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Mortgage Servicing

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This Article argues that a principal-agent problem plays a critical role in the current foreclosure crisis.

A traditional mortgage lender decides whether to foreclose or restructure a defaulted loan based on its evaluation of the comparative net present value of those options. Most residential mortgage loans, however, are securitized. Securitized mortgage loans are managed by third-party mortgage servicers as agents for mortgage-backed securities ("MBS") investors.

Servicers' compensation structures create a principal-agent conflict between them and MBS investors. Servicers have no stake in the performance of mortgage loans, so they do not share investors' interest in maximizing the net present value of the loan. Instead, servicers' decision of whether to foreclose or modify a loan is based on their own cost and income structure, which is skewed toward foreclosure. The costs of this principal-agent conflict are thus externalized directly on homeowners and indirectly on communities and the housing market as a whole.

This Article reviews the economics and regulation of servicing and lays out the principal-agent problem. It explains why the Home Affordable Modification Program ("HAMP") has been unable to adequately address servicer incentive problems and suggests possible solutions, drawing on devices used in other securitization servicing markets. Correcting the principal-agent problem in mortgage servicing is critical for mitigating the negative social externalities from uneconomic foreclosures and ensuring greater protection for investors and homeowners.

† Associate Professor, Georgetown University Law Center. The views expressed in this Article are solely those of the authors. This Article incorporates parts of Professor Levitin's congressional testimony on foreclosures and mortgage servicing before the Senate and House Judiciary Committees. I would like to thank William Bratton, Larry Cordell, Anna Gelpern, Paul Koches, Sarah Levitin, Robert Van Order, Susan Wachter, and Elizabeth Warren for their comments and encouragement; and to thank Grant MacQueen and Tai Nguyen for their research assistance. Comments? AJL53@law.georgetown.edu.

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Introduction

The home is the most significant asset of many American families,[1] and a wide array of federal and state regulatory schemes work to encourage and

1. *See* Brian K. Bucks et al., *Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances*, FED. RES. BULL., Feb. 2009, at A1, A33, *available at*

protect homeownership.[2] Homeownership is beyond the means of most families absent mortgage financing, and most of the regulatory schemes relate to the mortgage origination process and to the foreclosure sale process—the birth and death of the mortgage.[3] There is scant regulation, however, of everything that occurs in the course of the mortgage's lifespan, between its origination and its eventual end via payoff or foreclosure. This in-between period involves the management of mortgage loans, including collection of payments and restructuring of the loan in the event of the borrower's financial distress, and is known as mortgage servicing.

Mortgage servicing has begun to receive increased scholarly, popular, and political attention as a result of the difficulties faced by financially distressed homeowners when attempting to restructure their mortgages amid the home foreclosure crisis.[4] In particular, the mortgage servicing industry has been identified as a central factor in the failure of the various government loan modification programs, including the $75 billion Home Affordable Modification Program ("HAMP").[5] Mortgage servicing, however, remains a

http://www.federalreserve.gov/pubs/bulletin/2009/pdf/scf09.pdf (reporting that home equity accounted for 31.8% of total family assets).

2. Examples include the federal income tax deduction for home mortgage interest payments, state and federal homestead exemptions that limit creditors' ability to levy on debtors' homes, and rights of redemption for defaulted mortgages.

3. *See, e.g.*, Real Estate Settlement Procedures Act, 12 U.S.C. §§ 2601-2617 (2006); Home Mortgage Disclosure Act, 12 U.S.C. §§ 2801-2810; Homeowners Protection Act of 1998, 12 U.S.C. §§ 4901-4910; Truth in Lending Act, 15 U.S.C.A. §§ 1601-1616 (West 2010).

4. *See, e.g.*, CONG. OVERSIGHT PANEL, AN ASSESSMENT OF FORECLOSURE MITIGATION EFFORTS AFTER SIX MONTHS (2009) [hereinafter CONG. OVERSIGHT PANEL, AN ASSESSMENT]; CONG. OVERSIGHT PANEL, EVALUATING PROGRESS OF TARP FORECLOSURE MITIGATION PROGRAMS (2010) [hereinafter CONG. OVERSIGHT PANEL, EVALUATING PROGRESS]; CONG. OVERSIGHT PANEL, THE FORECLOSURE CRISIS: WORKING TOWARD A SOLUTION 44-56 (2009) [hereinafter CONG. OVERSIGHT PANEL, THE FORECLOSURE CRISIS]; Peter S. Goodman, *Late-Fee Profits May Trump Plan To Modify Loans*, N.Y. TIMES, July 30, 2009, at A1; Daniel Wagner, *Gov't Mortgage Partners Sued for Abuses*, ASSOCIATED PRESS, Aug. 6, 2009; *Marketplace: Bills Could Let Judges Rework Mortgages* (American Public Media Jan. 12, 2009), *available at* http://marketplace.publicradio.org/display/web/2009/01/12/pm_bankruptcy_judges.

5. *See, e.g.*, CONG. OVERSIGHT PANEL, AN ASSESSMENT, *supra* note 4; CONG. OVERSIGHT PANEL, EVALUATING PROGRESS, *supra* note 4; CONG. OVERSIGHT PANEL, THE FORECLOSURE CRISIS, *supra* note 4; Associated Press, *Pressed by White House, Mortgage Servicers Vow More Modifications*, N.Y. TIMES, July 29, 2009, at A3. The Treasury Department initially set a goal of helping three to four million homeowners through HAMP by the end of 2012. *See* MAKING HOME AFFORDABLE PROGRAM, SERVICER PERFORMANCE REPORT THROUGH SEPTEMBER 2010, at 8 n.2 (2010), *available at* http://www.financialstability.gov/docs/Sept%20MHA%20Public%202010.pdf. Through September 2010, however, it had managed to start permanent modifications on only 495,898 mortgages, and 28,726 had already redefaulted. *See id*. at 2 & n.5 (reporting that 29,190 permanent modifications had been cancelled, and only 428 of these cancellations could be attributed to homeowners paying off their loans). Fitch Ratings predicts a twelve-month redefault rate of 65% to 75% for modified subprime and Alt-A loans, and a twelve-month redefault rate of 55% to 65% for modified prime loans. *See* FITCH RATINGS, U.S. RMBS SERVICERS' LOSS MITIGATION AND MODIFICATION EFFORTS UPDATE II 1, 2 (2010) (analyzing redefault rates for borrowers who previously fell more than sixty days behind on loan payments under premodification terms). The number of new permanent HAMP modifications peaked in April 2010 at 68,291 and has since declined to 27,931 in September 2010, while the number of redefaults has climbed from 865 in April 2010 to 10,069 in September 2010. *See* MAKING HOME AFFORDABLE PROGRAM, SERVICER PERFORMANCE REPORT THROUGH APRIL 2010, at 4 (2010) *available*

poorly understood industry, and this has impeded policy responses to the foreclosure crisis. The business model and economics of servicing remain largely unexplored, and there has been almost no theorizing of the industry.

This Article is a first step in that direction. It provides a detailed overview of the servicing business, including its regulation and economics. In so doing, the Article identifies a principal-agent conflict in the servicing market that contributes to unnecessary home foreclosures, to the detriment of homeowners and mortgage investors alike.

The economics of the servicing industry often discourage the restructuring of defaulted mortgage loans, even when it would be value-maximizing for mortgage investors. Servicing combines two distinct lines of business: transaction processing and administration of defaulted loans. Transaction processing is highly automatable and susceptible to economies of scale. Defaulted loan administration, in contrast, can either be automated or hands-on. Automated default administration, referred to as "default management," means that defaulted loans are referred to foreclosure with factory-like precision.[6] This automation is perhaps most infamously illustrated by the robosigning scandal that emerged in the fall of 2010, when it came to light that major servicers had employed professional affiants for foreclosure cases who would sign as many as 10,000 affidavits a month without any personal knowledge of the facts to which they attested in the affidavits.[7] In contrast, hands-on default administration, referred to as "loss mitigation," is discretion-intensive and requires significant trained manpower. In normal times, default levels are low, and servicers compete by improving their economies of scale and automation. Servicers have little incentive to invest in the resources for hands-on loss mitigation, much less sufficient capacity for peak volumes. The combination of business lines means servicers are ill-prepared to perform their loss mitigation

at http://www.financialstability.gov/docs/April%20MHA%20Public%20051710%20FINAL.pdf; MAKING HOME AFFORDABLE PROGRAM, SERVICER PERFORMANCE REPORT THROUGH SEPTEMBER 2010, *supra* note 5, at 8. If linear trends of new permanent modifications and redefaults continue, the number of redefaults will surpass the number of new permanent modifications in December 2010, meaning that the total number of active permanent modifications will begin to decline.

Other government programs such as Hope for Homeowners and FHASecure have been even more dismal failures. The FHASecure refinancing program, created in September 2007, managed to refinance only around 4100 delinquent borrowers before the program ended in December 2008. Michael Corkery, *Mortgage 'Cram-Downs' Loom as Foreclosures Mount*, WALL ST. J., Dec. 31, 2008, at C1. The HOPE for Homeowners program, enacted as part of the Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654, *amended by* Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, § 202, 122 Stat. 1632, had succeeded in refinancing only 130 loans during its first two years (October 2008 through September 2010). *See* FED. HOUS. ADMIN., FHA SINGLE FAMILY OUTLOOK: SINGLE FAMILY OPERATIONS: SEPTEMBER 2010, at 5 (2010), *available at* http://www.hud.gov/offices/hsg/rmra/oe/rpts/ooe/ol2010.pdf.

6. *See, e.g.*, Andy Kroll, *Fannie and Freddie's Foreclosure Barons*, MOTHERJONES.COM, Aug. 4, 2010, http://motherjones.com/politics/2010/07/david-j-stern-djsp-foreclosure-fannie-freddie; Andy Kroll, *Florida AG Unveils Foreclosure Mills Probe*, MOTHERJONES.COM, Aug. 10, 2010, http://motherjones.com/mojo/2010/08/florida-ag-probing-foreclosure-mills.

7. *See, e.g.*, Gretchen Morgenson, *Flawed Paperwork Aggravates a Foreclosure Crisis*, N.Y. TIMES, Oct. 3, 2010, at A1.

function in a way that maximizes value for mortgage investors. Although housing markets are cyclical, servicers find it more profitable to automate everything across the cycle than to invest in countercyclical hands-on loss mitigation when the market is up in preparation for when the market falls.

Servicer compensation arrangements also create a moral hazard because the servicer does not bear the same costs of its loss mitigation decisions as do investors. Servicers' stake in the performance of the loans they manage is quite different from mortgage investors'. Servicers do not bear the credit risk on the loans they service, only prepayment risk. The asymmetry between servicers' and investors' risks, as well as servicers' compensation and cost structures, means that servicers have divergent interests from investors'. Whereas an investor (liquidity constraints aside) wants to maximize the net present value of a defaulted loan, the servicer wants to maximize the net present value of its servicing income, which is divorced from the value of the loan. Thus, a servicer is not necessarily interested in maximizing the value of a loan for the mortgage investors. Instead, servicers are sometimes incentivized either to foreclose when a loan restructuring would be optimal or engage in a suboptimal restructuring that will be likely to result in a redefault.[8]

Foreclosures that fail to maximize value for the mortgage investors are inefficient and impose significant negative economic and social externalities on homeowners, on communities, and, because of the serial correlation of neighboring real estate prices, on the housing market in general.[9] Defaulted homeowners find themselves streamlined to foreclosure, rather than to loan workouts. The result is elevated foreclosure levels. Foreclosures increase housing supply and push down housing prices, affecting neighboring

8. Unlike the typical moral hazard problem, in which the *insured* is the hazard, here the moral hazard is presented by the *insurer* because the insurance is not in the form of a fixed payment, but in the form of a service.

9. *See, e.g.*, Zhenguo Lin, Eric Rosenblatt & Vincent W. Yao, *Spillover Effects of Foreclosures on Neighborhood Property Values*, 38 J. REAL EST. FIN. & ECON. 387 (2009); WILLIAM C. APGAR & MARK DUDA, HOMEOWNERSHIP PRES. FOUND., COLLATERAL DAMAGE: THE MUNICIPAL IMPACT OF TODAY'S MORTGAGE FORECLOSURE BOOM 5 (2005) [hereinafter APGAR & DUDA, COLLATERAL DAMAGE], *available at* http://www.995hope.org/content/pdf/Apgar_Duda_Study_Short_Version.pdf; WILLIAM C. APGAR, MARK DUDA & ROCHELLE NAWROCKI GOREY, HOMEOWNERSHIP PRES. FOUND., THE MUNICIPAL COST OF FORECLOSURES: A CHICAGO CASE STUDY (2005), *available at* http://www.995hope.org/content/pdf/Apgar_Duda_Study_Full_Version.pdf; *see also* DAN IMMERGLUCK & GEOFF SMITH, WOODSTOCK INST., THERE GOES THE NEIGHBORHOOD: THE EFFECT OF SINGLE-FAMILY MORTGAGE FORECLOSURES ON PROPERTY VALUES (2005), *available at* http://www.woodstockinst.org/index.php?option=com_docman&task=doc_download&gid=52 (estimating that, in Chicago, the 3750 foreclosures that took place between 1997 and 1998 reduced surrounding property values by almost $600 million); Charles W. Calomiris, Stanley D. Longhofer & William Miles, *The Foreclosure-House Price Nexus: Lessons from the 2007-2008 Housing Turmoil* (Nat'l Bureau of Econ. Research, Working Paper No. 14294, 2008), *available at* http://www.nber.org/papers/w14294; Jenny Schuetz, Vicki Been & Ingrid Gould Ellen, *Neighborhood Effects of Concentrated Mortgage Foreclosures* (N.Y. Univ. Ctr. for Law & Econ. Research Paper Series, Working Paper No. 08-41, 2008), *available at* http://ssrn.com/abstract=127021.

homeowners' property values and eroding property tax bases.[10] This effect, in turn, hurts neighbors who have to bear either higher taxes or reduced services. Foreclosures also force families to relocate. Because many social ties are geographically based, foreclosures sever these ties. Children have to change schools, severing friendships; congregants are cut off from their houses of worship; even medical care and employment relationships are affected, as relocation can render commutes impracticable. And foreclosures contribute to urban blight and public health problems. Foreclosed properties often become centers of crime and arson,[11] and mosquitoes breeding in stagnant water in untended swimming pools on foreclosed properties have even been linked to the spread of the West Nile virus.[12]

The principal-agent problem in mortgage servicing has emerged because both types of parties with an economic interest in servicing performance—mortgage investors and mortgage borrowers—are unlikely or unable to bargain for adequate servicing of defaulted loans.

Mortgage investors are unlikely to bargain for adequate servicing because of the informational asymmetries and risk allocations involved in securitization. Most mortgage loans are securitized, meaning that they are sold by the original lender (typically through middlemen financial institutions) to trusts that finance the purchase through the sale of bonds. This arrangement allows investors in the bonds to assume solely the risks associated with the mortgages held by the trust, not the risks associated with the original lender or middlemen financial institutions. Because the debt service on the bonds is supported by the cashflow from the mortgage loans, the bonds are called mortgage-backed securities ("MBS").

MBS investors—the affected principals—cannot accurately value the quality of loss mitigation provided by a servicer; they lack sufficient information, and even if they had full information, evaluation is difficult because servicing decisions are highly qualitative and contextual. Lacking such information, MBS investors, particularly those who invested during a trough in the default cycle, are likely to undervalue the quality of servicing and therefore be unconcerned with the principal-agent cost.

Furthermore, the structure of mortgage investments largely removes the perception of servicing risk. Most mortgage investors are protected against

10. *See* GLOBAL INSIGHT, THE MORTGAGE CRISIS: ECONOMIC AND FISCAL IMPLICATIONS FOR METRO AREAS 2 (2007), *available at* http://www.vacantproperties.org:resources:documents: USCMmortgagereport.pdf; John Kroll, *Foreclosure Study Says Vacant Properties Cost Cleveland $35+ Million*, CLEVELAND.COM (Feb. 19, 2008, 12:29 AM), http://blog.cleveland.com/metro/2008/02/foreclosure_study_says_vacant.html.

11. *See, e.g.*, Dan Immergluck & Geoff Smith, *The Impact of Single-Family Mortgage Foreclosures on Neighborhood Crime*, 21 HOUSING STUD. 851, 855-56 (2006); APGAR & DUDA, COLLATERAL DAMAGE, *supra* note 9, at 6.

12. *See* Daniel DeNoon, *Foreclosures Worsen Spread of West Nile*, CBSNEWS.COM, Oct. 23, 2008, http://www.cbsnews.com/stories/2008/10/02/health/webmd/main4495947.shtml.

losses via various credit enhancements, and those with fewer credit enhancements were often resecuritized into collateralized debt obligations ("CDOs"), placing the investors in the CDOs a step removed from the mortgage servicer. Additionally, the MBS pricing mechanism through which investors could have influenced servicing arrangements is subject to so many other factors, particularly in heterogeneous private-label securitizations, that market discipline would have been diluted. MBS investors are therefore unlikely to exert market discipline to correct the principal-agent problem.

Homeowners, for their part, frequently do not know about securitization, much less its implications for the management of their loan upon default. Even if they do, they are unlikely to care because they neither anticipate defaulting nor understand the full implications thereof; homeowners are likely to exhibit a significant optimism bias when taking out a mortgage.[13] Moreover, even if homeowners were knowledgeable and concerned about management of their loan upon default, they could not know if their loan would be securitized, who would be the servicer, and what contractual provisions would govern the servicing of their loan; most loans' ultimate destination is unknown at origination. Accordingly, homeowners cannot price adequately for servicing risk when they take out a mortgage loan. Imperfect information, information asymmetries, and cognitive biases mean that homeowners do not exert market pressure to correct the principal-agent problem in servicing by demanding a discount in mortgage rates to compensate for the servicing externality.

Neither private monitoring arrangements nor public legal structures are effective to solve the principal-agent problem. The contractual design of mortgage securitization effectively makes servicers principal-less agents; there is no party with the ability and incentive to monitor a servicer's actions. Investors lack the information, capacity, and legal standing to effectively monitor servicer performance, and tranching and insurance often remove their incentive to do so. Securitization trustees have the ability, but little incentive, to monitor servicers; a trustee gains nothing from diligence and incurs both transaction costs and possible loss of future business because of the relationship between servicers and their affiliated securitization sponsors.[14]

Similarly, homeowners, who are also affected by servicer behavior, have few rights. The Real Estate Settlement Procedures Act[15] and Truth in Lending Act[16] give homeowners notice rights regarding the transfer of their loan and its servicing and some billing error resolution rights, but no right to obtain a value maximizing loan restructuring or even to consistent minimum servicing

13. *See* Oren Bar-Gill, *The Law, Economics, and Psychology of Subprime Mortgage Contracts*, 94 CORNELL L. REV. 1073, 1120-21 (2009).

14. *See infra* Section II.C.

15. 12 U.S.C. §§ 2601-2617 (2006).

16. *See* 15 U.S.C.A. §§ 1601-1616 (West 2010).

standards and procedures.[17] Thus, the principal-agent problem in mortgage servicing has rendered dysfunctional the loss mitigation component of the servicing, and this has been a critical factor in exacerbating the current foreclosure crisis.

This Article considers some possibilities for reforming mortgage servicing to alleviate these problems, including: creating cross-industry minimum servicing standards; standardizing servicing procedures and contracts; mandating the use of the special default servicers featured in commercial mortgage securitizations; adding skin-in-the-game compensation requirements; installing servicer licensing requirements; and making securitization or third-party servicing an opt-in, bargained-for term in mortgages. Yet, there are costs to improving servicing. Mortgage servicing is currently designed to add minimal costs to mortgage borrowing. Any reform of mortgage servicing to make it more conducive to loss mitigation via loan restructuring could add to the cost of mortgage finance and thereby discourage new homeownership. Thus, any mortgage servicing reform must be considered as part of a trade-off between making home purchases more affordable and ensuring sustainable, long-term homeownership levels.

In its consideration of servicing, this Article contributes to several distinct literatures. First, it adds to the literature on regulation of consumer finance, which has long focused on either regulation of loan origination or loan restructuring in bankruptcy, rather than on the ongoing creditor-debtor relationship. Historically, there was little reason to consider the ongoing creditor-debtor relationship. Traditionally, a financial institution would make a loan and keep it on its books. The financial institution would generally act rationally to manage a loan based on what it believed would maximize the loan's value. The growth of consumer debt securitization, with its inherent agency problem, makes loan management another major area of study in consumer finance.

Second, this Article adds to the literature on asset securitization. The securitization literature has focused almost entirely on the economic and policy issues involved in securitizing assets, rather than on what happens to those assets once they have been securitized.[18] A burgeoning literature on servicing

17. *See infra* Section II.A.

18. *See, e.g.*, Kenneth Ayotte & Stav Gaon, *Asset-Backed Securities: Costs and Benefits of Bankruptcy Remoteness*, 23 REV. FIN. STUDIES (forthcoming 2010), *available at* http://rfs.oxfordjournals.org/content/early/2010/09/13/rfs.hhq059; Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 102 (2007); Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061 (1996); Kenneth C. Kettering, *Pride and Prejudice in Securitization: A Reply to Professor Plank*, 30 CARDOZO L. REV. 1977 (2009); Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553 (2008); Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1 (1996); Lois R. Lupica, *Asset Securitization: The Unsecured Creditor's Perspective*, 76 TEX. L. REV. 595 (1998); Patricia A. McCoy, Andrey D. Pavlov & Susan M. Wachter, *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 CONN. L. REV. 493 (2009); Christopher Lewis Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV.

has recently emerged, but has not attempted to present a comprehensive picture of the servicing industry.[19] Yet, the management of securitized assets, like mortgage loans, is crucial to investors and to the consumers whose homes secure those loans. Servicing provides an essential link between the capital market investors who fund mortgage loans and consumer borrowers.

The literature on securitization has long noted the informational asymmetries that exist between the originator and the investors regarding the securitized assets. The literature has not, however, recognized two additional,

2185 (2007); Thomas E. Plank, *Sense and Sensibility in Securitization: A Prudent Legal Structure and a Fanciful Critique*, 30 CARDOZO L. REV. 617 (2008); Thomas E. Plank, *The Security of Securitization and the Future of Security*, 25 CARDOZO L. REV. 1655 (2004); Steven L. Schwarcz, *Securitization Post-Enron*, 25 CARDOZO L. REV. 1539 (2004); Steven L. Schwarcz, *Structured Finance: The New Way To Securitize Assets*, 11 CARDOZO L. REV. 607 (1990); Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J. L. BUS. & FIN. 133 (1994); Gary Gorton & Nicholas Souleles, *Special Purpose Vehicles and Securitization* (Nat'l Bureau of Econ. Research, Working Paper No. 11190, 2005), *available at* http://www.nber.org/papers/w11190.

19. *See* DIANE E. THOMPSON, NAT'L CONSUMER LAW CTR., WHY SERVICERS FORECLOSE WHEN THEY SHOULD MODIFY AND OTHER PUZZLES OF SERVICER BEHAVIOR: SERVICER COMPENSATION AND ITS CONSEQUENCES (2009); Kurt Eggert, *Comment on Michael A. Stegman et al.'s "Preventive Servicing Is Good for Business and Affordable Homeownership Policy": What Prevents Loan Modifications?*, 18 HOUSING POL'Y DEBATE 279 (2007) [hereinafter Eggert, *Comment*]; Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 HOUSING POL'Y DEBATE 753 (2004) [hereinafter Eggert, *Limiting Abuse*]; Christopher L. Foote et al., *Reducing Foreclosures: No Easy Answers*, *in* NBER MACROECONOMICS ANNUAL 2009, at 89 (Daron Acemoglu, Kenneth Rogoff and Michael Woodford eds., 2009); Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WIS. L. REV. 565; Tomasz Piskorski, Amit Seru & Vikrant Vig, *Securitization and Distressed Loan Renegotiation: Evidence from the Subprime Mortgage Crisis*, 97 J. FIN. ECON. 369 (2010) (finding a higher foreclosure rate on delinquent loans that are securitized than on loans that are bank-held); Katherine M. Porter, *Mortgage Misbehavior*, 87 TEX. L. REV. 121 (2008) (finding evidence of endemic servicer overcharges in bankruptcy cases); Alan M. White, *Deleveraging the American Homeowner: The Failure of 2008 Voluntary Mortgage Contract Modifications*, 41 CONN. L. REV. 1107 (2009) [hereinafter White, *Deleveraging*]; Alan M. White, *Rewriting Contracts, Wholesale: Data on Voluntary Mortgage Modifications from 2007 and 2008 Remittance Reports*, FORDHAM URB. L.J. 509 (2009) [hereinafter White, *Rewriting Contracts*]; Manuel Adelino, Kristopher Gerardi & Paul S. Willen, *What Explains Differences in Foreclosure Rates? A Response to Piskorski, Seru, and Vig* (Fed. Reserve Bank of Boston, Working Paper No. 2010-2, 2010), *available at* http://www.bos.frb.org/economic/wp/wp2010/wp1002.pdf; Larry Cordell & Adam J. Levitin, *What RMBS Servicing Can Learn from CMBS Servicing* (Georgetown Univ. Law Ctr., Bus., Econ. & Regulatory Policy Working Paper Series, Research Paper No. 1640326, 2010) (on file with authors); Yingjin Gan & Christopher Mayer, *Agency Conflicts, Asset Substitution, and Securitizatio*n (Nat'l Bureau of Econ. Research, Working Paper No. 12359, 2006), *available at* http://www.nber.org/papers/w12359.pdf (explaining that servicer behavior in commercial real estate securitizations depends on whether the servicer owns a first-loss position in the portfolio being serviced); Dan Magder, *Mortgage Loan Modifications: Program Incentives and Restructuring Design* (Peterson Inst. for Int'l Econ., Working Paper No. 09-13, 2009), *available at* http://www.iie.com/publications/wp/wp09-13.pdf; Anthony Pennington-Cross & Giang Ho, *Loan Servicer Heterogeneity and the Termination of Subprime Mortgages* (Fed. Reserve Bank of St. Louis, Working Paper No. 2006-024A, 2006), *available at* http://research.stlouisfed.org/wp/2006/2006-024.pdf (noting that the likelihood of default and of prepayment depend on the identity of the servicer); Sean Coffey, Regulating Mortgage Loan Servicing (Apr. 1, 2008) (unpublished M.P.A. thesis, University of North Carolina at Chapel Hill), *available at* http://ssrn.com/abstract=1266826; Andre Güttler, Ulrich Hommel & Julia Reichert, The Influence of Sponsor, Servicer and Underwriter Characteristics on RMBS Performance (Apr. 2, 2010), *available at* http://ssrn.com/abstract=1583582; Joseph R. Mason, Subprime Servicer Reporting Can Do More for Modification than Government Subsidies (Mar. 19, 2009), *available at* http://ssrn.com/abstract=1361331; Henri F. Pagès, Loan Servicers' Incentives and Optimal CDOs (Nov. 23, 2009), *available at* http://ssrn.com/abstract=1441253.

related informational asymmetries—that between the homeowner and the originator regarding the likelihood that the assets will be securitized (and the implications thereof), and that between the servicer and the investors regarding how defaulted loans will be handled.

