Every one of the five is owned by a major bank holding company. He noted that this concentration not only created an enormous management challenge, but left money losing servicers trapped in too-big-to-fail institutions. As a result, "the invisible hand of the market will not fix this."

In order to tackle shortfalls in mortgage servicing after the "robo-signing" scandal (wherein parties seeking to foreclose mortgages did not follow state law procedures for doing so), Kaufman said the Maryland Office of Financial Regulation joined the 50 state attorneys general and 37 state bank regulatory agencies in the multi-state investigation which followed that scandal. Kaufman indicated that it was particularly important as the states are "closer to the problems than [their] federal counterparts and foreclosure remains an issue with local ramifications." However, Kaufman also acknowledged the importance of federal level attention, as the largest servicers handling the bulk of mortgages are federally supervised.

Based upon the efforts thus far, Kaufman presented several recommendations. Given the gravity of the task at hand, Kaufman claimed that "compliance is and should be demanding." Nonetheless, increased regulation should not displace the benefit of the "originate to distribute" model, because it increases the amount of credit available from local and national sources, it is more efficient and thereby lowers costs, and can have the ability of making credit available for those who have lower incomes.

However, the laws that govern this scenario are many. There is the law of agency, which governs the relationships with the servicer and with MERS. State law governs the obligation reflected in the loan that the borrower owes and that the mortgage secures. State law also governs the mortgage, which is an interest in the real property covered by the mortgage, but it is a different state law than that which governs the loan obligation. Both federal and state law may govern the sale of the payment interests in the mortgage pool.

It is not surprising that this multiplicity of laws that are not necessarily found in one place, and whose interaction can be less than clear, creates complexities for people handling the mortgage or doing the servicing that they do not always understand and thus makes it difficult for them to know what they should do. Moreover, this may be true for the parties to the mortgage as well, particularly the borrower, and even for judges and juries who may become involved if the foreclosure process is begun and there is court action.

There is, however, a development that is aimed at alleviating these problems. Two organizations, the Uniform Law Commission and the American Law Institute, both of which have been in existence for well over half a century and whose mission is to clarify and update state laws, have joined forces with various stakeholders, including the Federal Reserve Bank of New York, to deal with the legal complexity and the fact that much of the applicable law no longer adequately reflects modern financial practice and technological developments.

First, the ULC and the ALI, through the Permanent Editorial Board for the UCC, which has representatives from both organizations, have issued a draft report that describes some of the applicable laws, and how they inter-relate and apply to mortgage transactions. The report will provide guidance for judges and lawyers involved in the transactions. This report should make the application of the present relevant laws more transparent, and prevent some of the erroneous conclusions that have stemmed from the complexity of laws, even though the complexity itself will not be reduced.

Second, one of more importance for the future, the two organizations have undertaken a meeting of their members, along with participation from interested organizations and parties – consumers, banks, mortgage servicers, lenders, brokers, and others, to discuss whether to:

(1) revise the law, whether state or federal (working with Congress and federal agencies) to remove unnecessary legal impediments to current good mortgage loan practice and the efficient and transparent processing of transactions;

(2) provide statutory or regulatory backup for market developed mortgage transfer operations and clarity for the documentation and procedures necessary to the certain operation of that process; and

(3) revise the law for maximum efficiency in the process to accomplish the lowest cost for transactions for lenders and borrowers alike.

This process of law reform will not be completed overnight. While a careful re-consideration of the law will not be immediate, nonetheless the existence of the process itself may serve to alleviate confusion and doubt, and thus allow the current process to operate with fewer uncertainties and mistakes. In the longer term, the result of such a careful process to revise and update the law, if undertaken, will serve to prevent current problems in the future as the law going forward will reflect good practice and reflect the benefits of technological development.