Finally, this Article contributes to the literature on the recent financial crisis by illuminating the role that servicing arrangements have played in inhibiting mortgage restructurings.[20] A nascent, crisis-driven literature has emerged that has undertaken formal analysis of servicing contracts to determine what constraints they place on loan modifications.[21] This literature has paid little attention, however, to the economics of servicing and the principal-agent problem involved, which is one of several factors limiting the ability to determine the obstacles posed to loan modifications solely from a formal analysis of the four corners of servicing contracts.[22] Future accounts of the financial crisis and the government response will be a story of contrasts: the relative success of government programs at stabilizing financial institutions, but also their failure in helping homeowners avoid foreclosure and reviving the housing market. No attempt to tell the story of the crisis and response will be complete without an understanding of the mortgage servicing industry.

20. THOMPSON, *supra* note 19; Christopher L. Foote, Kristopher Gerardi & Paul S. Willen, *Negative Equity and Foreclosure: Theory and Evidence*, 64 J. URB. ECON. 234 (2008) (noting servicers' informational problems in determining which loans are likely to default); Foote et al., *supra* note 19; Anna Gelpern & Adam J. Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage Backed Securities*, 82 S. CAL. L. REV. 1075 (2009); Levitin, *supra* note 19; Christopher Mayer, Edward Morrison & Tomasz Piskorski, *A New Proposal for Loan Modifications*, 26 YALE J. ON REG. 417 (2009) [hereinafter Mayer et al., *A New Proposal*]; White, *Rewriting Contracts*, *supra* note 19; Larry Cordell et al., *The Incentives of Mortgage Servicers: Myths and Realities* 3 (Fed. Reserve Bd., Fin. & Econ. Discussion Series, Working Paper No. 2008-46, 2008); Magder, *supra* note 19 (arguing that conflicts of interest are the reason for the lack of loan modifications); John P. Hunt, What Do Subprime Securitization Contracts Actually Say About Loan Modification? Preliminary Results and Implications (Mar. 25, 2009), *available* at http://www.law.berkeley.edu/files/Subprime_Securitization_Contracts_3.25.09.pdf (surveying pooling and servicing agreements for terms restricting loan modifications); Mason, *supra* note 19; Pagès, *supra* note 19; Christopher Mayer et al., Mortgage Modification and Strategic Default: Evidence from a Legal Settlement with Countrywide (July 20, 2010), *available at* http://www.nber.org/confer/2010/SI2010/HF/Mayer_Morrison_Piskorski_Gupta.pdf [hereinafter Mayer et al., Mortgage Modification] (finding evidence of borrowers defaulting to qualify for a modification program offered only to defaulted borrowers); Archana Sivadasn, *The 800 Pound Gorrilla in the Room: Servicers Profit While Investors Face Losses*, GLOBAL MACRO ECONOMONITOR (Nov. 4, 2008, 10:23AM), http://www.rgemonitor.com/globalmacro-monitor/254261/the_800_pound_gorrilla_in_the_room_servicers_profit_while_investors_face_losses; *see also Helping Families Save Their Homes in Bankruptcy Act of 2009, and the Emergency Homeownership and Equity Protection Act: Hearing Before the S. Comm. on the Judiciary*, 111th Cong. 35 (statement of Adam J. Levitin); Eggert, *Comment*, *supra* note 19.

21. *See, e.g.*, Hunt, *supra* note 20; *see also* Mayer et al., *A New Proposal*, *supra* note 20; Manuel Adelino et al., *Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization* 24 (Fed. Reserve Bank of Boston, Public Policy Discussion Paper No. 09-4, 2009), *available at* http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf (arguing that informational problems inhibit loan modifications).

22. *See* Gelpern & Levitin, *supra* note 20. The formal provisions of the servicing contract are only one element of a system that was not designed to facilitate loan modifications. The servicer business model, and the structural and functional aspects of securitization, as well as formal contractual limitations, all inhibit loan modifications.

This Article proceeds in four parts. Part I presents a detailed overview of the residential mortgage servicing industry, including its role in securitization, the servicing business model, and servicing contracts. Part II explains the existing system of regulation and monitoring of servicers. We recognize that Parts I and II are lengthy, but we know of no work that systematically explains the servicing business and its regulation, and we believe that such a work would be of value to practitioners, judges, and scholars. Part III presents the principal-agent problem in the servicing industry and its negative externalities on homeowners and investors. In particular, it shows how servicer incentives in handling a defaulted loan diverge from those of a portfolio lender, often to the detriment of homeowners and investors alike. Part IV concludes with a consideration of possible reforms to the servicing industry.

I. Overview of the Mortgage Servicing Industry

A. Servicing and Securitization

1. Traditional Portfolio Lending

In a traditional mortgage lending relationship, a lender makes a loan, retains the loan in its portfolio, and services the loan itself.[23] The lender sends out monthly billing statements and collects the payments. If the loan defaults, the lender will address the default with the goal of maximizing the loan's net present value, subject to its own valuation idiosyncrasies, such as liquidity needs.[24] A traditional portfolio lender has an undivided economic interest in the loan's performance and therefore fully internalizes the costs and benefits of its management decisions, such as whether to restructure or foreclose on a defaulted loan.

The traditional portfolio lending relationship, however, is now the exception in the home mortgage market. Instead, mortgages are generally financed through securitization. Securitization is a financing method involving the issuance of securities against a dedicated cashflow stream, such as mortgage payments, that is isolated from other creditors' claims. Securitization links consumer borrowers with capital market financing, potentially lowering the cost of mortgage capital. It also allows financing institutions to avoid the credit risk, interest-rate risk, and liquidity risk associated with holding the mortgages on their own books.

23. *See* Levitin, *supra* note 19, at 582 (providing Bailey Building & Loan in the movie *It's a Wonderful Life* as an example of a traditional mortgage lending relationship).

24. *See, e.g.*, Sarah P. Woo, *Regulatory Bankruptcy: How Bank Regulation Causes Fire Sales*, 99 GEO. L.J. (forthcoming 2011).

Currently, about 65% of all outstanding residential mortgages by dollar amount are securitized.[25] (See Figure 1.) The share of securitized mortgages by number of mortgages outstanding is much higher because the securitization rate is lower for larger "jumbo" mortgages.[26] Credit Suisse estimates that 75% of outstanding first-lien residential mortgages are securitized.[27] In 2009, nearly 90% of first-lien residential mortgages originated were securitized.[28] Most second-lien loans, however, are not securitized.[29]

25. 2 INSIDE MORTG. FIN., THE 2010 MORTGAGE MARKET STATISTICAL ANNUAL 10 (2010) (reporting a securitization rate of 64.6% as of 2009 for mortgages on one- to four-family dwellings).

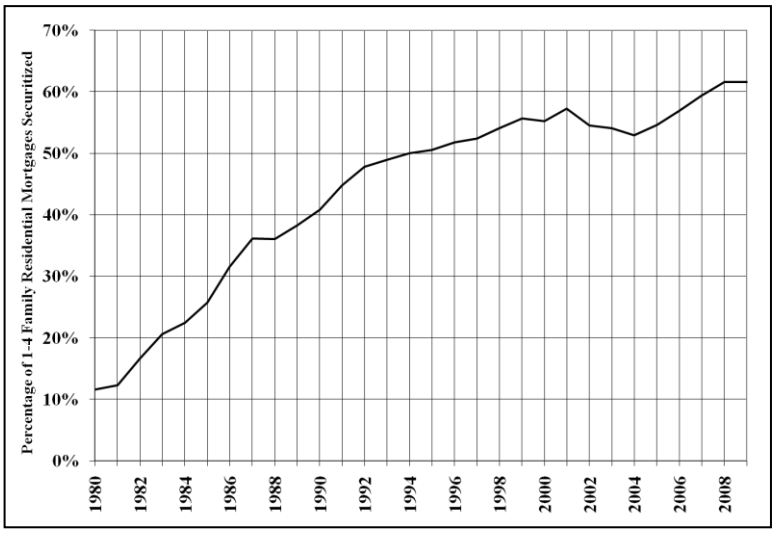
26. *See id.* at 3 (showing that 39.0% of prime jumbo originations were securitized from 2001 through 2009, whereas 68.5% of all home mortgage originations were securitized during that period).

27. CREDIT SUISSE, MORTGAGE LIQUIDITY DU JOUR: UNDERESTIMATED NO MORE 28 exhibit 21 (2007), *available at* http://seattlebubble.com/blog/wp-content/uploads/2007/10/2007-03-credit-suisse-mortgage-liquidity-du-jour.pdf.

28. *See* 2 INSIDE MORTG. FIN., *supra* note 25, at 3 (indicating that 89.4% of all mortgages that were originated in 2009—excluding home-equity lines of credit and closed-end second mortgages—were securitized). The percentage of new *mortgages* securitized is even larger than the percentage of the *dollar amount* of new mortgages securitized, because jumbo mortgages are larger in dollar amount than other loan types and less likely to be bundled into RMBS. Jumbo loans are generally defined as loans larger than $417,000. *See, e.g.*, Christine Ricciardi, *Jumbo Loan Limits Remain the Same in 2011*, HOUSINGWIRE (Nov. 19, 2010, 2:05 PM), http://www.housingwire.com/2010/11/19/jumbo-loan-limits-remain-the-same-in-2011.

29. *See* 2 INSIDE MORTG. FIN., *supra* note 25, at 3 (showing that between 2001 and 2007, only 14% of the dollar amount of closed-end second mortgages and home-equity lines of credit originated were securitized). Second-lien mortgages create a conflict of interest beyond the scope of this Article. In many cases, second-lien loans are owned by financial institutions that are servicing (but may not necessarily own) the first-lien loan. *Cf. Second Liens and Other Barriers to Principal Reduction as an Effective Foreclosure Mitigation Program: Hearing Before the H. Fin. Servs. Comm.*, 111th Cong. 44 (2009) (statement of Barbara Desoer, President, Bank of America Home Loans) (noting that Bank of America owns the second-lien mortgage on 15% of the first-lien mortgages it services); *id*. at 56 (statement of David Lowman, Chief Executive Officer, JPMorgan Chase Home Lending) (noting that Chase owns a second-lien mortgage on approximately 10% of the first-lien mortgages it services). Owning the second lien while servicing the first creates a direct financial conflict between the servicer qua servicer and the servicer qua owner of the second-lien mortgage, as the servicer has an incentive to modify the first-lien mortgage in order to free up borrower cashflow for payments on the second-lien mortgage.

Figure 1: Percentage of Outstanding 1-4 Family Residential Mortgage Debt Securitized, 1980-2008[30]



2. Mortgage Securitization

Although a mortgage securitization transaction is extremely complex and varies somewhat depending on the type of entity undertaking the securitization, the core of the transaction is relatively simple.[31]

First, a financial institution (the "sponsor" or "seller") assembles a pool of mortgage loans.[32] The loans were either made ("originated") by an affiliate of the financial institution or purchased from unaffiliated third-party originators. Second, the pool of loans is sold by the sponsor to a special-purpose subsidiary (the "depositor") that has no other assets or liabilities.[33] This is done to segregate the loans from the sponsor's assets and liabilities.[34] Third, the

30. *See* 2 INSIDE MORTG. FIN., *supra* note 25, at 10.

31. The structure illustrated is for private-label MBS. Ginnie Mae and other government-sponsored enterprise ("GSE") securitizations are structured somewhat differently. The private-label structure can, of course, be used to securitize any asset, from oil tankers to credit card debt to song catalogues, not just mortgages.

32. The contract by which the mortgage loans are transferred to the sponsor is generally called a mortgage loan purchase and sale agreement ("MLPSA").

33. This transfer is sometimes governed by a separate mortgage loan purchase and sale agreement or is sometimes covered with the pooling and servicing agreement ("PSA") that governs the transfer of the loans to the single-purpose vehicle ("SPV").

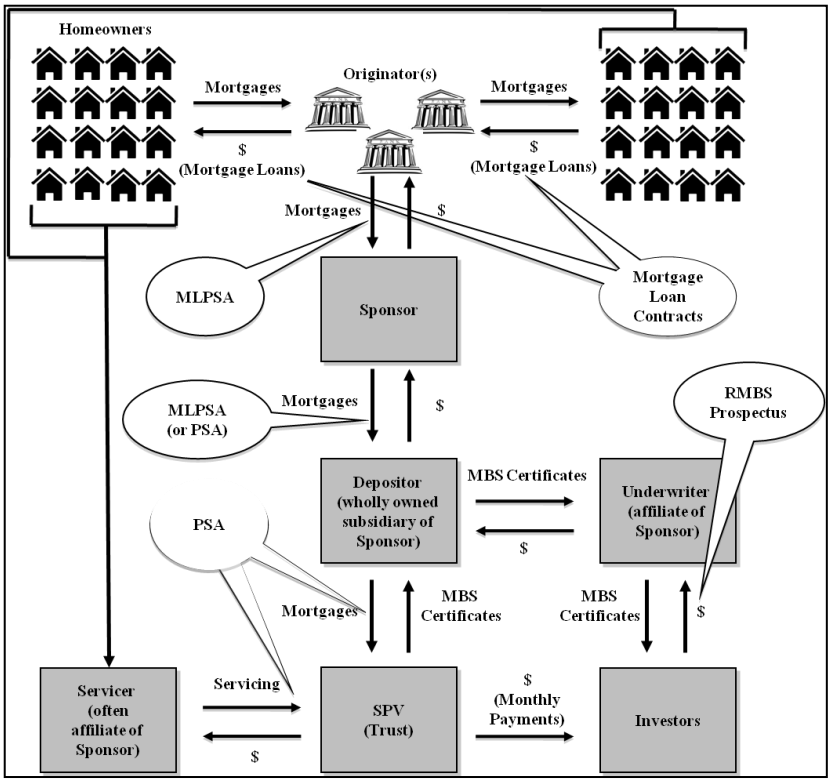
34. This intermediate entity is not essential to securitization, but since 2002, Statement of Financial Accountings Standards 140 has required this additional step for off-balance-sheet treatment because of the remote possibility that if the originator went bankrupt or into receivership, the securitization would be treated as a secured loan, rather than a sale, and the originator would exercise its equitable right of redemption and reclaim the securitized assets. Deloitte & Touche, *Learning the Norwalk Two-Step*, HEADS UP, Apr. 25, 2001, at 1.

depositor sells the loans to a passive, specially created, single-purpose vehicle ("SPV"), typically a trust in the case of residential mortgages.[35] The SPV issues certificated securities to raise the funds to pay the depositor for the loans. Most of the securities are debt securities—bonds—but there will also be a security representing the rights to the residual value of the trust or the "equity."

The securities can be sold directly to investors by the SPV or, as is more common, they are issued directly to the depositor as payment for the loans. The depositor then resells the securities, usually through an underwriting affiliate that then places them on the market. (See Figure 2.) The depositor uses the proceeds of the securities sale (to the underwriter or the market) to pay the sponsor for the loans. Because the certificated securities are collateralized by the residential mortgage loans owned by the trust, they are called residential mortgage-backed securities ("RMBS").

35. The trustee will then typically convey the mortgage notes and security instruments to a "master document custodian," who manages the loan documentation, while the servicer handles the collection of the loans. Increasingly, there are concerns that in many cases the loan documents have not been properly transferred to the trust, which raises issues about whether the trust has title to the loans and hence standing to bring foreclosure actions on defaulted loans. Because, among other reasons, of the real estate mortgage investment conduit ("REMIC") tax status of many private-label securitizations ("PLS"), see *infra* Subsection I.C.1, it would not be possible to transfer the mortgage loans (the note and the security instrument) to the trust after the REMIC's closing date without losing REMIC status. Similarly, it is not clear whether defaulted loans are eligible for inclusion in a REMIC, and default is typically the only scenario in which a belated transfer would occur. *See* NEWOAK CAPITAL, INVESTMENT DILEMMA IN NONPERFORMING MORTGAGES (2008), *available at* http://www.newoakcapital.com/dilema_merchant.pdf. Moreover, most trusts are governed by New York law, which provides that any transfer to the trust in contravention of the trust documents is void. N.Y. ESTATES, POWERS & TRUSTS LAW § 7-2.4 (McKinney 2002). As trust documents are explicit in setting forth a method and date for the transfer of the mortgage loans to the trust and in insisting that no party involved in the trust take steps that would endanger the trust's REMIC status, if the original transfers did not comply with the method and timing for transfer required by the trust documents, then such belated transfers to the trust would be void. In these cases, there is a set of far-reaching systemic implications from clouded title to the property and from litigation against trustees and securitization sponsors for either violating trust duties or violating representations and warranties about the sale and transfer of the mortgage loans to the trust.

Figure 2: Private-Label Mortgage Securitization Structure[36]



A variety of reasons—credit risk (bankruptcy remoteness), off-balance-sheet accounting treatment, and pass-through tax status (typically as a real estate mortgage investment conduit ("REMIC")[37] or grantor trust)—mandate that the SPV be passive; it is little more than a shell to hold the loans and put them beyond the reach of the creditors of the financial institution.[38] Loans, however, need to be managed. Bills must be sent out and payments collected. Thus, a third party must be brought in to manage the loans.[39] This third party is the servicer. The servicer is supposed to manage the loans for the benefit of the RMBS holders.

Every loan, irrespective of whether it is securitized, has a servicer. Sometimes that servicer is a first-party servicer, such as when a portfolio lender

36. *See* ACE Sec. Corp. Home Equity Loan Trust, Series 2006-NC3, Prospectus Supplement (Form 424B5) S-11 (Nov. 21, 2006), *available at* http://www.sec.gov/Archives/edgar/data/1380884/000114420406049985/v058926_424b5.htm [hereinafter ACE 2006-NC3].

37. *See* I.R.C. §§ 860A-860G (2006).

38. *See* Gelpern & Levitin, *supra* note 20, at 1093-98.

39. *See* Eggert, *Limiting Abuse*, *supra* note 19, at 754.

services its own loans. Other times, it is a third-party servicer that services loans it does not own. All securitizations involve third-party servicers, but many portfolio loans also have third-party servicers, particularly if they go into default. Third-party servicing contracts for portfolio loans are not publicly available, making it hard to say much about them, including the precise nature of servicing compensation arrangements in these cases or the degree of oversight portfolio lenders exercise over their third-party servicers. Thus, it cannot always be assumed that if a loan is not securitized, it is being serviced by the financial institution that owns the loan; however, if the loan is securitized, it has third-party servicing.

Securitization divides the beneficial ownership of mortgage loans from legal title to the loans and from the management of the loans. The SPV (or more precisely its trustee) holds legal title to the loans, and the trust is the nominal beneficial owner of the loans. The RMBS investors are formally creditors of the trust, not owners of the loans held by the trust.

The economic reality, however, is that the investors are the true beneficial owners. The trust is just a pass-through holding entity, rather than an operating company. Moreover, while the trustee has nominal title to the loans for the trust, it is the third-party servicer that typically exercises legal title in the name of the trustee. The economic realities of securitization do not track with its legal formalities; securitization is the apotheosis of legal form over substance, but punctilious respect for formalities is critical for securitization to work.

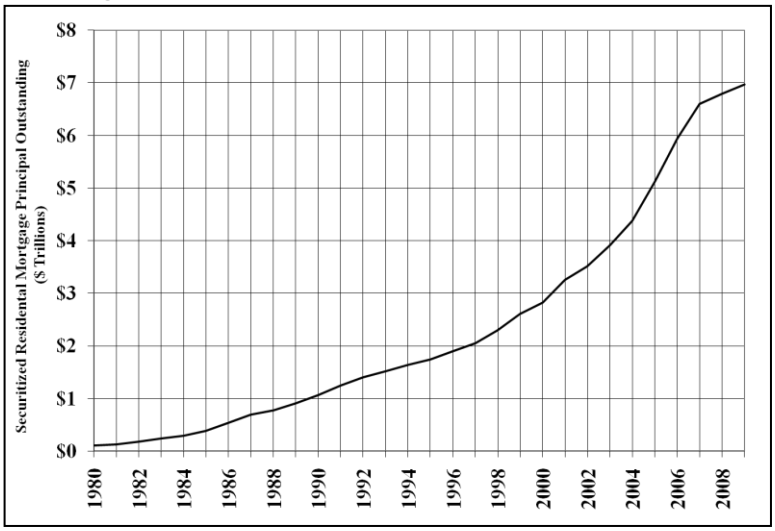
Mortgage servicers provide the critical link between mortgage borrowers and the SPV and RMBS investors, and servicing arrangements are an indispensable part of securitization.[40] Mortgage servicing has become particularly important with the growth of the securitization market. The mortgage securitization market has grown at a rapid pace in recent years. (See Figure 3.) By the end of 2009, there was $6.97 trillion in outstanding U.S. RMBS.[41] To put this in perspective, the principal amount of mortgage-related bonds outstanding at the end of 2009 was larger than the amount of U.S. Treasury bonds (which, in turn, was larger than the amount of U.S. corporate bonds), and accounted for over a fifth of the U.S. bond market.[42]

40. The servicing of nonsecuritized loans may also be outsourced. There is little information about this market because it does not involve publicly available contracts and does not show up in standard data.

41. *See* 2 INSIDE MORTG. FIN., *supra* note 25, at 10.

42. Sec. Indus. & Fin. Mkts. Ass'n, *Outstanding U.S. Bond Market Debt*, http://www.sifma.org/research/statistics.aspx (last updated Sept. 2010) (listing mortgage-related bonds at $9.19 trillion, U.S. Treasury bonds at $7.6 trillion, and corporate bonds at $6.87 trillion). Of the $9.19 trillion in mortgage-related bonds, over $6.97 trillion are RMBS. *See* 2 INSIDE MORTG. FIN., *supra* note 25, at 10. The remainder is made up of commercial mortgage-backed securities ("CMBS"). The true share of mortgage-related securities is higher than the Securities Industry & Financial Markets Association ("SIFMA") data would indicate because home equity loans and home equity lines of credit are categorized as part of the $2.4 trillion in outstanding "asset-backed" securities rather than as "mortgage-backed" securities. *Cf.* VINOD KOTHARI, SECURITIZATION: THE FINANCIAL INSTRUMENT OF

Figure 3: Growth of the RMBS Market, 1980-2008[43]



3. Segmentation of the Mortgage Securitization Market

The residential mortgage securitization market is divided into three broad segments:

(1) Privately issued RMBS guaranteed by the Government National Mortgage Association ("Ginnie Mae");[44]

(2) RMBS issued and guaranteed by government-sponsored enterprises ("GSEs") Federal National Mortgage Association ("Fannie Mae")[45] and Federal Home Loan Mortgage Corporation ("Freddie Mac")[46] (together with Ginnie Mae RMBS, called "agency RMBS");[47]

(3) RMBS issued by private-label securitizations ("PLS") conduits sponsored by major investment and commercial banks.

There are significant variations in servicing by segment of the mortgage market, as some parts of the market are more heavily regulated than others. This Article focuses on the PLS market both because mortgage servicing contracts for PLS are readily available, unlike for agency RMBS, and because

THE FUTURE 325-53 (2006) (explaining that securitized home equity loans and lines of credit are typically classified as asset-backed, rather than mortgage-backed, securities).

43. *See* 2 INSIDE MORTG. FIN., *supra* note 25, at 10.

44. For the statutory framework for Ginnie Mae, see 12 U.S.C. §§ 1716-1723i (2006). Ginnie Mae does not issue securities, but merely provides a guarantee for securities, backed by the Federal Housing Administration, the Department of Veterans Affairs, the Department of Agriculture, and the Department of Housing and Urban Development, that conform with Ginnie Mae guidelines.

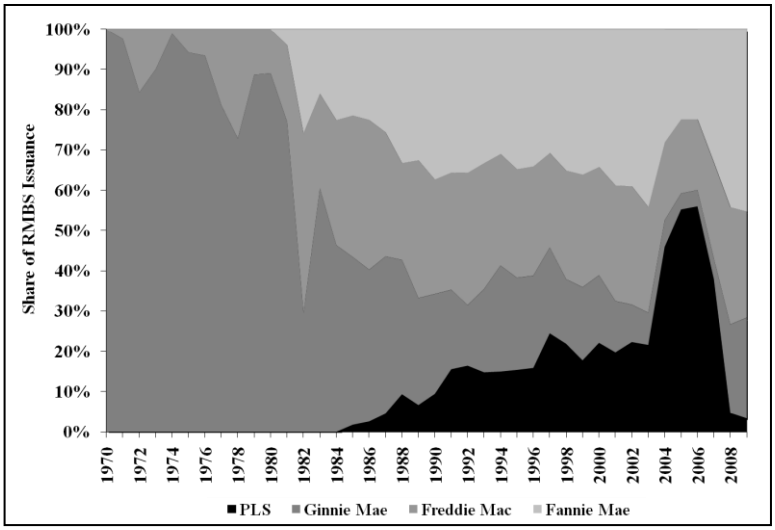
45. For the statutory framework for Fannie Mae, see 12 U.S.C. §§ 1716-1723i, 4501-4641.

46. For the statutory framework for Freddie Mac, see 12 U.S.C. §§ 1451-1459, 4501-4641.

47. There is a small amount of Ginnie Mae CMBS, based on securitizations of multifamily properties.

some of the worst problems in mortgage defaults and foreclosures have been in the PLS market.[48] Understanding this market is thus critical for understanding the present crisis and for crafting policy solutions to it and policy prescriptions to prevent its recurrence. PLS were intimately linked to the housing bubble and the economic crisis.[49] PLS grew from 22% of RMBS issuance in 2000 to 56% by 2006,[50] and from 7% of total mortgages outstanding by dollar amount in 2000 to 21% in 2006.[51] (See Figures 4 and 5.) Accordingly, most of this Article addresses PLS servicing, although many of its insights are equally applicable to agency RMBS servicing.

Figure 4: U.S. RMBS Issuance Market Share, 1970-2008[52]



48. *See, e.g., Are Mortgage Servicers Assisting Borrowers with Unaffordable Mortgages: Hearing Before the Subcomm. on Hous. & Cmty. Opportunity of the H. Fin. Servs. Comm.*, 111th Cong. 9 (2009) (statement of Patrick J. Lawler, Chief Economist, Federal Housing Finance Agency), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-111hhrg11148677/html/CHRG-111hhrg11148677.htm (noting that PLS represent 16% of securities outstanding, but 62% of serious delinquencies).

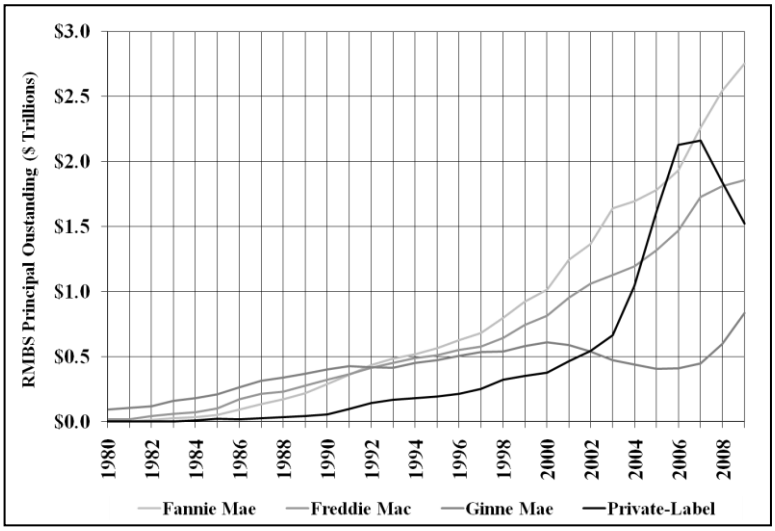
49. *See* Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble* (Georgetown Univ. Law Ctr., Bus., Econ. & Regulatory Policy Working Paper Series, Research Paper No. 1669401, 2010) (on file with authors).

50. *See* 2 INSIDE MORTG. FIN., *supra* note 25, at 9.

51. *See id.* at 10.

52. *Id*.

Figure 5: U.S. RMBS Market Growth by Principal Outstanding, 1980-2008[53]



The major difference between the agency securitizations and the PLS is in terms of credit risk. Agency RMBS carry a credit guarantee from the government or a GSE (Ginnie Mae, Fannie Mae, or Freddie Mac), whereas PLS do not.

Investors in Ginnie Mae RMBS have the full faith and credit of the United States government guaranteeing the timely payment of principal and interest on their securities.[54] The GSEs themselves provide a guarantee of the timely payment of principal and interest on their securities, but their RMBS do not

53. *Id*.

54. 12 U.S.C. § 1721(g) (2006). Unlike the GSEs, which purchase mortgages from originators (often paying in shares of their own stock) and securitize them, Ginnie Mae does not actually purchase the mortgages. Instead, it provides a third-party credit enhancement backed by the full faith and credit of the United States government, for approved private companies that wish to securitize loans insured or guaranteed by the Federal Housing Authority, the Veterans Administration, the Department of Agriculture's Rural Housing Service, and the Department of Housing and Urban Development's Office of Public and Indian Housing.

Ginnie Mae stands as a second-loss-position insurer. If a mortgage in a Ginnie Mae-insured pool defaults, the Ginnie Mae issuer is required to purchase the loan out of the pool, which treats the event as a prepayment. The issuer may then look to the relevant government agency (Federal Housing Administration, the Department of Veterans Affairs, the Department of Agriculture, and the Department of Housing and Urban Development) to collect the insurance on the mortgage. If the issuer fails to purchase the loan out of the pool, then Ginnie Mae will do so itself, and then be subrogated to the issuer's insurance rights on the loan. Ginnie Mae is thus a second level of insurance that is reinsured by other government agencies, meaning that it assumes very little credit risk itself. The value added by Ginnie Mae is that it ensures that Ginnie Mae MBS investors receive timely payment of their principal and interest. Payout on the underlying loan-level policies may not be timely, and Ginnie Mae guarantees investors their regular cash flow.

"carry the eagle"—they are not formally federally guaranteed. In this sense, the GSEs are akin to private monoline bond insurers.

Because of federal regulation of the GSEs and their origins as federally owned corporations, however, the GSEs' obligations are perceived to carry an implicit federal government guarantee.[55] Therefore, investors in agency RMBS do not see themselves as assuming credit risk; they are assuming solely the interest-rate risk on the mortgages.[56] This means that investors in agency

55. The GSEs are now in federal conservatorship, a situation that legally can last indefinitely, and their obligations carry an "effective guarantee" from the federal government, but do not enjoy a full faith and credit backing. *See* 12 U.S.C. § 1719(e) (stating that GSE debts are not government debts). *But see* Dawn Kopecki, *Fannie, Freddie Have "Effective" Guarantee, FHFA Says*, BLOOMBERG, Oct. 23, 2008, *available at* http://www.bloomberg.com/apps/news?pid=20601087&sid=aO5XSFgElSZA&refer=home. The difference, if any, between the "effective guarantee" and "full faith and credit" is uncertain. *But see* Press Release, U.S. Dep't of the Treas., Treasury Issues Update on Status of Support for Housing Programs (Dec. 24, 2009), http://www.ustreas.gov/press/releases/2009122415345924543.htm (asserting that the December 2009 amendments to the Treasury Department's agreements with Fannie Mae and Freddie Mac "should leave no uncertainty about the Treasury's commitment to support these firms as they continue to play a vital role in the housing market during this current crisis").

Ginnie Mae and the GSEs are limited to guaranteeing RMBS, backed by particular segments of the mortgage market. Ginnie Mae is restricted to securitizing government-insured or government-guaranteed mortgages, which come with a variety of eligibility restrictions.

The GSEs are subject to regulation by the Federal Housing Finance Agency, 12 U.S.C. § 4513, and are restricted to purchasing and securitizing only conventional (that is, not government insured), "conforming" mortgages—mortgages that meet various statutory requirements, including a maximum loan amount and loan-to-value ("LTV") limit absent private mortgage insurance—and the GSEs own nonstatutory underwriting quality guidelines. *See, e.g.*, 12 U.S.C. § 1454. The GSEs were not restricted in the type of RMBS they could purchase for their investment portfolios, however, and they were also able to receive affordable-housing-goal credit for their PLS holdings. 24 C.F.R. § 81.16(c)(2) (2010). GSEs were major purchasers of PLS because of the relatively attractive yields to ratings on PLS. Robert Stowe England, *The Rise of Private Label*, MORTGAGE BANKING, Oct. 1, 2006, at 70 ("In the subprime RMBS category, for example, Fannie Mae and Freddie Mac are big buyers of AAA-rated floating-rate securities. Indeed, Fannie and Freddie are by far the biggest purchasers of subprime RMBS."); *see also* Alan Greenspan, *The Crisis*, BROOKINGS PAPERS ON ECON. ACTIVITY, Spring 2010, at 201, 207 tbl.1, *available at* http://www.brookings.edu/~/media/Files/Programs/ES/BPEA/2010_spring_bpea_papers/spring2010_greenspan.pdf.

All other residential mortgages (conventional, nonconforming mortgages) enter the secondary market through PLS. This includes all jumbo mortgages, many second mortgages, home equity loans and lines of credit ("HELs and HELOCs"), and the bulk of Alt-A and subprime mortgages. Jumbo mortgages are prime, conventional mortgages for an amount greater than the GSE-conforming loan limit. HELs and HELOCs are typically junior mortgages made to prime borrowers. Alt-A mortgages are prime mortgages with limited documentation underwriting or niche product structure. Subprime mortgages are either mortgages made based on property value, not repayment ability (an older use of the term), mortgages made to poor-credit-risk borrowers, mortgages made at high rates, or mortgages by institutions that specialize in poor credit risk or high-rate loans. Not surprisingly, default and foreclosure rates have been far higher on mortgages backing PLS than in the GSE market. Default rates have always been higher on mortgages in Ginnie Mae pools compared to prime loans because of the inherently weak financial profiles of government-assisted borrowers.

Despite generalizations about what types of mortgages end up in what types of securitizations, it is important to note that mortgages do not generally have a destination (portfolio or securitization channel) at origination, and that GSE MBS contained some nonprime mortgages and PLS often contained prime, conventional, conforming loans, which were mixed with weaker nonprime loans in order to improve weighted average LTVs and credit scores.

56. The yield curve on RMBS generally exhibits negative convexity; if interest rates rise, the investors have their money locked into a below-market investment, while if rates fall sufficiently, fixed-

RMBS are not concerned with monitoring credit risk on the mortgages or with agency costs, as they know they will be paid.

Unlike the investors in agency RMBS, investors in PLS assume both credit and interest-rate risk on the mortgages. PLS do not come with a guarantee of timely payment of principal and interest. Because of this, PLS typically involve some sort of interest-rate hedge, as well as various internal and external credit enhancements to reduce credit risk.[57]

By far the most common form of credit enhancement is "tranching"—the issuance of the RMBS with an internal senior/subordinate repayment priority structure that allocates the default risk on the underlying mortgages into a cashflow waterfall among investors. Tranching decreases the credit risk for senior tranches (classes of securities), while increasing it for junior tranches. Tranching of credit risk is a hallmark of PLS; credit tranching is not found in agency deals. Instead, agency deals are either nontranched pass-throughs or are collateralized mortgage obligations ("CMOs"). In nontrached pass-throughs (also called participation certificates), monthly cashflows on mortgages minus guarantee and servicing fees are simply passed through to investors on a pro rata basis. CMOs structure prepayment risk through the tranched allocation of principal and interest payments, thereby allowing a pool of mortgages or pass-throughs of a fixed duration to be shaped into different classes of bonds of virtually any duration.[58]

Credit tranching is found in almost every PLS deal. Securitization of prime "jumbos" and alt-A loans is typically done in a "six-pack" form with six tranches,[59] while the typical subprime residential PLS deal has fifteen tranches.[60] Tranching and other credit enhancements do not eliminate credit risk. Instead, they concentrate it on the junior tranches, which bear higher coupons to compensate for the risk.

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rate mortgages (absent prepayment penalties) will be refinanced, leaving the investors with less appealing reinvestment opportunities.

57. *See* Levitin & Wachter, *supra* note 49. *Tranche* is the French term for "slice." The popularity of tranching as a credit enhancement device is likely because it is far cheaper than any other type of credit enhancement, such as third-party insurance, and does not involve a substitution of third-party credit risk for SPV credit risk, so it does not merely shift monitoring duties. Tranching is not only cheaper than third-party insurance (as there is no fee for tranching), but it is also likely an affirmative moneymaker for RMBS because it allows for the creation of highly tailored securities, meeting precise market demand.

58. CMOs are backed either by a pool of mortgages or a pool of agency pass-throughs or combination thereof. Sec. Indus. & Fin. Mkts. Ass'n, *About MBS/ABS: Mortgage Security Types*, INVESTING IN BONDS.COM, http://www.investinginbonds.com/learnmore.asp?catid=11&subcatid=56&id=136 (last visited Nov. 18, 2010). There is significant variation in the structuring of CMOs. Sec. Indus. & Fin. Mkts. Ass'n, *About MBS/ABS: Types of CMOs*, INVESTING IN BONDS.COM, http://www.investinginbonds.com/learnmore.asp?catid=11&subcatid=56&id=137 (last visited Nov. 18, 2010).

59. NOMURA FIXED INCOME RESEARCH, MBS BASICS 22-23 (2006), *available at* http://www.securitization.net/pdf/Nomura/MBSBasics_31Mar06.pdf.

60. Ingo Fender & Peter Hördahl, *Estimating Valuation Losses on Subprime PLMBS with the ABX HE Index—Some Potential Pitfalls*, BIS Q. REV., June 2008, at 6 n.7.

For all RMBS, the servicer is often, but not always, a corporate affiliate ("captive") of either the sponsor, the originator, or a third-party loan aggregator that purchases loans from multiple originators and sells them to securitization conduits.[61] Mortgage servicing rights ("MSRs") are often sold apart from the loans themselves,[62] and servicing duties are frequently subcontracted in part or whole.[63] Some servicers specialize in PLS servicing, particularly in the subprime sector of private-label, while some only service Ginnie Mae or GSE deals, and others do both.

There are two other salient distinctions between agency RMBS and PLS. First, because the SPV issuing RMBS is typically a trust, there is a trustee involved. Securitization trustees are not general fiduciary trustees. Instead, they have discrete, limited duties, discussed below in Section II.C. For GSE RMBS, the GSE serves as the trustee; for PLS, there is a third-party trustee, almost always a major banking house.

Second, agency RMBS come in a limited number of types and the RMBS of each type are homogeneous. For example, Fannie Mae RMBS of a particular type, coupon, and maturity are interchangeable with (and "good delivery" in the securities market for) any other Fannie Mae RMBS of the same type, coupon, and maturity. Agency RMBS are commodity products, so much so that they even trade before they are created in the To Be Announced ("TBA") market.[64]

Not so with PLS. PLS are heterogeneous creatures. While PLS of particular sponsors tend to be similar, varieties of tranching and other credit

61. Affiliations between the sponsor (or depositor or originator) and the servicer raise concerns about whether servicers will be vigorous in prosecuting violations of representations and warranties made to the SPV by the depositor (and to the depositor by the sponsor/seller and to the sponsor/seller by the originator or third-party loan aggregator) about the quality of the mortgage loans.

62. Mortgage servicing rights are freely bought and sold. They are even themselves securitized. O. Max Gardner III, *Mortgage Securitization, Servicing, and Consumer Bankruptcy*, 2 LAW TRENDS & NEWS (Am. Bar Ass'n, Chi., Ill.), Sept. 2005, at 1, *available at* http://www.abanet.org/genpractice/newsletter/lawtrends/0509/business/mortgagesecuritization.html.

63. *The Foreclosure Prevention and Sound Mortgage Servicing Act of 2008: Hearing on H.R. 5679 Before the Subcomm. on Hous. & Cmty. Opportunity of the H. Fin. Servs. Comm.*, 110th Cong. 25 (2008) (statement of Tara Twomey).

64. In the TBA market, the originator enters into a forward contract with the GSE issuer, in which the originator promises to deliver in the future a package of loans meeting the GSE's requirements in exchange for GSE MBS to be identified in the future.

Because the originator is able to resell the loan to the GSE for a guaranteed rate months *before* the closing of the loan, the originator is not exposed to interest-rate fluctuations between the time it quotes a rate and closing. Without the TBA market, originators would have to bear the risk that the market value of the loan would change before closing due to fluctuations in market rates. The commodity nature of GSE MBS means that they are sufficiently liquid to support a TBA market that allows originators to offer borrowers locked-in rates in advance of closing.

The TBA market facilitates home purchases, as homeowners are able to figure out what their financing costs will be and therefore what their purchasing capacity is; without a TBA market, more purchases would fall apart because of inability to get financing or purchase prices would be lower. Originators of nonconforming (non-GSE-eligible) loans, particularly prime jumbos, are able to piggyback on the TBA market to hedge their interest-rate risk by purchasing in the TBA market to offset the risks of the loans they originate.

enhancements make all PLS unique. The variations among PLS are not only matters of credit enhancement, however. Deal documentation in PLS also evinces significant variation. Whereas GSE RMBS are under a handful of master trust indentures that standardize the terms of the GSE RMBS, no such standardization exists for over 13,500 PLS deals done since 1977.[65] (Ginnie Mae insures, but does not issue MBS, so it does not have its own master trust indenture.) This Article addresses general features of PLS, but there are exceptional deals.

B. The Servicing Business

The mortgage servicer performs all the day-to-day tasks related to the mortgages owned by the SPV. Servicers are responsible for account maintenance activities such as sending monthly statements to mortgagors, collecting payments from mortgagors, keeping track of account balances, handling escrow accounts, calculating interest-rate adjustments on adjustable-rate mortgages, reporting to national credit bureaus, and remitting funds collected from mortgagors to the trust.[66] Servicers also are responsible for handling defaulted loans, including prosecuting foreclosures and attempting to mitigate investors' losses. Some servicers have "captive," or in-house, loss mitigation units, including collateral inspection teams and foreclosure attorneys; others outsource these functions.

Servicers are thus responsible for making sure that the mortgage loans are repaid to the SPV. Once the SPV receives the payments, a corporate trustee with limited duties is responsible for making distributions to the investors in the SPV's MBS.[67]

1. Servicer Specialization

There is a good deal of specialization among servicers. First, there is specialization by product type (among Ginnie Mae, GSE, and PLS loans). Some servicers work in all areas; some specialize in a particular market, usually because they also have an origination specialty in that market.

65. *See* Cordell & Levitin, *supra* note 19, at 24 n.55.

66. *See* Barbara Kiviat, *Forestalling Foreclosure*, TIME, Dec. 31, 2008, at 44 ("If you think subprime lenders are the loan sharks of real estate, then loan servicers—the outfits that collect mortgage money and run the books—are the enforcers. Their job is to keep the dough coming, no matter what.").

67. Sometimes the servicer handles this duty as well. When the trustee handles payments, it is referred to as the "paying agent." Paying agent is the typical arrangement, but sometimes, particularly if there is a master servicer, the trustee is not the paying agent and is merely the "nominal trustee." *See* Deposition of Ronaldo Reyes, Vice President, Deutsche Bank Nat'l Trust Co., at 13-15, 17-19, Ex. 3 to Doc. No. 153, Wood v. Deutsche Bank Nat'l Trust Co. (*In re* Bateman), No. 07-13346 (Bankr. W.D. Wash. filed Aug. 10, 2009) (deposed Apr. 29, 2010) (describing "nominal trustee" arrangements); *id.* at 19 (estimating that approximately 90% of deals involve trustees who also act as paying agents, while the remaining 10% have nominal trustees); *id.* at 20 (stating that the percentage of deals involving nominal trustees "stayed pretty consistent . . . over the last . . . five years").

Second, there is specialization by servicing function. Residential mortgage loans can be serviced by a combination of primary, master, and special servicers.[68] Most RMBS transactions have either a primary servicer or a primary servicer and master servicer; only a small minority have special servicers.[69]

These different types of servicers have different responsibilities, which vary somewhat by the deal. Primary servicers are typically responsible for collecting payments from the mortgagors and remitting them to the master servicer, if there is one, or to the trust directly if there is no master servicer. Primary servicers also "respond to borrower inquiries, account for principal and interest, hold custodial and escrow funds for payment of property taxes and insurance premiums, counsel or otherwise work with delinquent borrowers, supervise foreclosures and property dispositions and generally administer the loans."[70]

Master servicers are responsible for the oversight of primary servicers. They collect mortgage payments from primary servicers and remit them to the trust or to the investors directly. Master servicers advance payments to the trust on defaulted loans. If the homeowner does not pay, the servicer is required to remit payment to the trust from its own funds. If there is no master servicer, the primary servicer must make the advances. Because of the duty to make advances, the master servicer is thus also a financial backstop for the trust, guaranteeing uninterrupted cash flow, which is key for MBS investors. Master servicers may also perform additional services, such as "loan accounting, claims administration, oversight of primary servicers, loss mitigation, bond administration, cash flow waterfall calculations, investor reporting and tax reporting compliance."[71]

Special servicers are responsible for directly handling defaulted loans. If there is a special servicer, loans are automatically transferred to the special servicer at some point of delinquency. While standard for commercial mortgage-backed securities ("CMBS"), special servicers are very much the exception for RMBS deals, where the primary servicer generally handles defaulted loans. Additionally, servicing contracts usually permit servicers to subcontract their work out to "subservicers." It is unclear how extensively subservicing is used, but it appears that often master or primary servicers subcontract out special servicing, instead of having special servicing arrangements specified in the securitization deal documents.

68. FITCH RATINGS, GLOBAL RATING CRITERIA FOR STRUCTURED FINANCE SERVICERS 3 (2009); FITCH RATINGS, RATING U.S. RESIDENTIAL MORTGAGE SERVICERS 3-5 (2006); *see also* FRANK J. FABOZZI & VINOD KOTHARI, INTRODUCTION TO SECURITIZATION 124-25 (2008).

69. Cordell & Levitin, *supra* note 19, at 26 n.59 (noting that 2% of deals have special servicers and 13% of deals have master servicers that are distinct from the primary servicer).

70. Residential Capital LLC, Annual Report (Form 10-K) 9 (Feb. 27, 2009), *available at* http://www.secinfo.com/d14D5a.s16Ca.htm.

71. *Id*.

Except where otherwise noted, this Article simply refers to "servicers," recognizing that generalizations about servicing arrangements are just that and that there are many possible contractual relationships among servicers and subservicers that can create frictions and agency problems beyond those discussed in this Article.

2. Automation and Economies of Scale

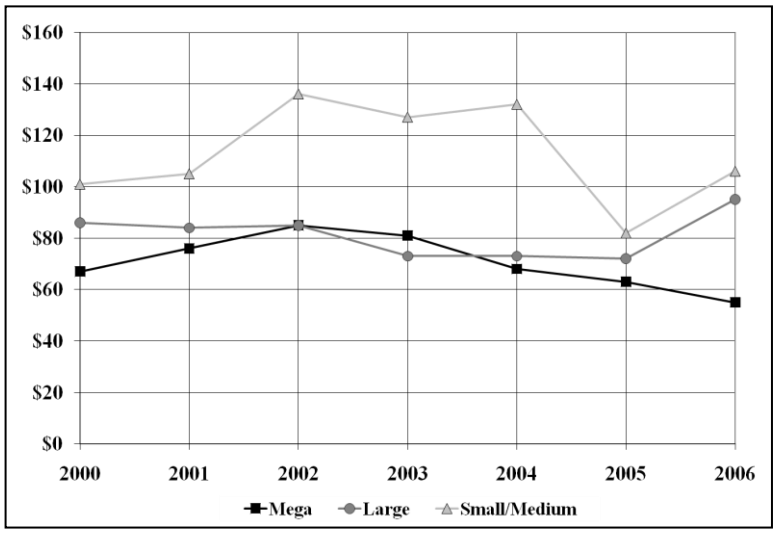
Servicers are essentially in two lines of business.[72] The first line of business is transaction processing—sending out monthly billing statements to homeowners and receiving the payments and remitting them to the SPV. This type of business involves little discretion, expertise, or manpower. The transaction processing business can be largely automated and has major economies of scale.[73] Thus, for megaservicers, direct servicing costs (excluding technology investments and corporate overhead) were just $36 per loan in 2000, compared to an industry average of $47 per loan that year.[74] (See Figure 6.)

72. Servicers have other functions that have traditionally been ancillary to these two main lines of business. Servicers' most important other function is to monitor for and prosecute violations of representations and warranties about the quality of the mortgage loans. *See infra* text accompanying notes 235-237.

73. Cordell et al., *supra* note 20, at 3. Because of the economies of scale that can be achieved through automated servicing, the servicing industry has become increasingly consolidated. In 1996, the five largest servicers accounted for 19% of the market. With the wave of bank failures and consolidations in 2008, the market share of the top five servicers rose from 46% in 2007 to nearly 60% in 2008. *See Top Mortgage Servicers*, INSIDE MORTG. FIN. PUBL'G, http://www.imfpubs.com/data/top_mortgage_servicers.html (last visited Dec. 13, 2010) (subscription access) (on file with authors).

74. Amy Crews Cutts & Richard K. Green, *Innovative Servicing Technology: Smart Enough To Keep People in Their Houses?* 4 (Freddie Mac, Working Paper No. 04-03, 2004), *available at* http://www.freddiemac.com/news/pdf/fmwp_0403_servicing.pdf.

Figure 6: Direct Servicing Expense Per Loan for Prime Servicers by Servicer Size, 2000-2006[75]



Servicers' second line of business is handling defaulted loans. Defaulted loans can be handled either through "default management" (the servicing industry's euphemism for foreclosure) or through "loss mitigation" (that is, foreclosure alternatives such as loan restructuring, accepting a deed in lieu of foreclosure, or approving a short sale).

Like transaction processing, default management can be highly automated. A recent bankruptcy court opinion, *In re Taylor*,[76] provides a detailed and troubling portrait of the default management. *In re Taylor* involved an order to show cause issued against servicer HSBC and its attorneys based on conduct relating to a motion they had filed to lift the automatic stay in a Chapter 13 bankruptcy. The bankruptcy judge issued the order *sua sponte* when it became clear that HSBC's attorney had no method for actually

75. Marina Walsh, *The 2007 Servicing Operations Study*, MORTGAGE BANKING, Sept. 2007, at 67, *available at* http://www.mbaa.org/files/ServingOperationsStudyWalsh9-07.pdf.

76. *In re* Taylor, 407 B.R. 618 (Bankr. E.D. Pa. 2009), *rev'd*, No. 09-cv-2479, 2010 U.S. Dist LEXIS 16080 (E.D. Pa. Feb. 18, 2010). *In re Taylor* resulted in sanctions for HSBC and its counsel under Federal Rule of Bankruptcy Procedure 9011, because "[t]he thoughtless mechanical employment of computer-driven models and communications to inexpensively traverse the path to foreclosure offends the integrity of our American bankruptcy system." *In re Taylor*, 407 B.R. at 651. The district court reversed the bankruptcy court's imposition of sanctions. *See In re Taylor*, 2010 U.S. Dist LEXIS 16080, at *8 ("[S]anctions were inappropriate in this case, for two reasons: First, because the conduct of the debtors' counsel was at least equally responsible for the difficulties in resolving the status of the mortgage payments, and second, because the record leaves the indelible impression that the appellants were sanctioned less for their specific failings than for the Bankruptcy Court's desire to 'send a message' regarding systemic problems in the litigation of bankruptcy cases and the reliance on computer databases in mortgage disputes.").

communicating directly with HSBC and verifying the loan payment history for the mortgage at issue.[77]

The communication problem at issue in the case resulted from HSBC's use of Loan Processing Services' Mortgage Servicing Platform ("MSP"). MSP is used to service over half of the mortgages in the United States.[78] MSP "supports all mortgage servicing functional areas within one comprehensive system, including comprehensive default functionality for collections work queue, foreclosure, bankruptcy and REO [real estate owned] management."[79]

MSP heavily automates the servicing process, creating automatic referrals to attorneys with specific work orders and supporting loan documentation and a performance timetable. For example:

> When a report indicates the existence of a 60 day post-petition loan payment delinquency, the HSBC processor enters a code into the MSP system which triggers the NewTrak system to make the referral to local counsel to file a motion for relief. The MSP system has a matrix which is coded with location, type of matter, etc., and will automatically pick one of the previously approved attorneys and send the referral information to NewTrak which makes the referral over its system to the attorney as coded. There is no human involvement in the designation or authorization of counsel for the task for which referral is made nor is there any authority granted to counsel other than to perform the task for which the referral is made. The coding will also cause the MSP to upload the data, including the note, mortgage and assignment (if any) and any other necessary documents for the filing, into NewTrak to be retrieved by local counsel. NewTrak provides the attorney with the precise information it is coded to produce to perform the given task. It also gives specific time lines for performance of each action which may be monitored.[80]

As the court noted, "the widespread use of the MSP for its touted benefits of increased employee productivity and reduced servicing costs illustrates the extent to which automation controls the management of mortgage loans."[81] The

77. *Id*. at 630.
78. *Id*. at 624 n.9.
79. *Id*.
80. *Id*. at 627.
81. *Id*. at 624 n.9. As a telling aside, the judge commented:

> I was struck by how Graves [HSBC's vice-president in charge of foreclosure and bankruptcy] and other users of the case management systems refer to the technology as an active participant in managing the loans in bankruptcy, giving it anthropomorphic qualities as though speaking of a member of their staff. For example, Graves was asked what happens when it learns of a foreclosure and responded: The foreclosure is put on hold. We have a way to suspend the work station and suspend all foreclosure coding, and a bankruptcy work station would be opened that would code the loan so that no correspondence would go onto it. When I asked whether she was referring to people, she replied: No, we have a case management system that we use that has screens on it; we refer to them as work stations.

picture that *In re Taylor* paints of default management is that of a highly automated process with virtually no discretion or oversight.

In contrast, handling defaulted loans through loss mitigation involves tremendous discretion, expertise, and manpower. It does not benefit from economies of scale and needs significant well-trained human labor to staff call centers.[82] As a Federal Reserve study noted, the human capital involved in loss mitigation is necessary to

> contact borrowers, collect and verify data, obtain home value estimates, determine whether the borrower has suffered a temporary or permanent setback, coordinate actions with second-lien holders, and calculate net present value estimates of loss mitigation alternatives. In contrast, other parts of the default management process, including initiating foreclosure, are much more automated and, importantly, do not require borrower contact.[83]

Loss mitigation involves pursuit of negotiated outcomes, and each negotiation is individualized, adding significantly to the transaction costs of loss mitigation. Loss mitigation is also a more uncertain process than foreclosure. Investor losses in foreclosure are largely a function of the housing market, transaction costs, and the care taken of the property. In contrast, loss mitigation can result in much better or much worse outcomes for investors. If the loan is successfully restructured and continues to perform, the investor will likely lose far less than in a foreclosure. But if the loan redefaults, then losses in the eventual foreclosure could potentially be greater, especially if the housing market is in decline. The loss mitigation outcome depends on the borrower's behavior, as well as market and property conditions, and borrower behavior is often a wild card. Ex ante, it is impossible to tell whether loss mitigation or default management will be more effective at limiting losses upon a default.

RMBS investors are not concerned, however, about the efficiencies for any particular loan, but rather the net efficiencies of loss mitigation and default management for the securitized pool of loans. Even if hands-on loss mitigation results in smaller losses than merely proceeding straight to foreclosure, the transaction cost savings from automation and quick foreclosure might well offset the benefit of hands-on loss mitigation. The net efficiencies are likely dynamic and depend on market conditions. For example, more defaults mean more cost savings from automation, but might also mean greater losses as a result of proceeding straight to foreclosure, especially in a depressed market. Thus, when defaults rise, the efficiencies of automated loss mitigation could decline. The net efficiency balance is impossible to determine in the abstract,

Id.

82. Cordell et al., *supra* note 20, at 15-16.

83. *Id*.

much less ex ante. Even ex post, determining the benefits of one approach or another is impossible because it necessarily involves comparison with a counterfactual. Thus, RMBS investors are unlikely to bargain for one approach or the other, instead leaving the question of loss mitigation or default management largely up to servicers' discretion. Servicers are likely to make their decision based on their own economic interests, rather than the RMBS investors'.

Because investors are unlikely to pay more for hands-on loss mitigation capacity, servicers have little incentive to invest in it, as it is more expensive for them. Handling defaulted loans through default management is much more compatible with the automated, scalable transaction processing side of the servicing business than loss mitigation. Particularly in a booming real estate market, servicers are unlikely to invest in loss mitigation capability, as there are few defaults and rising property values reduce losses in foreclosure. For servicers competing on cost efficiency, it makes little sense to maintain a large coterie of experienced loss mitigation personnel who command higher compensation than transaction processing employees.[84]

The lack of attention paid to loss mitigation, particularly during the bubble years, meant that there was limited loss mitigation capacity in the servicing system as mortgage defaults started to rise in 2006-2007. Expanding the system's loss mitigation capacity has been necessarily slow because it requires trained employees, and employee burn-out rates are reputedly high.[85] The system-wide lack of capacity for loss mitigation has been an acute problem in the current mortgage default crisis, and has encouraged use of foreclosure rather than restructuring to handle defaulted loans.

More generally, servicers' attempts to improve efficiency when dealing with defaulted loans have led them (and their attorneys) to cut corners in terms of legal procedure—most notably in the form of "robosigning." In the fall of 2010, depositions taken in foreclosure cases by homeowners' attorneys indicated that major servicers were routinely filing fraudulent affidavits with courts.[86] There are numerous types of affidavits that can be filed in a foreclosure case, but the most common are those attesting to the status of the loan, namely its default status and the amount owed, and lost note affidavits that attest to the original mortgage note being lost. Absent personal knowledge by the affiant of the facts alleged in the affidavit, such affidavits would be hearsay. Thus, such affidavits typically claim personal knowledge. Yet, in

84. *Id*. at 16.

85. *See* PATRICK MADIGAN, IOWA DEP'T OF JUSTICE, OFFICE OF THE ATTORNEY GEN., OVERVIEW OF THE SUBPRIME FORECLOSURE CRISIS 9 (2007), *available at* http://www.iowaattorneygeneral.org/latest_news/releases/sept_2007/Foreclosure_analysis.pdf ("Because many likely view the job as temporary, turnover rates [among front-line servicer employees] are high. It has been suggested that most front line servicing employees only last 6 to 12 months.").

86. *See, e.g*., Andrew Martin, *GMAC Expands Review of Its Foreclosures*, N.Y. TIMES, Oct. 13, 2010, at B9.

depositions it emerged that major servicers had professional affiants who signed perhaps as many as 10,000 affidavits a month (roughly one a minute, assuming a forty-hour work week), claiming personal knowledge of facts about which they had absolutely no knowledge.[87] Robosigning is a practice borne out of the attempt to automate the management of defaulted loans in the name of efficiency, but it collides squarely with the legal procedures required by statute and which are priced into the cost of the mortgage.[88]

While robosigning is the form of corner-cutting that has received the most attention,[89] it is only one symptom of servicers attempting to cut costs while faced with unprecedented volumes of foreclosure work. Another common problem is the failure of servicers (and their attorneys) to attach as exhibits both the note and the mortgage, even though civil procedure generally requires actions founded on a writing to include the writing in the complaint.[90] To actually procure a copy (or the original) of the note would require additional time and expense. Therefore, it is easier to proceed without it on the assumption that most foreclosure cases are default judgments, and judges are unlikely to interfere *sua sponte* in an uncontested case, when faced with the

87. *See* Deposition of Jeffrey Stephan at 7, GMAC Mortg., LLC v. Neu, No. 50 2008 CA 040805XXXX MB (Fla. Cir. Ct. filed Dec. 19, 2008) (deposed Dec. 10, 2009), *available at* http://theforeclosurefraud.com (follow link at top for "Page 6: Archive," then follow link for "Deposition of Jeffrey Stephan [GMAC Robosigner]") (stating that a GMAC employee signed approximately 10,000 affidavits a month for foreclosure cases).

88. *See* Karen M. Pence, *Foreclosing on Opportunity: State Laws and Mortgage Credit*, 88 REV. ECON. & STAT. 177, 180 (2006) (suggesting that judicial foreclosure costs are factored into the cost of credit in states that require such processes, thus affecting the supply of credit in judicial foreclosure states).

89. As the result of the robosigning practice coming to light, several major loan servicers briefly imposed some form of foreclosure moratorium or internal review. It is unclear at this point whether the problem has been satisfactorily solved. *See, e.g.*, *GMAC Lifts Foreclosure Freeze, Review Continues*, REUTERS, Oct. 19, 2010, http://www.reuters.com/article/idUSTRE69I2D020101019.

90. *See, e.g.*, *In re* Fla. Rules of Civil Procedure 1967 Revision, 187 So. 2d 598, 605 (Fla. 1966) ("All bonds, notes, bills of exchange, contracts, accounts or documents upon which action may be brought or defense made, or a copy thereof or a copy of the portions thereof material to the pleadings, shall be incorporated in or attached to the pleading."); IndyMac Fed. Bank, FSB v. Rogers, No. 08-15958-CI-20 (Fla. Cir. Ct. Mar. 1, 2010), *available at* http://mattweidnerlaw.com/blog/wp-content/uploads/2010/04/The-Florida-Law-Weekly.pdf (dismissing IndyMac's complaint in a foreclosure case "because the Plaintiff failed to attach a copy or any evidence of the promissory note that is alleged to be at issue in this case"); *see also* 735 ILL. COMP. STAT. ANN. 5/2-606 (West 2010) ("If a claim or defense is founded upon a written instrument, a copy thereof . . . must be attached to the pleading as an exhibit or recited therein, unless the pleader attaches to his or her pleading an affidavit stating facts showing that the instrument is not accessible to him or her."); 231 PA. CODE § 1019(i) (West 2010) ("When any claim or defense is based upon a writing, the pleader shall attach a copy of the writing, or the material part thereof, but if the writing or copy is not accessible to the pleader, it is sufficient so to state, together with the reason, and to set forth the substance of the writing."); Everhome Mortg. Co. v. Rowland, No. 07AP-615, 2008 WL 747698, at *3 (Ohio Ct. App. Mar. 20, 2008) (holding that a mortgage servicer was not entitled to summary judgment in a foreclosure case where the servicer "failed to attach the note to its complaint" and provided no other "evidence demonstrating the circumstances under which it received an interest in the note and mortgage"). Sometimes there is a public records exception, which permits incorporation by reference of public records, for example, 231 PA. CODE § 1019(g) (West 2010), but such an exception is unlikely to cover the absence of the note because the note is almost never filed in public records, unlike the security instrument.

need to go through several hundred foreclosure cases in a sitting. The efficiency imperative in servicing has resulted in attempts to handle defaulted loans in ways that clash with longstanding requirements of legal practice.

C. Servicing Contracts (Pooling and Servicing Agreements)

Servicers carry out their duties according to what is specified in their contract with the SPV. This contract is known as a "pooling and servicing agreement" ("PSA") and is also typically the indenture under which the RMBS are issued.[91]

1. Loan Management Standard

Although there are many common features in PLS PSAs, they are heterogeneous contracts, typically varying by securitization sponsor.[92] Generally, however, PSAs require servicers to manage the loans held by the trust as if for their own account.[93] Little general guidance beyond this is provided. Sometimes there is a specific requirement that the servicer attempt to maximize the net present value ("NPV") of the loan when considering loss mitigation options, but NPV is dependent on assumptions about probable loss severities and redefault and self-cure probabilities that are left undefined and, therefore, presumably at the servicer's discretion.

In theory this means that when a mortgage loan defaults, there would be a wide range of options available to the servicer, just as if it were itself the mortgagee. The servicer could forbear on collecting. The servicer could modify the loan so that it is affordable for the borrower and will perform. To accomplish this, the servicer can choose among several options: switching between fixed and adjustable interest rates; waiving penalties and fees; stretching out amortization periods; capitalizing arrearages; or reducing

91. *See* Gelpern & Levitin, *supra* note 20 (discussing other aspects of the PSA, including its status under the Trust Indenture Act of 1939, 15 U.S.C. § 77aaa-bbb (2006), and the difficulties in modifying PSAs).

92. *See* Hunt, *supra* note 20.

93. *See, e.g.*, ABFC Asset-Backed Certificates/Series 2005-OPT1, Pooling and Servicing Agreement (Form 8-K) EX-4 § 3.01 (Oct. 31, 2005), *available at* http://www.secinfo.com/dRSm6.z251.d.htm [hereinafter ABFC 2005-OPT1] ("The Servicer, as independent contract servicer, shall service and administer the Mortgage Loans in accordance with this Agreement and the normal and usual standards of practice of prudent mortgage servicers servicing similar mortgage loans and, to the extent consistent with such terms, in the same manner in which it services and administers similar mortgage loans for its own portfolio, and shall have full power and authority, acting alone, to do or cause to be done any and all things in connection with such servicing and administration which the Servicer may deem necessary or desirable and consistent with the terms of this Agreement (the '*Servicing Standard*')."); Goldman Sachs Mortg. Co. & Bank One, N.A., Seller's Purchase, Warranties and Servicing Agreement (Form 8-K) EX-10.1.3 § 4.01 (Mar. 8, 2002), *available at* http://www.sec.gov/Archives/edgar/data/807641/000095017202000467/s575865.txt ("The Servicer shall service and administer the Mortgage Loans through the exercise of the same care that it customarily employs for its own account.").

principal outstanding or interest rates. Or the servicer could reclaim the property, by taking the deed in lieu of foreclosure, by accepting the proceeds of a nonrecourse "short sale" in satisfaction of the loan, or through a foreclosure sale.

Despite the general direction in PSAs for servicers to manage the loans as if for their own account, nearly all PSAs restrict modifications to loans that are in default or where default is imminent or reasonably foreseeable. This restriction protects the SPV's pass-through tax status and off-balance-sheet accounting treatment.[94] RMBS originators and sponsors do not want the RMBS on their balance sheets, especially if they are entities like banks that must hold regulatory capital against their assets. Therefore, maintaining off-balance-sheet treatment is critical.

Similarly, ensuring pass-through tax treatment is virtually indispensable for RMBS, and RMBS are generally structured to avoid double-level taxation, that is, taxation of both the SPV and the RMBS holder. This means that the SPV must be a pass-through entity for tax purposes, so it will not be subject to taxation on its income, although the MBS investors will be taxed on theirs. While there are several methods through which pass-through tax status can be achieved, the most common ones for RMBS are to ensure that the SPV qualifies as a real estate investment mortgage conduit (REMIC, the typical form for PLS and some agency RMBS)[95] or as a grantor trust (the form used for some agency RMBS).[96] Treasury regulations prohibit REMICs from engaging in any "significant modification" of the loans that they hold.[97] Similarly, agency RMBS will lose "trust" status if holders have the "power . . . to vary the investment,"[98] and "the mere ability" to modify the loans in trust "may reflect that the trust's beneficial interest holders possess a prohibited 'power to vary.'"[99]

The economics of mortgage securitization only work if the RMBS have pass-through tax status; an additional level of taxation would add significant

94. *See* I.R.C. §§ 860A-860G (2006) (discussing REMIC treatment); ACCOUNTING FOR TRANSFERS AND SERVICING OF FIN. ASSETS AND EXTINGUISHMENTS OF LIABILITIES, Statement of Fin. Accounting Standards No. 140 (Fin. Accounting Standards Bd. 2000) (concerning off-balance-sheet accounting treatment). SFAS 140 was amended by SFAS 166 and 167, effective January 1, 2010, but most outstanding PLS have deal structures designed to comply with SFAS 140. *See* ACCOUNTING FOR TRANSFERS OF FIN. ASSETS, Statement of Fin. Accounting Standards No. 166 (Fin. Accounting Standards Bd. 2009); AMENDMENTS TO FASB INTERPRETATION NO. 46(R), Statement of Fin. Accounting Standards No. 167 (Fin. Accounting Standards Bd. 2009).

95. *See* I.R.C. §§ 860A-860G.

96. *See id.* §§ 651-52, 671 (discussing tax treatment of grantor trusts).

97. *See* 26 C.F.R. § 1.860G-2(b) (2010).

98. *See id.* § 301.7701-4(c).

99. Jeffrey P. Cantrell, William A. Levy & Helen P. Holmberg, *Modifications of Securitized Subprime Mortgage Loans* 1 n.1, *in* TAX NEWS FOR BUS. L.: NEWSLETTER OF THE A.B.A. SECTION OF BUS. L. COMM. ON TAX'N, Feb. 20, 2008 http://www.abanet.org/buslaw/committees/CL690000pub/newsletter/200802 (scroll down to "Featured Articles" and follow link for Cantrell, Levy & Holmberg).

costs to securitization. Therefore, preservation of pass-through status is of paramount importance to investors and the trust. Pass-through taxation and the off-balance-sheet accounting restriction also prevent servicers from modifying performing loans, but in so doing, they encourage defaults from borrowers who realize that modification is impossible absent default.[100]

Additionally, almost all PSAs restrict the ability to extend the term of any loan in the pool beyond the latest maturity date of the other loans in the pool.[101] As most loans in a pool have their maturity dates within at most a couple of years of each other, this means there is very little ability to stretch out the term of the loans. This restriction is near universal because of the need to match the timing of the trust's income from the mortgages with the timing of the payment of the PLS. The final maturity date of the PLS is matched to the final maturity date of the underlying loans; thirty-year mortgages are matched with thirty-year bonds, and the like. Extending the final maturity date on the mortgages would mean that the SPV's payment obligations on the PLS would come due before the mortgage payments, necessitating a default by the SPV.

There is little standardization among PSAs in terms of the types of additional restrictions on modification. A few PSAs seem to prohibit nearly all types of modifications.[102] Sometimes only certain types of modifications are permitted, such as interest-rate reductions,[103] and sometimes the total number

100. *See* Mayer et al., Mortgage Modification, *supra* note 20 (finding evidence that borrowers strategically default in order to qualify for loan modifications).

101. *See, e.g.*, ABFC 2006-OPT1, Pooling and Servicing Agreement (Form 8-K) EX-4.1 § 3.01 (Aug. 10, 2006), *available at* http://www.secinfo.com/dRSm6.v2K1.c.htm [hereinafter ABFC 2006-OPT1] ("[T]he Servicer may permit a modification of such Mortgage Loan to . . . extend the term, but not beyond the latest maturity date of any other Mortgage Loan.").

102. Morgan Stanley Capital I Inc. Trust 2006-HE1, Pooling and Servicing Agreement (Form 8-K) EX-4 § 3.01(c) (Feb. 28, 2006), *available at* http://www.secinfo.com/dRSm6.vM3.c.htm ("Notwithstanding anything in this Agreement to the contrary . . . the Servicer shall not (i) permit any modification with respect to any Mortgage Loan that would change the Mortgage Rate, reduce or increase the principal balance (except for reductions resulting from actual payments of principal) or change the final maturity date on such Mortgage Loan . . . ."); Morgan Stanley Capital I Inc. Trust 2006-NC2, Pooling and Servicing Agreement (Form 8-K) EX-4 § 3.01(c) (Feb. 28, 2006), *available at* http://www.sec.gov/Archives/edgar/data/1354446/000091412106001553/ms898247-ex4.txt (same); Securitized Asset Backed Receivables LLC Trust 2005-FR3, Pooling and Servicing Agreement (Form 8-K) EX-4 § 3.01(c) (Aug. 11, 2005), *available at* http://www.secinfo.com/dRSm6.z1Fa.d.htm ("Notwithstanding anything in this Agreement to the contrary, the Servicer . . . shall not (i) permit any modification with respect to any Mortgage Loan that would change the Mortgage Rate, reduce or increase the principal balance (except for reductions resulting from actual payments of principal) or change the final maturity date on such Mortgage Loan . . . ."). It appears that the amortization could be changed under these PSAs, but little else.

103. *See, e.g.*, ABFC 2005-OPT1, *supra* note 93, at EX-4 § 3.03 ("In the event that any payment due under any Mortgage Loan is not paid when the same becomes due and payable, or in the event the Mortgagor fails to perform any other covenant or obligation under the Mortgage Loan and such failure continues beyond any applicable grace period, the Servicer shall take such action as it shall deem to be in the best interest of the Certificateholders. With respect to any defaulted Mortgage Loan, the Servicer shall have the right to review the status of the related forbearance plan and, subject to the second paragraph of Section 3.01, may modify such forbearance plan; including extending the Mortgage Loan repayment date for a period of one year or reducing the Mortgage Interest Rate up to 50 basis points.").

of loans that can be modified is capped (typically at 5% of the pool), without consent from a third party.[104] Others limit the amount by which the interest rate may be reduced,[105] require a particular amortization method for capitalized arrearages,[106] or require full payments for three months before arrearages may be capitalized.[107] Still, others limit the number of modifications that can be made to a particular loan or in a particular year.[108] Additionally, servicers may be required to purchase any loans they modify at the face value outstanding (or even with a premium).[109] This functions as an anti-modification provision, as it would impose a monetary loss on a servicer that modified a loan.

No one has a firm sense of the frequency of contractual limitations to modification for PLS. A small and unrepresentative sampling by Credit Suisse

104. *See, e.g.*, *id.* at EX-4 § 3.01 ("The NIMS Insurer's prior written consent shall be required for any modification, waiver or amendment if the aggregate number of outstanding Mortgage Loans which have been modified, waived or amended exceeds 5% of the number of Mortgage Loans as of the Cut-off Date."); *see also* Vikas Bajaj, *For Some Subprime Borrowers, Few Good Choices*, N.Y. TIMES, Mar. 22, 2007, at C1 (citing a study by Bear Stearns that found that in 40% of the MBS making up a widely followed index, rating agency approval is required if more than 5% of the loans in the pool are modified); CREDIT SUISSE, THE DAY AFTER TOMORROW: PAYMENT SHOCKS AND LOAN MODIFICATIONS 5 exhibit 1 (2007) (on file with authors) (noting that eight MBS in a sample of thirty-one had a 5% limit on modifications, and two out of thirty-one prohibited modifications entirely).

105. Residential Asset Mgmt. Prods. Series 2006-RZ4 Trust, Pooling and Servicing Agreement (Form 8-K) § 3.07 (Oct. 10, 2006), *available at* http://www.secinfo.com/d19uz2.v9.d.htm [hereinafter RAMP 2006-RZ4] ("No such modification shall reduce the Mortgage Rate on a Mortgage Loan below the greater of (A) one-half of the Mortgage Rate as in effect on the Cut-off Date and (B) one-half of the Mortgage Rate as in effect on the date of such modification, but not less than the sum of the Servicing Fee Rate and the per annum rate at which the Subservicing Fee accrues.").

106. Citigroup Mortg. Loan Trust 2007-AMC1, Pooling and Servicing Agreement (Form 8-K) § 3.07 (Jan. 23, 2007), *available at* http://www.secinfo.com/dqTm6.uTa.c.htm [hereinafter Citigroup 2007-AMC1] ("[T]he Servicer shall not modify any Mortgage Loan in a manner that would capitalize the amount of any unpaid Monthly Payments or tax or insurance payments advanced by the Servicer on the Mortgagor's behalf unless the related Mortgagor shall have remitted an amount equal to a full Monthly Payment (or, in the case of any Mortgage Loan subject to a forbearance plan or bankruptcy plan, a full modified monthly payment under such plan) in each of the three calendar months immediately preceding the month of such modification.").

107. *Id.*

108. CREDIT SUISSE, *supra* note 104, at 20 app. A; *see, e.g.*, Carrington Mortg. Loan Trust/Series 2006-RFC1, Pooling and Servicing Agreement (Form 8-K) EX-4.1 § 3.07 (May 17, 2006), *available at* http://www.secinfo.com/dqTm6.v1v8.d.htm#1stPage ("[I]n no event shall the Servicer grant any such forbearance . . . with respect to any one Mortgage Loan more than once in any 12 month period or more than three times over the life of such Mortgage Loan.").

109. *See* Greenwich Fin. Servs. Distressed Mortg. Fund 3, LLC v. Countrywide Fin. Corp., 654 F. Supp. 2d 192, 194 (S.D.N.Y. 2009), *appeal dismissed*, 603 F.3d 23 (2d Cir. 2010) (citing language in PSAs that, according to the plaintiffs, required servicer Countrywide "to purchase any loans it modifies at a price equal to the unpaid principal and accrued interest thereon"). Prior to the *Greenwich Financial* case, a coalition of state attorneys general brought a suit against Countrywide alleging that the firm had engaged in predatory lending practices. Under a settlement agreement, Countrywide promised to implement a loan modification program for affected homeowners. *Id*. Greenwich Financial, a distressed debt investment fund, then brought a putative class action suit on behalf of itself and other MBS investors alleging that Countrywide—in agreeing to modify the loans but refusing to repurchase the modified loans from investors—thus violated the terms of the PSAs that governed the affected loans. *Id*. at 193-94. The Greenwich Financial suit was dismissed because the suit was not brought by MBS holders with 25% of the investor voting rights in the relevant trusts, as required by the PSAs. Greenwich Fin. Servs. Distressed Mortg. Fund 3, LLC v. Countrywide Fin. Corp., No. 650474/08 (N.Y. Sup. Ct. Oct. 7, 2010).

indicates that nearly all PLS PSAs permit modification when a loan is in default or default is reasonably foreseeable.[110] Almost 60% of the sampled PSAs had no other restrictions to modification.[111] Of the PSAs with additional restrictions, 27% capped loan modifications at 5% of the loan pool, either by count or balance.[112] The Credit Suisse study, however, did not track all types of modification restrictions, such as face-value repurchase provisions, so the true number of restrictive PSAs may be higher.

An example of a variety of restrictions can be found in a 2005 PSA for Option One Mortgage Corporation (a now-defunct H&R Block affiliate) as servicer for loans deposited by the Asset Backed Funding Corporation (a Bank of America affiliate).[113] The Option One PSA provides that:

> Consistent with the terms of this Agreement, the Servicer may waive, modify or vary any term of any Mortgage Loan or consent to the postponement of strict compliance with any such term or in any manner grant indulgence to any Mortgagor if in the Servicer's reasonable and prudent determination such waiver, modification, postponement or indulgence is not materially adverse to the Certificateholders . . . .[114]

The PSA qualifies this broad grant of authority to modify the mortgage loans terms consistent with the interests of the MBS holders, by forbidding modifications that would change the interest rate, reduce the principal, or forgive the past due payments of the loan.[115]

The PSA sets forth two exceptions to this general limitation on loan modification. First, for defaulted loans, the PSA provides that the servicer may write down principal or extend the term of the loan.[116] Thus, it appears that the servicer may write down the principal on a defaulted or distressed loan or may extend the term of the loan. As noted above, however, the ability to extend the term is very limited, because most securitized loans in a pool will be of roughly

110. CREDIT SUISSE, *supra* note 104, at 5.

111. *Id.*

112. *Id.*

113. *See* Bank of Am. Corp., Annual Report (Form 10-K) 2 exhibit 21 (Feb. 26, 2010), *available at* http://www.secinfo.com/d14D5a.r18md.s.htm (listing the Asset Backed Funding Corp. as a subsidiary of Bank of America).

114. *See* ABFC 2005-OPT1, *supra* note 93, at EX-4 § 3.01.

115. *Id.* ("[T]he Servicer shall not make future advances and, except as set forth in the following sentence or Section 3.03, the Servicer shall not permit any modification with respect to any Mortgage Loan that would (i) change the Mortgage Interest Rate, defer or forgive the payment thereof of any principal or interest payments, reduce the outstanding principal amount [except for actual payments of principal] or extend the final maturity date with respect to such Mortgage Loan, [or adversely affect the MBS' REMIC pass-through tax status].").

116. *Id.* ("In the event that the Mortgagor is in default with respect to the Mortgage Loan or such default is, in the judgment of the Servicer, reasonably foreseeable, the Servicer may permit a modification of such Mortgage Loan to reduce the Principal Balance thereof and/or extend the term, but not beyond the latest maturity date of any other Mortgage Loan [so long as it does not affect the MBS' tax status].").

identical tenor and origination date, so it is unlikely that a loan could be restructured to stretch the term out beyond an additional year, although the amortization could be stretched out beyond the term of the note. The second exception provides that for defaulted loans, the servicer may offer up to one year of forbearance or a fifty-basis-point reduction in the interest rate.[117]

Finally, the PSA limits modifications made without the consent of the Net Interest Margin Security ("NIMS") Insurer to 5% of the original number of mortgages in the pool.[118] The NIMS is the resecuritization of the residual (lowest priority) tranche of the MBS that has claim to any cashflows beyond those needed to pay all the other tranches.[119] PLS deal sponsors initially retain the residual value of the deal, as there can be excess cashflows due to excess spread on the mortgages over that needed to pay the PLS investors, overcollateralization, lower than anticipated defaults, and lower than anticipated prepayment rates. Residual interests in securitizations are the most capital intensive asset a bank can hold; they are subject to a dollar-for-dollar capital requirement, meaning $100 million in value of residuals on a bank's books requires $100 million of Tier 1 capital.[120] Accordingly, banks resecuritize the residuals when possible, while nonbanks resecuritize in order to monetize the high-risk residual interest.

The principal amount of the NIMS (but not the interest) is typically credit-enhanced through a credit insurance policy. The NIMS Insurer guarantees payments made to the holders of the resecuritization of the lowest priority PLS that have the residual interest in the trust.[121] Because the NIMS Insurer has the first loss position, it is given veto power over wide-scale modifications. If the NIMS are out-of-the-money, however, there is no reason for the NIMS Insurer to cooperate without a payout from the other PLS holders. Such a payout is

117. *Id*. § 3.03 ("In the event that any payment due under any Mortgage Loan is not paid when the same becomes due and payable, or in the event the Mortgagor fails to perform any other covenant or obligation under the Mortgage Loan and such failure continues beyond any applicable grace period, the Servicer shall take such action as it shall deem to be in the best interest of the Certificateholders. With respect to any defaulted Mortgage Loan, the Servicer shall have the right to review the status of the related forbearance plan and, subject to the second paragraph of Section 3.01, may modify such forbearance plan; including extending the Mortgage Loan repayment date for a period of one year or reducing the Mortgage Interest Rate up to 50 basis points.").

118. *Id*. § 3.01. ("The NIMS Insurer's prior written consent shall be required for any modification, waiver or amendment if the aggregate number of outstanding Mortgage Loans which have been modified, waived or amended exceeds 5% of the number of Mortgage Loans as of the Cut-off Date.").

119. Allen Frankel, *Prime or Not So Prime? An Exploration of U.S. Housing Finance in the New Century*, BIS Q. REV., Mar. 2006, at 67, 70-72.

120. *See*, *e.g*., 12 C.F.R. pt. 3, app. A, § 4(f)(2) (2010) (relating to national banks); *see also* Direct Credit Substitutes and Residual Interests in Asset Securitizations, 66 Fed. Reg. 59,614, 59,620-21 (Nov. 29, 2001) (explaining the dollar-for-dollar capital charge for certain retained residual interests in securitizations).

121. WACHOVIA SEC., NIMS—THE NEXT COMMODITY? (2002), *available at* http://www.securitization.net/pdf/wach_nims_062702.pdf; Keith L. Krasney, *The Legal Structure of Net Interest Margin Securities*, 13 J. STRUCTURED FIN. 54 (2007).

unlikely, however, as the PSA provides no mechanism for coordinating such a deal and the PLS holders do not even know each other's identities.

Mortgage servicers have substantial leeway in interpreting PSA restrictions, but many have interpreted them as limiting their ability to do modifications. Despite a limited safe harbor for servicers to perform loan modifications, many servicers still interpret PSAs as restricting their authority in order to avoid the risk of investor suits[122] and possible SEC action.[123] Restrictive PSAs can thus stand in the way of a servicer modifying loans even when the modification would benefit both investors and homeowners.

2. Servicer Compensation

Pooling and servicing agreements also set forth servicer compensation. Servicers typically pay upfront for MSRs. To make a profit, servicers must recoup their outlay based on their net servicing income. Net servicing income is gross servicing income minus servicing costs. Servicers are compensated in four ways: a servicing fee, float income, ancillary fees, and a retained interest in the securitization. The values of three of the four types of compensation—servicing fees, float, and retained interests—vary based on factors beyond the servicer's control, particularly mortgage prepayment speeds, which are largely a function of interest rates.[124] Accordingly, a servicer's ability to influence its net servicing income depends on its ability to levy ancillary fees and to control servicing costs. This compensation structure incentivizes servicers to aggressively pursue ancillary fees and to pursue loss mitigation strategies that minimize costs, even if they fail to maximize returns to investors.

a. Servicing Fees

Servicers receive a percentage of the outstanding unpaid principal balance ("UPB") in the trust as a servicing fee. Each month the servicer deducts the servicing fee from the total mortgage payments received from the homeowners before remitting the remainder to the MBS investors. This means that the servicing fee is effectively an interest-only, first priority tranche.

122. To date, there appears to only be a single instance of investor litigation against a servicer for violation of PSA modification restrictions, and the case is *sui generis* in its factual situation. *See* Greenwich Fin. Servs. Distressed Mortg. Fund 3, LLC v. Countrywide Fin. Corp., 654 F. Supp. 2d 192, 194 (S.D.N.Y. 2009), *appeal dismissed*, 603 F.3d 23 (2d Cir. 2010). Congress enacted a limited safe harbor for servicers to perform loan modifications as part of the Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, 123 Stat. 1638 (to be codified at 15 U.S.C. § 1639a).

123. If the servicer violates the terms of a PSA, it could constitute a securities law violation on account of the servicer's Regulation AB certification. *See infra* Subsection II.B.1.

124. Foreclosures and other liquidations function like prepayments, so credit risk is translated into interest-rate risk. Because they are so interest-rate dependent, MSRs are a hedge on origination activity, though they are themselves frequently hedged with Treasuries. *See* Peter Eavis, *Unlocking the MSR Mystery*, WALL ST. J., Oct. 23, 2009, at C10.

As an interest-only tranche, servicing fees' value depends upon prepayment speeds; the longer loans remain in an MBS pool, the longer the servicer collects the servicing fee. For performing loans, the most expensive part of servicing is "boarding" the loans onto the servicers' system, which occurs at the beginning of the loans' life. The servicer is then hoping that the loans will stay in the pool and generate servicing fees long enough to cover its sunk costs.

Prepayment speeds depend on interest rates. When rates go down sufficiently, borrowers refinance their mortgages, and the principal balance of the pool on which the servicing fee percentage rate is applied shrinks. If rates rise, however, borrowers do not refinance, as they now have a below-market mortgage rate. For an MBS investor, there is interest-rate risk both from rate declines, as the MBS investor will be prepaid and have to reinvest at a lower yield, and from rate increases, which leave the MBS investor holding MBS with below-market yield. For servicers, however, the only risk is that of an interest-rate decline, as the servicing fee is not dependent on the total yield on the MBS.

Servicing fees range from twenty-five basis points annually on UPB for prime GSE servicing to fifty basis points annually for subprime servicing.[125] For example, in a PSA that governs loans originated by Argent Mortgage and Ameriquest, the annual servicing fee is fifty basis points[126] on the UPB of a securitized pool of 9588 mortgage loans[127] with an original UPB of approximately $1.934 billion. The resulting servicing fee would be approximately $9.67 million for the first year, but declining thereafter because the UPB is reduced through homeowners' payments, so the total servicing fee income is also reduced. As the UPB of the mortgages is reduced, the largely fixed costs of servicing will eventually exceed the percentage-based servicing fee. Accordingly, when the loan balance is reduced to a specified threshold

125. Office of the Comptroller of the Currency, Economic Issues in Predatory Lending 12-13 (July 30, 2003) (unpublished manuscript), *available* at http://www.selegal.org/occ_workpaper0730.pdf. Sometimes fees are stepped up over time to account for declining principal balances in the pools and to smooth out servicer income streams. *See, e.g.*, ABFC 2006-OPT1, *supra* note 101, § 1.01, *available at* http://www.secinfo.com/dRSm6.v2K1.c.htm#9znf ("*'Servicing Fee Rate'*: With respect to each Mortgage Loan, 0.30% per annum for the first 10 calendar months following the Cut-off Date, 0.40% per annum for the 11th through 30th calendar months following the Cut-off Date, and 0.65% per annum for all calendar months thereafter.").

126. Ameriquest Mortg. Sec. Trust 2006-M3, Pooling and Servicing Agreement (Form 8-K) EX-4 § 1.01 (Sept. 7, 2006), *available at* http://www.secinfo.com/dqTm6.v3gw.htm [hereinafter Ameriquest Mortg. Sec. Trust 2006-M3] (defining "Servicing Fee" as "[w]ith respect to each Mortgage Loan and for any calendar month, an amount equal to one month's interest (or in the event of any payment of interest which accompanies a Principal Prepayment in full made by the Mortgagor during such calendar month, interest for the number of days covered by such payment of interest) at the applicable Servicing Fee Rate on the same principal amount on which interest on such Mortgage Loan accrues for such calendar month. A portion of such Servicing Fee may be retained by any Sub-Servicer as its servicing compensation," and defining the "Servicing Fee Rate" as "0.50% per annum").

127. Ameriquest Mortg. Sec. Trust 2006-M3, Prospectus Supplement (Form 424B5) annex III (Sept. 27, 2006), *available at* http://www.secinfo.com/dqTm6.v343.htm.

(often 10%), the servicer may usually exercise a "clean-up call" option and purchase the mortgages for face value from the trust.[128]

Because servicing fees are treated as an interest-only strip, they are sometimes paid only to the extent that interest payments are collected on a mortgage, including accrued interest collected upon liquidation of foreclosure property.[129] In such a situation, the servicing fee on a nonperforming loan will not be paid until the loan reperforms or is liquidated, and the servicer is not compensated with interest for the delay in payment. Sometimes, however, servicing fees continue to be paid on delinquent mortgages and even, in some cases, on properties that are in REO (based on the pre-REO balance).[130]

b. Float

Servicers earn "float" income by investing the funds they receive from mortgagors for a short period before remitting them to the trust. Homeowners might pay their mortgage by the first of the month, but the servicer has to remit the payments to the trust only on the twenty-fifth of the month. In the interim, the servicer will place the payments in investment-grade investments and keep the investment income itself.

For loans with escrow accounts for taxes and insurance, float income may also be earned on collected escrow funds until they are disbursed to the taxing authority or insurance provider.[131] Escrow disbursement timing, escrow analysis, and cushion requirements can all affect the amount of float income received by servicers for escrow accounts.

For example, recent SEC filings for Ocwen Financial Corporation show an average balance for custodial accounts (escrow accounts) of $677 million for 2007. These funds generated an additional $30 million in revenue for Ocwen and made up approximately 9% of its servicing income.[132] Countrywide, the nation's largest loan servicer, reported holding $19.2 billion

128. VINOD KOTHARI, SECURITIZATION: THE FINANCIAL INSTRUMENT OF THE FUTURE 200-01, 239 (2006).

129. CWABS Asset-Backed Certificates/Series 2006-BC1, Pooling and Servicing Agreement (Form 8-K) EX-4.1 § 3.15 (Mar. 30, 2006), *available at* http://www.secinfo.com/dqTm6.v188.d.htm ("As compensation for its activities hereunder, the Master Servicer shall be entitled to retain or withdraw from the Certificate Account out of each payment of interest on a Mortgage Loan included in the Trust Fund an amount equal to interest at the applicable Servicing Fee Rate on the Stated Principal Balance of the related Mortgage Loan for the period covered by such interest payment.").

130. ABFC 2006-OPT1, *supra* note 101, at EX-4.1 § 3.18 ("As compensation for its activities hereunder, the Servicer shall be entitled to retain the amount of the Servicing Fee with respect to each Mortgage Loan (including REO Properties) and any Prepayment Interest Excess.").

131. *See, e.g., id.* at EX-4.1 § 3.04 ("Funds on deposit in the Collection Account, the Distribution Account, any REO Account and any Escrow Account may be invested in Permitted Investments . . . . Any investment earnings or interest . . . shall accrue to the benefit of the Master Servicer and the Master Servicer shall be entitled to retain and withdraw such interest from each such account on a daily basis.").

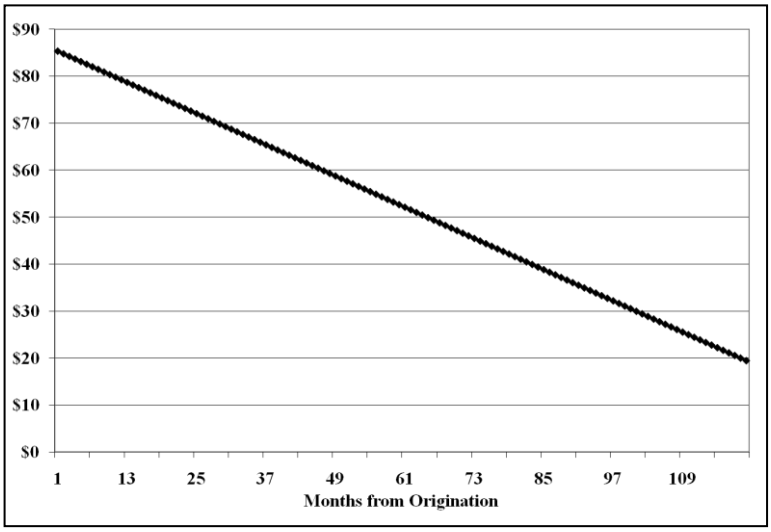
132. Ocwen Fin. Corp., Annual Report (Form 10-K) 28 (Mar. 13, 2008), *available at* http://www.sec.gov/Archives/edgar/data/873860/000101905608000419/ocn_10k07.htm.

in borrower and investor custodial cash accounts at the end of December, 2007[133] producing significant float income.

Float income varies with monthly payment amounts. If the total monthly payment amount in a pool is reduced, either by prepayments (generally driven by declining market interest rates) or by lower payments on adjustable-rate mortgages ("ARMs") due to a fall in the index rate, then the total amount of float income falls. Conversely, if interest rates rise and ARM payments increase, float income goes up. Float income is thus procyclical with interest rates.

For fixed-rate mortgages ("FRMs"), float income, like servicing fee income, declines as the pool's total UPB declines. (On the loan level, however, float income on an FRM is constant, regardless of UPB.) Accordingly, a servicer's gross income on a performing loan declines every month, as Figure 7 shows for a stylized loan. This also means that cumulative gross servicing income on a performing loan tapers off over time, as Figure 8 shows. Neither Figure 7 nor Figure 8, however, discounts the servicer's income stream for the likelihood that the loan will be refinanced.[134] For a normal loan, there is a high annual prepayment rate, but for defaulted loans, the risk of prepayment is much lower.

Figure 7: Monthly Servicing Fee and Float Income over Time[135]

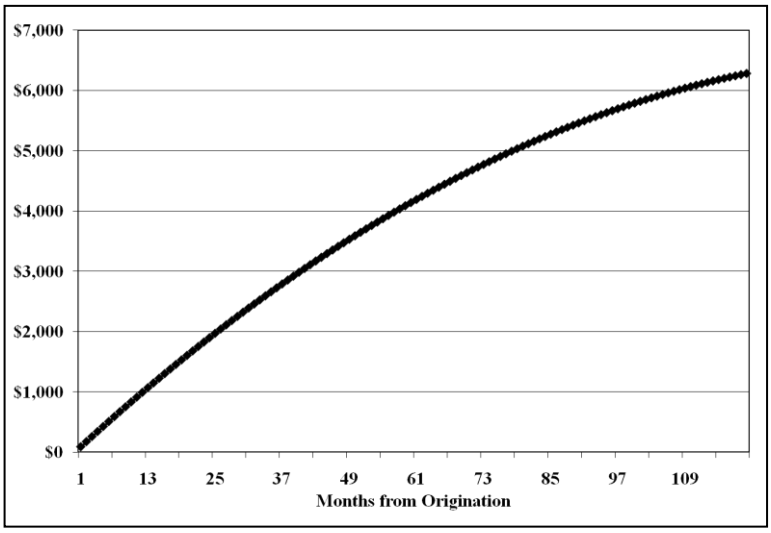


133. Countrywide Fin. Corp., Annual Report (Form 10-K) F-99 (Feb. 29, 2008), *available at* http://www.secinfo.com/dVut2.t21n.htm.

134. Discounting for prepayment would result in Figure 7's curve tapering downward more quickly, while Figure 8's curve flattens more quickly.

135. Authors' calculations (assuming a fifty-basis-point rate on a $200,000 original principal balance for an 8% APR thirty-year FRM).

Figure 8: Cumulative Servicing Fee and Float Income over Time[136]



c. Ancillary (and Possibly Illegal) Fees

Servicers are typically permitted to retain any ancillary fees they levy on the homeowner to the extent they are collected.[137] Ancillary fees are imposed on borrowers to compensate servicers for the occurrence of particular events, such as late payment, bounced checks, and mortgage modification or extension.

These fees are provided for either by the mortgage loan documents themselves or by direct contract between the servicer and the borrower. Mortgage loan documents typically provide for servicers to retain late fees (typically 5% of the monthly payment) and fees for any costs involved in collection, including the costs of foreclosure and maintaining the property.[138]

136. *Id.*

137. *See, e.g.*, ACE 2006-NC3, *supra* note 36, at 134 (stating that the servicer is also "entitled to retain all servicing-related fees, including assumption fees, modification fees, extension fees, nonsufficient funds fees, late payment charges and other ancillary fees and charges in respect of the related Mortgage Loans"); Ameriquest Mortg. Sec. Trust 2006-M3, *supra* note 126, at EX-4 § 3.18 ("Additional servicing compensation in the form of assumption fees, late payment charges, insufficient funds fees, reconveyance fees and other similar fees and charges (other than Prepayment Charges) shall be retained by the Master Servicer . . . to the extent such amounts, fees or charges are received by the Master Servicer."); *see also* Eggert, *Limiting Abuse*, *supra* note 19, at 758.

138. For example, the standardized Fannie Mae security instrument provides that:

> Lender may charge Borrower fees for services performed in connection with Borrower's default, for the purpose of protecting Lender's interest in the Property and rights under this Security Instrument, including, but not limited to, attorneys' fees, property inspection and valuation fees. In regard to any other fees, the absence of express authority in this Security Instrument to charge a specific fee to Borrower shall not be construed as a prohibition on the charging of such fee. Lender may not charge fees that are expressly prohibited by this Security Instrument or by Applicable Law.

The expenses involved in foreclosure and REO maintenance are frequently insourced rather than competitively bid by servicers. In addition, servicers charge borrowers various direct fees, such as fax fees for sending (or receiving) a document via fax rather than through the mail. Prepayment penalties, however, when charged, are not typically retained by the servicer, but instead allocated to the holders of a special "P" tranche.

Ancillary fees are a crucial part of the servicers' income. For example, Ocwen Financial Corporation reported that in 2007 nearly 15% (just over $59 million) of its servicing income was derived from late fees and other loan collection fees.[139] In 2006, Countrywide, the largest servicer, reported $285 million in revenue from late fees alone,[140] representing nearly 10% of its total of $2.876 billion in operating revenue from servicing.[141] These fees reportedly covered Countrywide's entire servicing operating costs, leaving its servicing fees and float as pure profit.[142] Thus, in Countrywide's 2007 third quarter earnings call, Countrywide's President David Sambol emphasized that increased revenue from ancillary fees and insourced default management functions could offset Countrywide's losses from mortgage defaults:

> Now, we are frequently asked what the impact on our[]servicing costs and earnings will be from increased delinquencies and los[s] mitigation efforts, and what happens to costs. And what we point out is . . . that *increased operating expenses in times like this tend to be . . . offset by increases in ancillary income in our servicing operation,[]greater fee income from items like late charges, and importantly from[]in-sourced vendor functions* that represent part of our diversification[]strategy, a counter-cyclical diversification strategy such as our businesses[]involved in foreclosure trustee and default title services and property[]inspection services.[143]

In June 2010, Countrywide settled with the FTC for $108 million on charges that it overcharged delinquent homeowners for default management services. According to the FTC:

Fannie Mae/Freddie Mac, Maryland—Single Family—Uniform Instrument 11 § 14, https://www.efanniemae.com/sf/formsdocs/documents/secinstruments/doc/3021w.doc (last visited Oct. 24, 2010). Note that the Fannie Mae and Freddie Mac standard security instruments do not themselves impose a reasonableness or cost-relation requirement on the fees.

139. Ocwen Fin. Corp., *supra* note 132, at 27.

140. *See* Gretchen Morgenson, *Dubious Fees Hit Borrowers in Foreclosures*, N.Y. TIMES, Nov. 6, 2007, at A1.

141. Countrywide Fin. Corp., Annual Report (Form 10-K) 68 (Feb. 29, 2008), *available at* http://www.secinfo.com/dVut2.t21n.htm.

142. Ted Cornwell, *Countrywide: Fees Cover Cost of Servicing*, NAT'L MORTG. NEWS, May 17, 2004, at 6 (quoting Countrywide CEO Angelo Mozillo).

143. Transcript, Countrywide Fin. Corp., Q3 2007 Earnings Call (Oct. 26, 2007) (emphasis added), *available at* http://seekingalpha.com/article/51626-countrywide-financial-q3-2007-earnings-call-transcript. Sambol also mentioned that "[o]ur vertical diversification businesses . . . are counter-cyclical to credit cycles, like the lender-placed[]property business in Balboa and like the in-source vendor businesses in our[]loan administration unit." *Id.*

> Countrywide ordered property inspections, lawn mowing, and other services meant to protect the lender's interest in the property. . . . But rather than simply hire third-party vendors to perform the services, Countrywide created subsidiaries to hire the vendors. The subsidiaries marked up the price of the services charged by the vendors—often by 100% or more—and Countrywide then charged the homeowners the marked-up fees.[144]

Because servicers are permitted to retain ancillary fees, they have an incentive to charge borrowers as much in fees as they can, even if the fees are not provided for by the mortgage loan documents or a direct contract. Financially distressed homeowners are unlikely to notice unauthorized fees. Even if they do, they lack the fiscal and emotional wherewithal to fight them and get little benefit from avoiding them. Avoiding an illegal servicer fee will not cure a mortgage default, much less make the mortgage affordable going forward. Unless the homeowner has equity in the property, once that homeowner is losing the property, there is little point in haggling over another $15 or even $1000, especially as deficiency judgments are often not permitted and even when permitted, are frequently not pursued.

Servicers recover their fees before any payments are made to RMBS holders, so a larger deficiency judgment is of no consequence to the servicer, who is functionally the senior-most creditor within the RMBS priority scheme. If the mortgage is (legally or functionally) nonrecourse, as most mortgages are, and if there is no equity in the property (which is often the case in foreclosure), then illegal fees are ultimately coming out of RMBS investors' pockets, specifically from the junior-most in-the-money tranche.

Even small illegal fees, which are less likely to draw attention, can be quite profitable. Just one improper late fee of $15 on each loan in a fairly typically sized loan pool of 7000 loans would generate an additional $105,000 in income for the servicer. Whereas illegal fees on performing mortgages might engender complaints and pushback from the mortgagors, a defaulted homeowner is unlikely to have the presence of mind to notice an illegal fee, much less the financial means to fight it. Even if a mortgage is performing, a small fee is easily overlooked, especially as servicers are under no obligation to send borrowers detailed payment histories with the loan accounting, and typically send just an invoice. Thus, there is relatively low risk to imposing illegal fees upon defaulted accounts, and a significant upside.[145] If challenged

144. Press Release, Fed. Trade Comm'n, Countrywide Will Pay $108 Million for Overcharging Struggling Homeowners; Loan Servicer Inflated Fees, Mishandled Loans of Borrowers in Bankruptcy (June 7, 2010), *available at* http://www.ftc.gov/opa/2010/06/countrywide.shtm.

145. The major risk from illegal fees comes if the homeowner files for bankruptcy and the bankruptcy trustee or court reviews the fees. *See* Porter, *supra* note 19, at 131 (offering empirical evidence pointing to endemic servicer overcharges in bankruptcy cases). Yet, because of a provision in the Bankruptcy Code that makes it impossible to restructure defaulted mortgages in bankruptcy, bankruptcy is not an attractive option for defaulted homeowners seeking to keep their homes. *See*

about an illegal fee, a servicer can easily refund the fee, apologize, and claim that it was a one-off mistake; the homeowner is unlikely to pursue legal action or to know if illegal fees are a systemic practice.

There has been little investigation of illegal fees in general;[146] in bankruptcy, however, there is greater scrutiny of mortgagees' claims, and patterns of illegal fees become apparent and are challenged.[147] Katherine Porter has documented that when mortgage creditors file claims in bankruptcy, they generally list amounts owed that are much higher than those scheduled by debtors.[148] There is also growing evidence of servicers requesting payment for services not performed or for which there was no contractual right to payment. For example, in one particularly egregious case from 2008, Wells Fargo filed a claim in the borrower's bankruptcy case that included the costs of two brokers' price opinions on a property in Jefferson Parish, Louisiana. According to Wells Fargo, the price opinions were obtained in September 2005—a time when the entire Parish was under an evacuation order due to Hurricane Katrina.[149] Because of concerns about illegal fees, the United States Trustee's Office has undertaken several investigations of servicers' false claims in bankruptcy[150] and brought suit against Countrywide,[151] while the Texas Attorney General has sued American Home Mortgage Servicing for illegal debt collection practices.[152]

Similarly, Kurt Eggert has noted a variety of abusive servicing practices, including "improper foreclosures or attempted foreclosures; imposition of improper fees, especially late fees; forced-placed insurance that is not required or called for; and misuse of escrow funds."[153] Servicers' ability to retain

Levitin, *supra* note 19, at 582. Notably, much of the political opposition to legislation to amend the Bankruptcy Code to permit mortgage restructuring, which would invite more bankruptcy filings by homeowners, is from the mortgage *servicing* industry, which would come under much closer scrutiny. *See* Anne Flaherty, *Senate Defeats Anti-Foreclosure Bill*, ASSOCIATED PRESS, May 1, 2010, *available at* 2009 WLNR 8278698 (noting that JPMorgan Chase, Bank of America, and Wells Fargo played a prominent role in the effort to defeat the bill). *But see* Shahien Nasiripour, *Bank of America Now Supports Cramdown, Giving Judges Authority To Modify Home Mortgages*, HUFFINGTON POST (Apr. 13, 2010, 7: 10 PM), http://www.huffingtonpost.com/2010/04/13/bank-of-america-breaks-fr_n_536283.html (reporting that officials from Bank of America and Citigroup recently expressed support for judicial mortgage modifications, but also noting that "Bank of America and Citi were alone" among servicers on this issue).

146. *See* Eggert, *Limiting Abuse*, *supra* note 19, at 756.

147. This might explain part of the mortgage industry's opposition (spearheaded by servicers) to permitting modification of mortgages in bankruptcy—it would enable greater scrutiny of their fees.

148. Porter, *supra* note 19, at 162.

149. *In re* Stewart, 391 B.R. 327, 355 (Bankr. E.D. La. 2008).

150. Ashby Jones, *U.S. Trustee Program Playing Tough with Countrywide, Others*, LAW BLOG (Dec. 3, 2007, 10:01 AM), http://blogs.wsj.com/law/2007/12/03/us-trustee-program-playing-tough-with-countrywide-others.

151. Complaint, Walton v. Countrywide Home Loans, Inc. (*In re* Atchely), No. 05-79232, (Bankr. N.D. Ga. filed Feb. 28, 2008).

152. Complaint, State v. Am. Home Mtg. Servicing, Inc., No. 2010-3307 (Tex. Dist. Ct. 448th Jud. Dist. filed Aug. 30, 2010).

153. Eggert, *Comment*, *supra* note 19, at 287.

foreclosure-related fees has even led them to attempt to foreclose on properties when the homeowners are current on the mortgage or without attempting any sort of repayment plan.[154] Eggert also notes that because servicers keep the late fees they charge, they may delay in working with borrowers to bring loans current:

> Faced with a borrower who is only 30 days delinquent, a servicer may have interests that conflict with a rapid resolution of the delinquency. First of all, the servicer may be deriving substantial income from the continuing late fees. Second, the servicer might hope to save money by doing nothing, in the hope that the borrower will bring the loan current without any action.[155]

Subprime servicers may have an additional incentive to be aggressive in applying fees; their excess servicing margin (servicing fees net of costs) is often smaller than prime servicers'. While subprime servicers generally charge a fifty-basis-point servicing fee—twenty-five basis points higher than prime servicers—a 2003 study by the Office of the Comptroller of the Currency estimated subprime servicers' costs to be forty basis points higher than prime servicers.[156] We might extrapolate from this that excess servicing for subprime servicers is likely around fifteen basis points lower than for prime servicers.

Many servicers also insource activities like force-placed insurance, appraisals, title searches, and legal services to affiliated entities.[157] Insourcing allows servicers affiliates to charge inflated fees that get passed along to the homeowner and can come at the expense of investors if a foreclosure does not produce sufficient income to repay them all.

The profit potential of retained fee income gives servicers a financial incentive to overreach in imposing ancillary fees and to load up accounts with such fees. This practice lowers the ultimate return to investors by driving some borrowers into foreclosure in the first place or by reducing the share of foreclosure recoveries available to RMBS investors because of the senior priority of servicers' fees.

d. Retained Interest in Securitization and the "Titanic" Problem

Finally, when the servicer is an affiliate of the originator (or sponsor, or seller, or depositor), it will sometimes retain the junior, first-loss tranche of the

154. Eggert, *Limiting Abuse*, *supra* note 19, at 757.

155. Eggert, *Comment*, *supra* note 19, at 287.

156. Office of the Comptroller of the Currency, *supra* note 125, at 12-13. These costs may have come down since 2003, as subprime mortgage servicing was still in its infancy then.

157. Peter S. Goodman, *Lucrative Fees May Deter Efforts To Alter Loans*, N.Y. TIMES, July 30, 2009, at A1.

securitization pool.[158] The idea behind this is that by putting the servicer in the first-loss position, the servicer will be incentivized to maximize the performance of the loan pool. By holding the junior-most tranche, the servicer is in a position much like common shareholders in a corporation. Because they are paid last, the thinking goes, servicers will have the strongest interest in maximizing corporate value. In similar contexts, servicers appear to be sensitive to this incentive; Yingjin Gan and Christopher Mayer have shown that in commercial mortgage securitizations, servicer behavior depends on whether the servicer owns a first-loss position in the portfolio being serviced.[159]

The use of first-loss positions to align incentives ceases to be effective, however, if losses are high enough that the servicer's tranche is out-of-the-money. At that point, it is as if there is no first-loss position for the servicer. The inadequacy of first-loss positions to align incentives is a financial "*Titanic*" problem. The great ship was supposedly unsinkable because of watertight bulkheads that separated it into multiple seemingly hermetic compartments. Any one or two of those compartment could flood, and the ship could still remain afloat. The bulkheads in *Titanic*, however, were not built high enough to prevent spillover if the ship listed sufficiently. When *Titanic* hit an iceberg, her hull was breached below the waterline at the bow compartment, and as the water filled up the bow compartment, the ship started to list forwards under the weight of the water flooding the compartment. Eventually, the water thus spilled over the top bulkhead into the next compartment until the entire ship foundered.

Relying on a junior-most tranche for incentive alignment merely transposes a nautical architecture flaw into the financial world. Giving servicers a first-loss position, rather than an untranched "vertical" prorated interest in the SPV's assets, leaves PLS vulnerable to incentive misalignment during a sharp market decline, which is precisely when the servicer's role is most critical.

e. Advances and Reimbursable Expenses

Servicers are entitled to reimbursement for certain expenses related to delinquent loans under PSAs. First, servicers are entitled to reimbursement for any expenses they incur in foreclosure, such as title searches and the costs of protecting the collateral.[160] In contrast, servicers are not compensated in most cases for the additional costs (primarily labor) of modifying a loan or setting up a repayment plan.[161]

158. Joseph R. Mason, Mortgage Loan Modification: Promises and Pitfalls 20 (Oct. 3, 2007) (unpublished manuscript), *available at* http://ssrn.com/abstract=1027470.

159. Gan & Mayer, *supra* note 19.

160. Ocwen Fin. Corp., *supra* note 132, at 6.

161. Cordell et al., *supra* note 20, at 15.

Foreclosure expenses have priority in repayment over all other claims, including investors'. Servicers are thus paid off the top from foreclosure sale proceeds.[162] This means that unlike MBS investors or a portfolio lender, servicers are economically indifferent to property values (as long as there is minimal value) and that servicers have little incentive to maximize foreclosure-sale prices.

Second, servicers get reimbursement on advances. Servicers are required to advance monthly principal and interest ("P&I") and taxes and insurance ("T&I") payments on delinquent loans.[163] Servicers also advance legal fees, maintenance, and preservation costs ("corporate advances") on properties that have already been foreclosed and become wholly owned by the SPV (or REO), rather than sold to a third party.

Servicers are able to recover their P&I advances from the net proceeds of the property. If a servicer believes that the P&I advances will exceed the net proceeds, the servicer generally has the right to cease making the P&I advances and to look to the rest of the SPV's loan pool for recovery of any excess paid. This means that P&I advances are functionally the most senior claim on the SPV. As explained by Ocwen Financial, a major subprime servicer: "Most of our advances have the highest standing and are 'top of the waterfall' so that we are entitled to repayment [from loan proceeds] before any interest or principal is paid on the bonds."[164] In the majority of cases, the servicer may recover advances in excess of loan proceeds from pool-level proceeds.[165]

Because P&I advances are the senior-most claims on the SPV, they will almost always be recoverable so long as there is some land value remaining. Thus, the obligation to make P&I advances usually continues as long as the trust has an interest in the property.[166]

162. Ocwen Fin. Corp., *supra* note 132, at 6 ("The costs incurred in meeting these obligations [of advances] include, but are not limited to, the interest expense incurred to finance the servicing advances.").

163. The obligation to make advances is subject to the servicer's determination that they will be recoverable, see Cordell et al., *supra* note 20, at 15, but land value alone will usually suffice for advances to be recoverable on a first mortgage. Until 2008, for GSE loans, the advances were only made through the fourth month of delinquency, at which point the GSE would purchase the loan out of the pool. *Id*.

164. Ocwen Fin. Corp., *supra* note 132, at 4.

165. *Id*. at 26.

166. The limitations on servicer's requirement to make advances explains the mortgagee "walk away" problem that has surfaced in some severely depressed housing markets, however, such as Detroit and Cleveland. In these markets, the resale value of the property might be so low that it cannot cover the servicers' advances. In such cases, servicers simply stop collection actions and do not complete foreclosures, lest they take title to the property and liability for taxes and property nuisances. For municipalities, however, this creates a serious problem. The owner of record is still the homeowner, as there has been no completed foreclosure. But the homeowner has often abandoned the home. At best, the municipality can foreclose on its own tax lien, but then it is stuck with a property that it does not want.

T&I and corporate advances continue to be advanced as long as the net proceeds from a sale are projected to exceed future advances.[167] T&I and corporate advance, however, can only be recovered from the specific loan's proceeds, so if the mortgage is foreclosed, the servicer has to wait until the foreclosure sale or, if a third party does not buy at the foreclosure sale, the sale from REO to a third party.

Critically, servicers are not entitled to recover interest on these advances. Advances are an interest-free loan to the investors.[168] This makes servicing advances expensive for servicers, particularly ones that are unaffiliated with depositors and thus do not have access to a low-cost funding source.

Servicing advances can also present liquidity challenges for servicers. The servicer must have sufficient funds to be able to pay its regular operating expenses and the servicing advances. Liquidity is rarely a problem for servicers that are affiliated with large depository institutions; the deposit base alone provides sufficient liquidity, and the depository institution has a liquidity backstop through its access to the Federal Reserve's discount window or Federal Home Loan Bank advances.

For servicers that are unaffiliated with depositories, however, liquidity concerns can loom large if there is a large number of defaults in a portfolio. Thus, in 2008, subprime servicing specialist Ocwen—which is currently unaffiliated with a depository institution—began aggressively modifying defaulted loans, including write-downs of principal.[169] Ocwen did this in part because of the liquidity squeeze placed on it by servicing advances combined with tightened credit markets.[170] By modifying the loans and bringing them out of delinquency, Ocwen was able to reduce its obligation to make servicing advances, which reduced the strains on its liquidity. Other servicers have attempted to address liquidity concerns by securitizing their servicing fees in order to obtain immediate funds.[171]

f. Modeling Servicer Income and Costs on Defaulted Loans

The interaction between the various revenue and cost components of servicing is hard to see in the abstract. Thus, it is worth examining the impact of a default on a stylized loan. Consider a loan with a $200,000 unpaid principal balance at time of default. The loan note has a fixed interest rate of 8% with a thirty-year amortization. The monthly payments on the loan are thus $1467.53. If a servicer's cost of funds is 5%, then the total cost of funds for

167. Ocwen Fin. Corp., *supra* note 132, at 4.

168. *Id*. ("The costs incurred in meeting these obligations [of advances] include, but are not limited to, the interest expense incurred to finance the servicing advances.").

169. Kate Berry, *Debt Forgiveness: Ocwen Enters Uncharted Waters*, AM. BANKER, June 24, 2008, at 1.

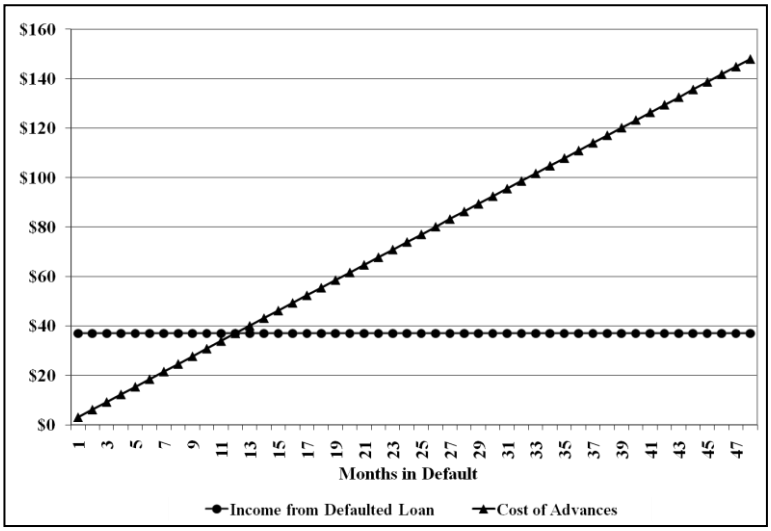
170. Kate Berry, *Ocwen Seeks U.S. Charter and a Bank Buy*, AM. BANKER, Dec. 3, 2008, at 1.

171. *See* Gardner, *supra* note 62.

advances (assuming no compounding) would be approximately $477 for twelve months, $1045 for eighteen months, and $1833 for twenty-four months.[172]

The cost of advances, however, will be offset, at least in part, by any ancillary fees that the servicer can levy (and ultimately collect in foreclosure). For simplicity's sake, assume that the only ancillary fee is a monthly late fee of 5% of the monthly payment, or $73.38. The servicer will not receive any float income or servicing fee on the defaulted loan. Thus, we can model the revenue streams from a stylized loan, as shown in Figure 9. This figure also shows that a servicer's income on a defaulted loan is flat, while the cost of advances increases linearly over time.

Figure 9: Comparison of Cost of Servicing Advances and Fee Income on Defaulted Loan[173]

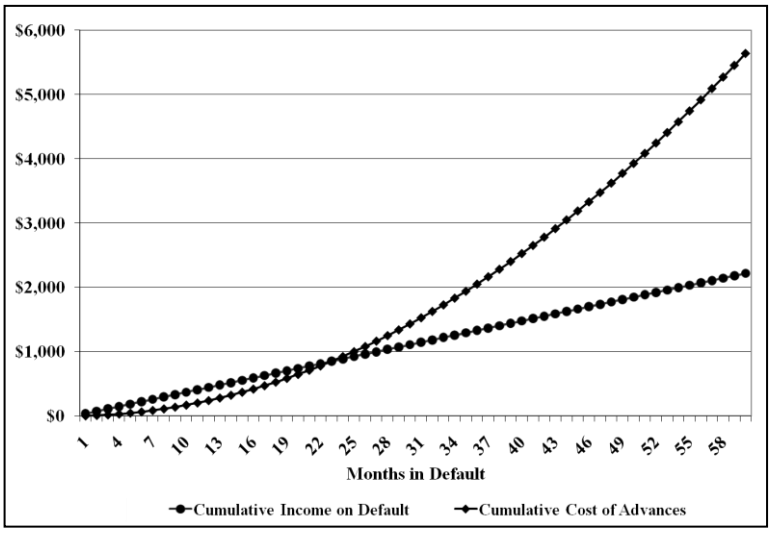


When monthly income and costs are viewed cumulatively over time, in Figure 10, the cumulative income increases linearly, while the cumulative costs increase exponentially.

172. The total cost of funds for making the monthly advance m for n months is equal to $m*(n+1)*(n/2)$. For this particular loan, the cost of funds for one month's advance would be $6.11 (the monthly cost of funds (.05/12) multiplied by the monthly advance amount ($1467.53). Thus, the cost of funds for twelve months of advances is $6.11*(12+1)*(12/2) ≈ $477. For eighteen months, it is $6.11*(18+1)*(18/2) ≈ $1045, and for twenty-four months, it is $6.11*(24+1)*(24/2) ≈ $1833.

173. Authors' calculations (assuming a fifty-basis-point servicing fee on a $200,000 original principal balance, with an 8% note rate on a thirty-year FRM and a 5% cost of funds for servicer).

Figure 10: Comparison of Cumulative Cost of Servicing Advances and Cumulative Servicing Income on Defaulted Loan[174]



To be sure, there are many factors not included in the model, such as servicers' transaction costs, overhead, and the like. But the model does provide a general sense of servicers' income on defaulted loans. All else being equal, higher monthly payments (a function of higher original principal balances, shorter amortization periods, and higher interest rates) shift the parabolic cumulative advance cost curve to the left (increasing a and b in the parabolic equation of $y=ax^2+bx+c$), meaning default becomes unprofitable for the servicer more quickly. Likewise, all else being equal, higher ancillary fee income (including from insourced functions) shifts the cumulative default income curve upwards (increasing b in the linear equation $y=mx+b$), meaning default stays profitable for the servicer for longer.

Figures 11 and 12 display the netting of the curves in Figures 9 and 10. Figure 11 shows the servicer's monthly net income for the stylized loan in default, while Figure 12 shows the servicer's cumulative monthly net income for a defaulted loan. Figure 11 shows that monthly net income on a defaulted loan continually falls, eventually becoming negative, while Figure 12 shows that the cumulative effect of a long default is to erode net profitability on a default.

Defaults can be quite costly to servicers, but they also provide new sources of income. Whether or not a default ends up being profitable for a servicer depends on the servicer's cost of funds for advances, the servicer's ability to levy junk fees and insource costs, and the length of time of the

174. *Id.*

default. As Figure 12 shows, a default can initially be profitable, and cumulative profits can increase over the course of the default, but after a certain point, the growing cost of advances will erode and eventually wipe out cumulative profitability. Servicers must play a delicate timing game when they manage defaults in order to maximize their own net revenue.

Figure 11: Servicer's Net Income if the Loan is in Default

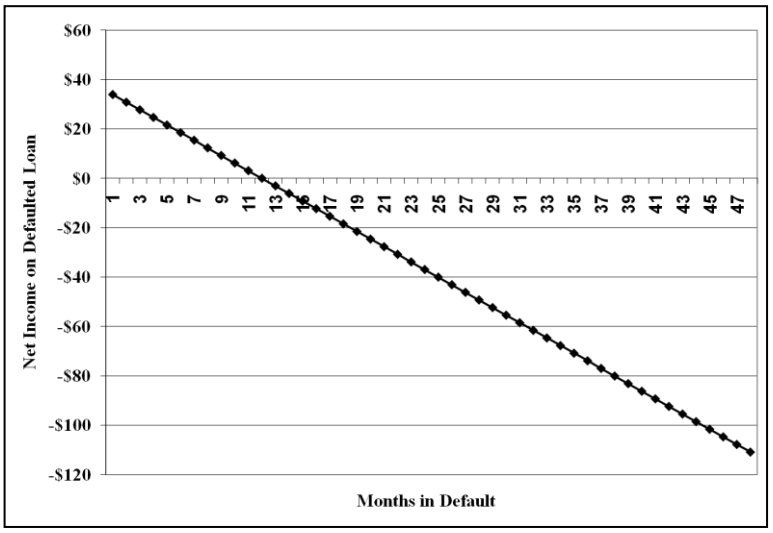
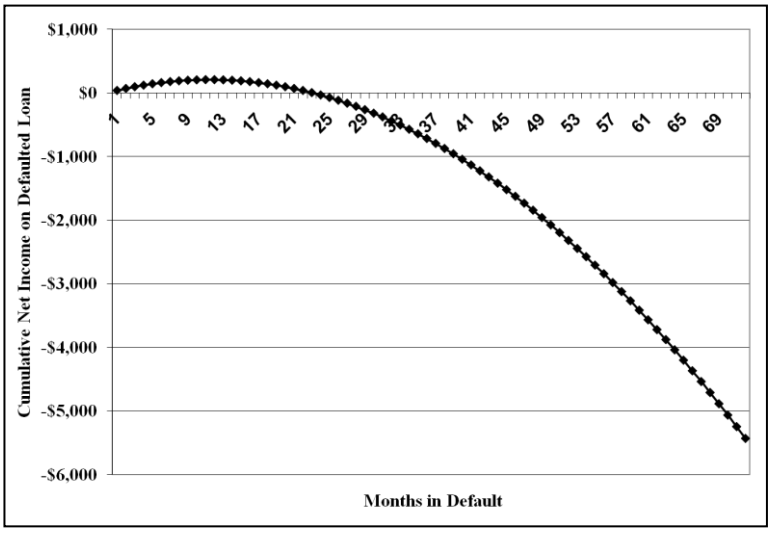


Figure 12: Servicer's Cumulative Net Income on Defaulted Loan



II. Regulation and Monitoring of Servicers

There is little regulation or monitoring of servicers, and what exists has little impact on servicers' loss mitigation activities. Servicers are subject to public regulation for both consumer and investor protection purposes. They are also subject to a private monitoring regime by securitization trustees and ratings agencies. Servicers for federally or GSE-insured or guaranteed mortgages are also subject to special regulation systems, and several states have limited regulation systems focused on registration. The following Sections explain each component of the servicer regulation and monitoring regimes and why they are ineffective at ensuring that servicers engage in optimal loss mitigation strategies.

A. Consumer Protection Regulations Applicable to Servicers

The consumer protection regime gives homeowners the right to know that servicing and ownership of their mortgage loan can be transferred, the right to receive notice of the transfer and contact information for the servicer and owner, and some error resolution rights. Homeowners are not, however, given any rights regarding loss mitigation decisions.[175] The Fair Debt Collection Practices Act ("FDCPA"), the primary protection for consumer debtors against debt collectors, has little applicability to mortgage servicers. Servicers are, however, subject to some provisions of the Real Estate Settlement Procedures Act ("RESPA")[176] and Truth in Lending Act ("TILA").[177] There are also specific regulations for government-insured and guaranteed mortgages, as well as state regulations, that apply only to servicers not affiliated with national banks and thrifts, and some private regulation through ratings agencies.

175. There are additional protections for mortgages that qualify for the federal government's Home Affordable Modification Program, but thus far, it does not appear that homeowners have a right of action for being wrongfully denied a HAMP modification. *See, e.g.*, Zoher v. Chase Home Fin., No. 10-14135, 2010 U.S. Dist LEXIS 109936, at *7-14 (S.D. Fla. Oct. 14, 2010) (finding no private right of action under HAMP); Marks v. Bank of Am., N.A., No. 03:10-cv-0803, 2010 U.S. Dist LEXIS 61489, at *13-20 (D. Ariz. June 21, 2010) (finding no private right of action under HAMP); Williams v. Geithner, 2009 U.S. Dist LEXIS 104096, at *13-14, *21 (D. Minn. Nov. 9, 2009) (denying motion for preliminary injunction to stop all foreclosures in Minnesota by bank defendants because plaintiffs "do not have a legitimate claim" that failure to grant them modifications under HAMP violates due process of law). *But see* Marques v. Wells Fargo Home Mortg., Inc., No. 09-cv-1985, 2010 U.S. Dist LEXIS 81879, at *16, *19 (S.D. Cal. Aug. 12, 2010) (concluding that the HAMP servicer participation agreement "expresses a clear intent to directly benefit the eligible borrowers" and that a borrower "may be able to state a claim against [Wells Fargo] as an intended beneficiary of the [a]greement").

176. 12 U.S.C. §§ 2601-2617 (2006).

177. 15 U.S.C.A. §§ 1601-1616 (West 2010).

1. Fair Debt Collection Practices Act

The main federal protection for consumer debtors is the Fair Debt Collection Practices Act.[178] The FDCPA prohibits a wide variety of collection actions, including collection of amounts not owed by contract. Although the FDCPA does not mandate loss mitigation by creditors, the ability to credibly allege violations of the FDCPA often gives a consumer debtor leverage to force a negotiated settlement.

The FDCPA, however, applies only to actions undertaken by "debt collectors,"[179] and the definition of "debt collector"[180] does not encompass mortgage servicers. Although the FDCPA definition covers entities that are in the business of using the "instrumentalities of interstate commerce" to collect the debts of others,[181] there is an exclusion for third-party debt collectors who "obtained" the debt before it was in default.[182]

The FDCPA does not define "obtained," but the legislative history unambiguously states that the term "debt collector" is not intended to cover "mortgage service companies and others who service outstanding debts for others, so long as the debts were not in default when taken for servicing."[183]

Thus, the FDCPA covers only servicers that obtain a mortgage that is already in default. This could arise either with a transfer of mortgage servicing rights or via the use of a special default servicer to handle delinquent loans, but neither situation is typical.

2. Real Estate Settlement Procedures Act

RESPA, which applies to almost all mortgage loans,[184] has four requirements regarding servicers.[185] First, RESPA requires disclosure to a mortgage loan applicant of "whether the servicing of the loan may be assigned, sold, or transferred to any other person at any time while the loan is outstanding."[186]

178. 15 U.S.C. § 1692a-1692p (2006).

179. *Id.* § 1692b-1692i.

180. *Id.* § 1692a(6).

181. *Id*.

182. *Id.* § 1692a(6)(F)(iii).

183. S. REP. NO. 95-382, at 3-4 (1977), *reprinted in* 1977 U.S.C.C.A.N. 1695, 1698; *see also* Brown v. Morris, 243 F. App'x 31, 34-35 (5th Cir. 2007).

184. RESPA applies to "federally related mortgage loans," a term defined to include all mortgage loans made by federally insured lenders, guaranteed or insured by the federal government, intended to be sold to a GSE or to a financial institution that will sell them to a GSE, or made by any creditor who invests more than $1 million annually in real estate. *See* 12 U.S.C. § 2602(1) (2006). The result is to cover virtually all mortgage loans except for those made by individuals.

185. The Secretary of Housing and Urban Development is empowered to pass regulations under RESPA, 12 U.S.C. § 2617(a), and has enacted a regulation that explicates the RESPA servicing provision but does little to change its essential terms. *See* 24 C.F.R. § 3500.21 (2010).

186. 12 U.S.C. § 2605(a).

Second, RESPA requires that if the servicing of a loan is transferred, both the transferor servicer and transferee servicer: must give the borrower advanced notice; must provide the borrower with contact information for the new servicer;[187] must disclose any impact that the transfer will have on mortgage insurance;[188] and must provide a "statement that the assignment, sale, or transfer of the servicing of the mortgage loan does not affect any term or condition of the security instruments other than terms directly related to the servicing of such loan."[189] RESPA transfer notices do not break down the amount owed or provide the current status of the loan (for example, current or in default).[190]

Third, RESPA regulates mortgage escrow accounts and mandates escrow account disclosures at closing and each year thereafter.[191] The disclosures must itemize the amount to be paid into the account by the borrower and the amount disbursed from the account by the servicer. There is generally no private right of action available to the borrower if the servicer fails to comply with the escrow requirements.[192]

Fourth, RESPA imposes a duty on mortgage servicers to respond to qualified written requests from borrowers for information regarding the loan's status and history, and to respond to requests for the correction of account errors.[193] RESPA also protects borrowers by limiting late fees during a servicing transfer period, and it creates a private right of action against servicers for failure to comply with its provisions.[194]

The result is that a mortgagor with a nongovernment-insured mortgage is entitled to a generic notice that their mortgage could be serviced by someone other than the initial lender, some advance notification if the servicing on their mortgage is to be transferred, notice that the transfer does not affect the loan, and some limited error resolution rights.

187. *Id.* § 2605(b)-(c).

188. *Id.* § 2605(b)(3)(F).

189. *Id*. § 2605(b)(3)(G).

190. *See* 24 C.F.R. § 3500 app. B (2010) (regarding a sample RESPA notice).

191. 12 U.S.C. §§ 2605(g), 2609.

192. A private right of action is only available if the servicer fails to make timely escrow payments as required by 12 U.S.C. § 2605(g). Violations of the escrow requirements contained in § 2609 have no private right of action.

193. The requests must identify the borrower and account as well as the information the borrower seeks or the account error the borrower wishes to correct. 12 U.S.C. § 2605(e). The servicer must acknowledge receipt of the inquiry within twenty business days and has sixty business days to respond to the substance of the inquiry. *Id*. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 1463, 124 Stat. 1376, 2182, reduces these time periods to five and thirty days, respectively. The servicer is supposed to correct any errors to the account or explain in writing why the servicer believes the account is correct, 12 U.S.C. § 2605(e)(2), but does not provide any special mechanism for resolving disputes. RESPA thus gives homeowners some error resolution rights against servicers that are similar to those the Truth in Lending Act gives them against the actual holder of the loan. *See* 15 U.S.C. § 1666(a) (2006).

194. 12 U.S.C. § 2605(f).

These rights are of limited value. The initial notice that servicing rights *could* be transferred does not tell the borrower whether they *will* be transferred, much less to whom and on what terms. Moreover, the initial notice is only one piece in the mountain of paperwork that confronts a borrower at a real estate closing; a typical borrower is unlikely to read most of these disclosures, much less cogitate over their significance.[195] Although RESPA notices may be useful for the borrower in ensuring that payments are made to the proper party, the homeowner still has no say in the servicing.

RESPA's procedural error resolution rights are important, but if the homeowner is not satisfied, the only remedy is the expensive one of litigation. A homeowner does not have a right to withhold payment because of an alleged account error; doing so could result in the servicer commencing a foreclosure action.[196] The typical homeowner is unlikely to gamble with his or her home in this way. As a result, homeowners are likely to accept small servicing errors. Individually, these errors may not amount to much in dollar terms, but in aggregate, they could be tremendous. A profit-maximizing servicer recognizes the leverage this provides and how it is essentially a license for aggressive or illegal billing practices. A servicer will levy charges to which it is not entitled and will retain the funds unless it encounters strong homeowner pushback, in which case it will refund the homeowner and apologize for the error.[197]

RESPA's significance for servicing is not the rights it grants, but those it does not. RESPA does not allow borrowers to choose their servicer or have any say in how the servicer handles their loan beyond complaining of errors. If a borrower is dissatisfied with a servicer, the borrower can sue the servicer for specific acts, but has no ability to switch servicers, and there is no cause of action for a homeowner not offered a loss mitigation option instead of foreclosure.

3. Truth in Lending Act

Prior to 2009, the Truth in Lending Act had little applicability to mortgage servicing. The Helping Families Save Their Homes Act of 2009, however,

195. To be sure, a borrower whose loan is originated by a small mortgage bank or broker is likely to intuit that the servicing will be handled by another party.

196. 24 C.F.R. § 3500.21(e)(4)(ii) (2010) (permitting servicers to pursue collection remedies, including foreclosure, even if borrowers allege accounting errors). While statutory penalties could provide a check on servicers' conduct, such statutory damages are not available under RESPA unless the borrower demonstrates a pattern and practice of noncompliance. *See* 12 U.S.C. § 2605(f)(1).

197. RESPA clearly permits class actions. Courts, however, have generally denied class certification. *See, e.g.*, Friedman v. Mkt. St. Mortg. Corp., 520 F.3d 1289 (11th Cir. 2008) (reversing district court's decision to certify class and remanding case with instructions to dismiss RESPA claims with prejudice); O'Sullivan v. Countrywide Home Loans, Inc., 319 F.3d 732 (5th Cir. 2003) (reversing district court's certification of class in RESPA "kickback" suit). When available, class action damages are limited to actual damages and the lesser of $1 million or 1% of the net worth of the servicer. Dodd-Frank Wall Street Reform and Consumer Protection Act § 1463. Prior to the Dodd-Frank Act, damages were limited to the lesser of $500,000 and 1% of the net worth of the servicer.

brought servicing under some parts of TILA.[198] Now, whenever a "mortgage loan is sold or otherwise transferred or assigned to a third party, the creditor that is the new owner or assignee of the debt shall notify the borrower in writing of such transfer" within thirty days of the transfer.[199] There is also a private right of action for violations of the provision with statutory damages of up to $4000 and reasonable legal fees.[200] An assignment to a servicer, however, is not covered by TILA.[201]

TILA also requires servicers to provide, upon written request by the mortgagor, the contact information for the master servicer or the owner of the mortgage loan.[202] Although there is a private right of action for failure to provide the information, there is no deadline for the information's provision.

TILA does not create any borrower rights to loss mitigation actions or mandate any particular loss mitigation undertakings, but the 2009 amendments to TILA aimed to encourage loan modifications to ease the foreclosure crisis by creating a safe harbor for servicers that undertake modifications of distressed loans that would maximize NPV. TILA now provides that for loans in existence before the 2009 amendment, "notwithstanding any other provision of law," whenever a servicer enters into a qualified loss mitigation plan, including for "mortgages held in a securitization or other investment vehicle," any duty the servicer owes to investors to maximize NPV of the mortgages is a duty owed to all investors, rather than to any particular investor.[203] This provision aims to prevent servicers from becoming caught in the middle of "tranche warfare" litigation between different tranches of RMBS investors.

The safe harbor also provides that a servicer fulfills such a duty if it implements a loss mitigation plan for owner-occupied mortgages in default or for which default is imminent or reasonably foreseeable, so long as the servicer has reasonably determined, consistent with Treasury foreclosure prevention program guidelines, that the loss mitigation plan will result in a smaller loss than foreclosure.[204] Finally, the safe harbor provides that servicer shall not be liable to any party to whom it owes a duty to maximize NPV "based solely upon the implementation by the servicer of a qualified loss mitigation plan."[205] However, it is doubtful whether this safe harbor would extend to a servicer's breach of explicit loan modification restrictions in a PSA. TILA's safe harbor thus gives some minimal legal protection to servicers against investors, but does not give homeowners any rights to loss mitigation.

198. Helping Families Save Their Homes Act of 2009, Pub L. No. 111-22, §§ 201, 404, 123 Stat. 1632, 1638-40, 1658 (to be codified at 15 U.S.C. §§ 1639a, 1640(a), 1641(g)).

199. *Id*. § 404(a).

200. 15 U.S.C. § 1640(a)(2)(iv) (2006).

201. *Id.* § 1641(f)(1).

202. *Id.* § 1641(f)(2).

203. Helping Families Save Their Homes Act § 129(a).

204. 15 U.S.C. § 1639a(a)(2).

205. Helping Families Save Their Homes Act § 129(b).

B. Investor Protection Regulations Applicable to Servicers: Regulation AB

Because of their involvement in the securities industry, servicers are also subject to some investor protection regulations. Since 2005, servicers of securitized loan pools have been subject to Regulation AB ("Reg AB"),[206] promulgated in 2005 by the SEC under the Securities Act of 1933 and the Securities Exchange Act of 1934. Reg AB does not apply to agency MBS; it applies solely to PLS.[207]

Reg AB is a disclosure regulation that requires various types of potentially material information about asset-backed securities ("ABS"), including RMBS. Unlike with corporate securities, there is generally no business or management to describe for ABS, and GAAP financial information about the issuing entity (the SPV) is of little use to investors. "Instead," according to Reg AB, "information about the transaction structure and the characteristics and quality of the asset pool and servicing is often what is most important to investors."[208]

Therefore, Reg AB requires the sponsor of the securitization transaction—usually an investment bank or financial holding company—to provide information on the past performance of the "static pool"—the prior securitized pools of the securitization transaction's sponsor, including delinquencies, cumulative losses, and prepayments.[209] Because the static pool information is about the past deals of the transaction's sponsor, it does not necessarily inform investors about the *servicer's* past performance, especially if servicing rights are not retained by an affiliate of the sponsor.

In addition, Reg AB requires disclosure of information regarding the servicer's function, experience, and servicing practices, including loss mitigation and ability to modify terms, fees, or penalties.[210] The servicer is also required to certify its compliance with the PSA as part of the MBS issuer's Form 10-K annual report,[211] so false certification creates securities law liability for the servicer to both the SEC and investors.

Reg AB is designed to promote disclosure so that there will be sufficient information for market discipline to ensure optimal outcomes. Reg AB, however, cannot overcome the informational problems inherent in PLS. PLS are heterogeneous products. PLS deals vary from each other not only by sponsor, but even deal to deal because of differences in the quality of the underlying collateral, borrowers, and transaction structures. For the collateral,

206. Asset-Backed Securities, 70 Fed. Reg. 1506-1631 (Jan. 7, 2005) (codified at 17 C.F.R. §§ 210, 228, 229, 230, 232, 239, 240, 242, 245, 249 (2010)).

207. 15 U.S.C. § 77(d)(5)(B) (concerning the exemption from registration requirements for Fannie Mae, Freddie Mac, and Ginnie Mae); *id.* § 77ddd(a)(5) (regarding the exemption from the Trust Indenture Act for securities backed by Federal Housing Administration-insured loans).

208. Asset-Backed Securities, 70 Fed. Reg. 1506, 1508 (Jan. 7, 2005).

209. 17 C.F.R. § 229.1105 (2010).

210. *Id.* § 229.1108 (c)(5)-(6).

211. *Id.* §§ 229.1122-.1123, 240.15d-.18.

LTV distributions, lien priority, property locations, and occupancy status will vary between deals. So too will borrowers' credit scores, loan sizes and vintages, debt-to-income ratios, and income documentation status. And deals vary in their tranching structures and other credit enhancements. The heterogeneity of PLS makes it very difficult to compare deals in a way to isolate the impact of particular features in a transaction, like servicing, on the pool's ultimate performance. While Reg AB does ensure greater information disclosure, it cannot overcome the fundamental information asymmetry in securitization between securitization sponsors and servicers and investors. Sponsors and servicers will always know far more about the securitized assets and servicing practices than investors.

C. Supervision of Servicers by Investors and Trustees

There is very little supervision of servicers. RMBS investors are globally dispersed, presumably diversified, and hold transferable securities. These characteristics reduce their ability and incentive to monitor servicers. Moreover, RMBS investors have little ability to supervise their servicers. They have no direct contact with servicers and no ability to examine servicers' decisions, including how to handle a defaulted loan. Instead, their interests are supposed to be represented by the securitization trustee.

The securitization trustee is not a traditional trustee with a full set of fiduciary duties. Instead, it is a corporate trustee with narrow and specifically defined duties and no others.[212] As a Moody's report noted "some trustees have characterized their role in ABS and RMBS transactions as an essentially administrative one. They have argued that their conduct is subject to the 'prudent person' standard of care only after a transaction has defaulted."[213]

212. *See, e.g.*, Wells Fargo Mortg. Backed Sec. 2006-AR10 Trust, Pooling and Servicing Agreement (Form 8-K) § 8.01, at 11 (June 29, 2006), *available at* http://www.secinfo.com/dRSm6.v2Ac.c.htm [hereinafter Wells Fargo MBS 2006-AR10] ("The Trustee, prior to the occurrence of an Event of Default of which a Responsible Officer of the Trustee shall have actual knowledge and after the curing of all Events of Default which may have occurred, undertakes to perform such duties and only such duties as are specifically set forth in this Agreement."). *See generally* John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 YALE L.J. 165, 172 (1997) (noting that trusts are used to finance trillions of dollars of mortgage, credit card, automobile, and student loan debt); Steven L. Schwarcz, *Commercial Trusts as Business Organizations: An Invitation to Comparatists*, 12 DUKE J. COMP. & INT'L L. 321 (2003); Steven L. Schwarcz, *Commercial Trusts as Business Organizations: Unraveling the Mystery*, 58 BUS. L. 559 (2003).

213. MOODY'S INVESTOR SERV., MOODY'S RE-EXAMINES TRUSTEES' ROLE IN ABS AND RMBS 2 (2003), *available at* http://www.moodys.com.ar/PDF/Research/Trustee%27s%20Role.pdf; *see also* FITCH RATINGS, REVIEWING STRUCTURED FINANCE TRUSTEES 1 (2001) ("Market participants' perspectives on trustee roles and responsibilities, interpretation of indenture agreement provisions, and reasonable expectations of trustee performance vary widely. Some, including the trustees, contend that the transaction documents and the minimal fees limit the degree to which trustees can be expected to affect the performance of structured transactions. Others believe that trustees are provided sufficient latitude in the documents and should be pricing their services to more effectively and proactively protect investor interests.").

Consistent with this view, PSAs contain broad exculpations for trustees.[214] Unless there is an "Event of Default"—the financial collapse of the servicer, failure of the servicer to remit funds to the trust, or the failure of the servicer to file certain regulatory reports[215]—the trustee's duties consist of monitoring the trusts' agents (primarily the servicer) and making periodic distributions and trust performance reports to MBS holders.[216] The trustee also plays the role of a financial backstop. In the event that the servicer fails to remit payments to the trust, the trustee must make the servicing advances,[217] and the trustee must act as backup servicer in the event that the servicer cannot perform its duties.[218] The backup servicer duty is primarily as a financial guarantor, rather than an actual fallback servicer. As Eric Gross has noted, "the Trustee collect[s] the backup servicer fee even though, if required, they d[o] not have the ability or capacity to perform the servicing duties. The rational[e] being that, if a problem arose . . . the Trustee could locate and contract with the servicer to assume portfolio servicing responsibility."[219]

RMBS trustees are essentially passive ministerial entities and financial backstops; they play only a bit part in the management of the SPV's assets.[220] As Fitch Ratings has noted, "[t]he trustee's role in ABS transactions has clearly

214. *See* Wells Fargo MBS 2006-AR10, *supra* note 212, § 8.01, at 11 ("Prior to the occurrence of an Event of Default of which a Responsible Officer of the Trustee shall have actual knowledge and after the curing of all such Events of Default which may have occurred, the duties and obligations of the Trustee shall be determined solely by the express provisions of this Agreement, the Trustee shall not be liable except for the performance of such duties and obligations as are specifically set forth in this Agreement, no implied covenants or obligations shall be read into this Agreement against the Trustee and, in the absence of bad faith on the part of the Trustee, the Trustee may conclusively rely, as to the truth of the statements and the correctness of the opinions expressed therein, upon any certificates or opinions furnished to the Trustee, and conforming to the requirements of this Agreement.").

215. *See id.* § 7.01, at 10.

216. Some deals define a level of mortgage loan defaults reaching a particular threshold as a servicer event of default. *See, e.g.*, ABFC 2006-OPT1, *supra* note 101, § 7.01(a)(v) (terminating the servicing arrangement if more than 18% of the pool, as determined by dollar amount, is more than sixty days deliquent); Argent Sec. Inc. Asset-Backed Pass-Through Certificate Series 2003-W5, Pooling and Servicing Agreement (Form 8-K) § 1.01, at 28 (Oct. 9, 2003), *available at* http://www.secinfo.com/dqTm6.21Kx.d.htm ("With respect to any Distribution Date, the Master Servicer Termination Test will be failed if the Cumulative Loss Percentage exceeds 4.00%."); Asset Backed Sec. Corp. Home Equity Loan Trust Series NC 2005-HE8, Pooling and Servicing Agreement (Form 8-K) § 1.01 (Dec. 22, 2005), *available at* http://www.secinfo.com/d13f21.z131.d.htm (providing for termination of the servicer if the loss percentage for mortgage loans exceeds 5% after November 2010, with lower termination thresholds for pre-2010 dates).

217. *See* Wells Fargo MBS 2006-AR10, *supra* note 212, § 8.14, at 11.

218. *Id.* § 7.05, at 10 ("When the Master Servicer receives notice of termination . . . or the Trustee receives the resignation of the Master Servicer . . . , the Trustee shall be the successor in all respects to the Master Servicer in its capacity as master servicer under this Agreement . . . and be subject to all the responsibilities, duties and liabilities relating thereto placed on the Master Servicer . . . .").

219. Eric Gross, *Portfolio Management: The Evolution of Backup Servicing*, SECURITIZATION.NET, July 11, 2002, http://www.securitization.net/knowledge/article.asp?id=147&aid=2047. Gross also describes the function of a stand-alone backup servicer: "Historically, backup servicers did little more than receive a monthly data tape from the primary servicer, verify it could be read and placed the tape on a shelf." *Id.*

220. Eggert, *Limiting Abuse*, *supra* note 19, at 754.

been marginalized over time due to a combination of fear of liability and low fees."[221]

In theory, the trustee is supposed to monitor the servicer, but trustees have little incentive to do so vigorously and little potential recourse against servicers. Trustee monitoring of servicers is generally passive. Trustees rely on servicers' data reporting and have little obligation to analyze it.[222] As Moody's notes:

> The trustee is not in a position to verify certain of the numbers reported by the servicer. For example, the amount of delinquent receivables and the amount of receivables charged off in a given month are figures that are taken from the servicer's own computer systems. While these numbers could be verified by an auditor, they are not verifiable by the trustee.[223]

Trustees also generally wait for servicers to notify them of servicer defaults,[224] and trustees are often unresponsive to information from third parties indicating breaches by servicers.[225]

Trustees cannot fire servicers except for specific causes outlined in the PSA. Generally, this is limited to failures to remit payments to the trust or the servicer's insolvency.[226] Some PSAs also permit the firing of the servicer if defaults on the mortgages rise above a certain threshold.[227] Such provisions have little disciplining effect, however, because the servicer cannot control default levels. The servicer can encourage defaults to be cured by offering restructurings, but this creates the danger that the servicer will be incentivized to restructure loans too aggressively and fail to maximize economic value for the trust. In any case, the trustee has little interest in firing the servicer, as the trustee is required to become the stand-in servicer unless another qualified servicer can be found, and corporate trust departments at large banks have no interest in picking up this role.

Additionally, there is often a very close relationship between the servicer and the trustee; many originators and servicers have a "pet" or "pocket" trustee that they use for most of their deals. For example, nearly two-thirds of Bank of New York Mellon's ("BNY Mellon") RMBS trusteeships are for Countrywide-

221. *Fitch: Seller/Servicer Risk Trumps Trustee's Role in U.S. ABS Transactions*, BUS. WIRE, Feb. 24, 2003, http://findarticles.com/p/articles/mi_m0EIN/is_2003_Feb_24/ai_98008927.

222. MBIA Ins. Corp. v. Royal Indem. Co., 321 F. App'x 146, 149 (3d Cir. 2009) ("Royal argues that Wells Fargo [the trustee] had the contractual obligation to analyze data using certain financial accounting principles and to detect any anomalies that analysis might have uncovered. As Royal suggests, this analysis may not have been very labor-intensive. Yet, the contract did not call for any analysis at all. It simply required Wells Fargo to perform rote comparisons between that data and data contained in various other sources, and to report any numerical inconsistencies. Wells Fargo did just that.").

223. *See* MOODY'S INVESTOR SERV., *supra* note 213, at 4.

224. *Id.*

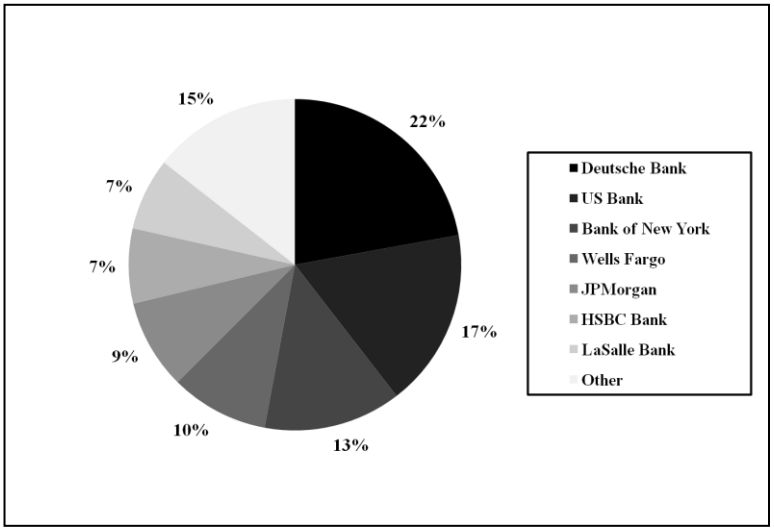
225. *Id.*

226. *See, e.g.*, Wells Fargo MBS 2006-AR10, *supra* note 212, § 7.01.

227. *See* sources cited *supra* note 216.

Bank of America deals.[228] This is hardly unique given the concentration in the trustee market, shown in Figures 13 and 14, with seven trustees making up around 90% of the market, and four trustees comprising around two-thirds of the market. This broader relationship has the potential to reduce monitoring of the servicer by the trustee. Because such a large portion of BNY Mellon's RMBS trustee business comes from one single depositor, BNY Mellon will inevitably have to be deferential to that depositor. And because the depositor frequently serves as the servicer, BNY Mellon as trustee will have a strong incentive to be deferential to Countrywide as servicer.

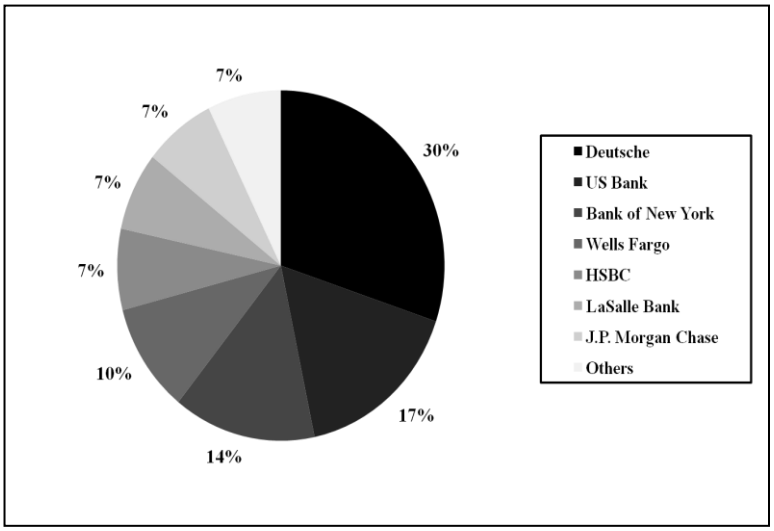
Figure 13: MBS Trustee Market Share by Issuance Amount, 2003-2009 Cumulative[229]



228. Of BNY Mellon's 1840 RMBS trusteeships, 1064 (58%) were for Countrywide, and an additional 72 (4%) were for Bank of America. Bank of New York Mellon had 7869 total trusteeships, of which 1136 (14%) were for Countrywide-Bank of America. *See* Bank of New York Mellon Corp., Global Corporate Trust Reporting, https://gctinvestorreporting.bnymellon.com/Home.jsp (last visited Oct. 26, 2010) (follow "View All" link on right side; then choose "RMBS" under "Search Product Type" dropdown menu; mark "By Deal" option in tool bar; click "Search" to see number of RMBS deals; choose "ALL" under "Select Product Type" to see total trusteeships; and jump to "B" and "C" under "Quick Issuer Lookup" menu to see total number of Bank of New York-Countrywide-affiliated securitizations).

229. *See Non-Agency MBS and Non-Mortgage ABS Trustees*, INSIDE MORTG. FIN. PUBL'G, http://www.imfpubs.com/data/mbs-abs_trustees.html (last visited Dec. 13, 2010) (subscription access) (on file with authors).

Figure 14: MBS Trustee Nonprime Market Share by Issuance Amount, 2003-2009 Cumulative[230]



Corporate trustees can easily have oblique conflicts of interest like a business relationship dependency, such as the one between Countrywide and BNY Mellon. This oblique conflict further diminishes the trustee's already limited incentive to monitor the servicer, even within its limited duties.

Recently, investors have become more active in their attempts to monitor servicers. A major challenge for investors is that they must act collectively to make a demand on the trustee. The collective action threshold required varies from deal to deal, but typically 25% of the voting rights across all tranches (or sometimes 25% of the voting rights in a single tranche) is required for PLS investors to collectively demand action by the trustee.[231] Higher thresholds, typically 51% of voting rights are required to remove the trustee.[232] It is difficult for investors to achieve these collective action thresholds for two reasons. First, investors simply do not know who the other investors are in particular deals, and institutional investors tend to be quite secretive about their investment positions. Second, tranching means that investors can have interests

230. *Id.*

231. *See, e.g.*, Citigroup 2007-AMC1, *supra* note 106, § 7.01(i)-(ii) (noting that 25% of voting rights are required for PLS investors to initiate declaration of servicer default); *id.* § 8.02(a)(v) (stating that trustee investigation requires request by 25% of voting rights); RAMP 2006-RZ4, *supra* note 105, § 7.01 (noting that 25% of voting rights in a single class are necessary to declare a servicer event of default); *see also* Greenwich Fin. Servs. Distressed Mortg. Fund 3, LLC v. Countrywide Fin. Corp., No. 650474/08 (N.Y. Sup. Ct. Oct. 7, 2010) (dismissing investors' suit for failure to meet the collective action threshold).

232. *See, e.g.*, Citigroup 2007-AMC1, *supra* note 106, § 8.07 (stating that 51% of voting rights are required to remove the trustee).

adverse to each other. Super-senior tranches are unlikely to support demands for action because they see no advantage in rocking the boat, while out-of-the-money junior tranches will only act if they anticipate a sufficient likelihood that they will recover a portion of their claim.

Investors have begun to coordinate through law firms, however, and have made their first public demand on a trustee in regard to servicing. Investors (including BlackRock, PIMCO, and the Federal Reserve Bank of New York) claiming to represent 25% of the voting rights in 115 Countrywide-issued RMBS trusts with an initial value of $47 billion have notified BNY Mellon, the trustee for these deals, that the servicer, Countrywide Home Loans Servicing LP, has failed to meet its servicing obligations. Among other allegations, Countrywide allegedly failed to pursue representation and warranty claims on the mortgage loans against the loans' seller(s) to the trusts (presumably against a Countrywide affiliate), and incurred avoidable and unnecessary servicing fees and advances by sourcing reimbursable work to affiliated vendors who charged significantly above-market prices.[233] Failure by Countrywide to cure the (incurable) breaches within sixty days, the investors allege, would be an event of default permitting the removal of Countrywide as servicer.[234]

Other investors have been working to assemble the necessary collective action thresholds to make demands on trustees to take action against servicers, primarily to ensure compliance with representations and warranties on the loans, with the goal of obtaining "putbacks" of the loans to the securitization sponsors.[235] Major securitization sponsors (affiliated with servicers) have vowed to fight putback claims vigorously,[236] resulting in "a Korean ground war" fought on a loan-by-loan basis.[237] Collective action problems created by PSAs pose a significant obstacle to effective investor discipline of servicers.

233. Letter from Kathy D. Patrick, Partner, Gibbs & Bruns LLP, to Countrywide Home Loans Servicing LP and the Bank of New York (Oct. 18, 2010), *available at* http://www.scribd.com/Bondholders-Letter-to-BofA-Over-Countrywide-Loans-inc-NYFed/d/39686107.

234. *Id*. at 5-6.

235. *See* Dawn Kopiecki & Jody Shenn, *N.Y. Fed May Require Banks To Buy Back Faulty Mortgages, Assets*, BLOOMBERG, Aug. 5, 2010, http://www.bloomberg.com/news/2010-08-04/new-york-fed-may-make-banks-buy-back-faulty-mortgages-bought-in-bailouts.html; John W. Schoen, *Lenders Face Mounting Mortgage Claims*, NBC N.Y., Nov. 9, 2010, http://www.nbcnewyork.com/news/business/Lenders_face_mounting_mortgage_claims-106962198.html.

236. David Mildenberg, Erik Schatzker & Andrew Frye, *BofA Will 'Defend' Shareholders in Mortgage Buybacks*, BLOOMBERG, Oct. 19, 2010, *available at* http://www.businessweek.com/news/2010-10-19/bofa-will-defend-shareholders-in-mortgage-buybacks.html.

237. *See* Al Yoon, *Mortgage Pioneer Capasse Shuns Repurchase Strategy*, REUTERS, Nov. 10 2010, http://www.reuters.com/article/idUSTRE6A95SJ20101110.

D. Market Segment Specific Regulations

1. Housing and Urban Development Regulations for Mortgages Insured by the Federal Housing Administration

The sparseness of servicer regulations under RESPA contrasts notably with servicing requirements for the government and government-sponsored enterprises. A number of government agencies insure or guarantee mortgages or mortgage-backed securities, and they all have detailed servicing requirements that address loss mitigation in particular.

For mortgages insured by the Federal Housing Administration ("FHA"), servicers are subject to additional Housing and Urban Development ("HUD") regulations, including specific loss mitigation procedures.[238] Specifically, HUD requires mortgagees of FHA-insured mortgages (or the mortgagees' servicers) to "consider the comparative effects of their elective servicing actions, and must take those appropriate actions which can reasonably be expected to generate the smallest financial loss to the Department."[239] These regulations also provide that "[c]ollection techniques must be adapted to individual differences in mortgagors and take account of the circumstances peculiar to each mortgagor."[240] The term "collection techniques" includes loan modification.[241] However, these regulations specify a number of explicitly permitted loss mitigation techniques, which might imply that other techniques are not permitted. FHA regulations permit mortgagees or their servicers to accept a deed in lieu of foreclosure,[242] conduct a short sale,[243] file a partial FHA insurance claim,[244] permit assumption of the mortgage by another borrower,[245] forbear from collecting on the debt if the default is found by the mortgagee to be "due to circumstances beyond the mortgagor's control,"[246] and modify through reamortization of unpaid principal balance and accrued but unpaid interest and fees over a term of up to thirty years.[247] Additionally, if the default is "due to circumstances beyond the mortgagor's control," "special forbearance" is permitted.[248]

238. 24 C.F.R. § 203.500-.681 (2010).
239. *Id.* § 203.501.
240. *Id.* § 203.600.
241. *Id.* § 203.616. This provision, however, only authorizes reamortization of unpaid principal and arrearage over a maximum of thirty years. It is not clear whether this excludes other modifications.
242. *Id.* § 203.357.
243. *Id.* § 203.370.
244. *Id.* § 203.414.
245. *Id.* § 203.512.
246. *Id.* § 203.471-.615.
247. *Id.* § 203.616.
248. *Id.* § 203.614.

HUD must approve the form of delinquency notices,[249] and the servicer must make a reasonable attempt to have a face-to-face interview with the defaulted homeowners.[250] For defaulted loans, servicers must evaluate on a monthly basis the most appropriate loss mitigation technique and document all of its evaluations.[251] Before foreclosing the servicer must ensure its compliance with the guidelines.[252]

The regulations also make both mortgagees and third-party servicers jointly liable to HUD for servicing actions,[253] and HUD ranks servicers of its insured loans on their loss mitigation performance. A servicer with an unsatisfactory rating that is found to have failed to engage in required loss mitigation is liable for a monetary penalty of up to three times the total amount of mortgage insurance benefits claimed by the servicer for any mortgage for which the servicer failed to engage in loss mitigation.[254]

Likewise, for mortgages guaranteed by the Department of Veterans Affairs ("VA"), there are also detailed servicer requirements, including mandatory servicing qualifications and procedures,[255] a tiered ranking of servicers by performance,[256] and an explicit schedule of incentive payments for workouts by type, with higher ranked servicers receiving more generous incentive payments.[257]

2. Ginnie Mae Servicing Regulations

Another set of federal regulations of mortgage servicing come from the Ginnie Mae, which guarantees timely payment of principal and interest on mortgage-backed securities issued against pools of loans insured or guaranteed by the FHA, VA, the Department of Agriculture's Rural Housing Service, and the HUD's Office of Public and Indian Housing. While Ginnie Mae does not actually issue the securities, it provides a credit enhancement backed by the full faith and credit of the United States government, so investors only incur interest-rate risk, not credit risk.

The agencies that insure or guarantee the mortgages underlying Ginnie Mae-guaranteed MBS themselves have servicing regulations, but Ginnie Mae has further requirements. First, Ginnie Mae requires that it approve the

249. *Id.* § 203.602.
250. *Id.* § 203.604(b).
251. *Id.* § 203.605(a).
252. *Id.* § 203.606.
253. *Id.* § 203.502.
254. *Id.* §§ 30.35(c)(2); 203.605(c).
255. 38 C.F.R. § 36.4346, 36.4815-.4819, 36.4850 (2010).
256. *Id.* § 36.4818.
257. *Id.* § 36.4819.

servicers of the loans.[258] Second, Ginnie Mae requires that the servicer "manage foreclosure or assignment procedures in accordance with applicable servicing and claims collection requirements of the mortgage insurance or guaranty agency, the applicable Guaranty Agreement, and accepted mortgage lending and servicing practices, ethics and standards."[259]

Third, and most importantly, Ginnie Mae provides that if a loan is delinquent, the servicer may either modify the securitized loan in ways that do not affect the loan's duration and the amount of payment or that the servicer repurchase the loan out of the securitized Ginnie Mae guaranteed pool by paying 100% of the remaining principal balance (minus any payments advanced by the issuer on the loan).[260] While it might appear at first blush that an issuer would have little incentive to repurchase a nonperforming loan at 100% of the outstanding balance, Ginnie Mae places a threshold on the level of delinquencies that can exist in any MBS pool it guarantees.[261] If that threshold is exceeded, a range of negative consequences can result for the issuer, including cutting off the issuer from future Ginnie Mae guarantees and civil monetary penalties.[262]

As Ginnie Mae issuers are repeat players, often with businesses that depend on access to Ginnie Mae, the threat of being denied future Ginnie Mae guarantees on MBS creates a strong incentive for issuers to purchase delinquent mortgages out of the pool. The issuer should not incur any loss, as the mortgage is still insured or guaranteed by a federal agency, so there is little reason to leave a delinquent mortgage in a Ginnie Mae pool. As for the mortgage itself, it remains subject to the relevant insuring agency's servicing provisions regardless of whether it is in a Ginnie Mae pool.

3. Fannie Mae/Freddie Mac Servicing Guidelines

Fannie Mae and Freddie Mac, for-profit federally chartered and regulated corporations, also have their own servicing requirements. Fannie and Freddie purchase mortgages in the secondary market and securitize them. Fannie and Freddie guarantee the timely payment of principal and interest on their MBS, like Ginnie Mae. Because Fannie and Freddie bear the credit risk on the mortgages in their MBS pools, they have a strong interest in ensuring servicing quality, and, by serving as their own trustees, they have the ability to oversee servicers in a way that PLS investors lack. Fannie and Freddie have lengthy and

258. GINNIE MAE MBS GUIDE 4-4 (2007), *available at* http://www.ginniemae.gov/guide/pdf/chap04.pdf. Ginnie Mae must approve issuers, who are presumed to service the loans, as well as contract subservicers, if any. *Id.*

259. *Id.* at 18-1, *available at* http://www.ginniemae.gov/guide/pdf/chap18.pdf.

260. *Id*. at 18-1, 18-2.

261. *Id*. at 18-3, 18-4.

262. *Id*. at 18-4, 18-5.

detailed servicing guides, but it is not clear how vigorously they monitor compliance or what steps they take to enforce their rules.

In theory, the GSEs and Ginnie Mae have significant power to ensure compliance. The GSEs and Ginnie Mae retain the ability to strip a servicer of its servicing rights and transfer them to another servicer if the servicer performs poorly. Because servicers pay for their MSR upfront, a servicer that is stripped of its MSR loses its investment. The GSEs can use this system as a method of bonding servicers through a forced investment.

PLS, in contrast, do not provide the sponsor with the ability to transfer the servicing rights; instead, the trustee is able to transfer them only under extremely limited conditions.[263] Moreover, in PLS, the servicing rights are frequently awarded without fee to a servicing affiliate of the sponsor investment bank, so there is no upfront investment. Therefore, PLS do not benefit from the bonding that is imposed on GSE servicers.

4. Rating Agencies' Ratings of PLS Servicers

For PLS, the major constraint on servicers is reputational—a servicer whose portfolios perform poorly will have trouble getting future business. The main vehicle through which reputation is communicated is through servicer ratings from credit rating agencies. Credit rating agencies such as Fitch Ratings and Standard & Poor's have servicer rating systems that should, in theory, provide market discipline that would encourage servicers to engage in value-maximizing loss mitigation techniques. The nature of the ratings, however, makes them an ineffective disciplining tool.

Servicer ratings are used primarily as a component of the overall rating of an RMBS transaction, rather than as a stand-alone rating. As Fitch Ratings explains, "Fitch's assessment of the quality of the seller/servicer's financial condition and operations will have a direct impact on the determination of credit enhancement levels."[264] In other words, while a credit rating of an RMBS transaction is fundamentally a rating about the quality of the securitized assets, the quality of servicing is one of many possible credit enhancements or detractions that might tweak that rating.

Fitch awards seller/servicer ratings that evaluate three factors: corporate performance, origination, and servicing. The servicing component comprises nine subcomponents: (1) account maintenance; (2) customer service; (3) payment processing and cash management; (4) investor reporting and remitting; (5) collections and loss mitigation; (6) default loan management; (7) risk management; (8) staffing and training; and (9) technology.[265]

263. *See infra* Section II.C.

264. Rui Pereria & Mary Osako, *Rating ABS Seller/Servicers: Credit Where Credit Is Due*, ASSET SECURITIZATION REP., Sept. 13, 2004.

265. *Id*.

In other words, loss mitigation is one of the nine pieces that makes up one of the three components of the seller/servicer rating, which is itself a secondary factor in the credit rating of an RMBS transaction. This result means that there is likely to be little if any market discipline on servicers' loss mitigation capabilities and practices via ratings.

Servicer ratings suffer from other flaws as well. The distinction between ratings levels does not have clear meaning, and the ratings are historically based, providing only a limited guide to current quality. The trust is also required to report on the pool's actual performance, including delinquencies and modifications of each distribution period.[266] This data permits some comparison among servicers, but is only required to be made available to the trust's investors, not to the market or regulators. Thus, ratings are not real-time.

In addition, servicer ratings are hard to test and verify; they cannot easily be compared with loan performance to gauge their accuracy retrospectively, the way a corporate debt rating can, as much of a loan pool's performance has nothing to do with the servicer. Servicer ratings are based on perceived capacity, not actual performance, and distinguishing servicer performance is difficult. As no two servicers have identical portfolios, it is hard to know how much portfolio performance is actually related to the servicer. And as the ratings come with no guarantee, investors are unlikely to place much weight in them. There is simply too much noise involved in servicer ratings for them to exert meaningful market discipline on servicers' loss mitigation practices.

Even if reputational sanctions via ratings were generally a reasonable disciplining tool for servicers, they would cease to function in a nationwide real estate downturn. When default levels at all servicers surpass historical levels, it becomes near impossible to ascribe the relative percentage of losses to servicer behavior or to the innate character of the underlying mortgages in a pool.

5. State Regulation

Thirty states regulate mortgage servicers in some way.[267] State regulation varies, but it generally consists of registration or licensing requirements, in addition to generally applicable state mortgage foreclosure law. These requirements typically require the posting of a bond, but little else. Many mortgage servicers, however, are operating subsidiaries of national banks and federal thrifts, and are therefore exempt from state licensing and reporting requirements. Separate standards for state and federally chartered entities create a regulatory arbitrage opportunity that exerts downward pressure on all regulation.

Some states have adopted additional regulations in response to the foreclosure crisis. Some of these regulations are general foreclosure

266. 17 C.F.R. § 229.1121 (2010).

267. *See* NATIONAL MORTGAGE SERVICER REFERENCE DIRECTORY (2010).

regulations, such as requiring a pre-foreclosure settlement conference,[268] while others have been specific to third-party servicers. For example, Maryland requires servicers to submit loss mitigation reports[269] Other states have attempted to influence the foreclosure process with servicers in mind; California requires that a foreclosure sale be delayed by 180 days after default, but waives ninety of those days for servicers that implement loan modification programs that implement modifications when modified NPV would exceed foreclosure NPV.[270] Additionally, California provides a safe harbor for servicers that modify loans. If the servicer has a duty to maximize net present value of serviced loans, it owes that duty to all investors in a securitized pool and fulfills that duty if it implements a modification plan when the loan is in default or default is reasonably foreseeable and the modification is anticipated to increase recover compared to a foreclosure on a net present value basis.[271]

III. Mortgage Servicing's Principal-Agent Problem

The current structure of the mortgage servicing industry creates a principal-agent conflict between mortgage investors and servicers, the costs of which are borne by both investors and homeowners, with second-order spillovers to communities. The core of this principal-agent conflict is that servicers' incentives in managing a loan diverge from that of investors. Existing regulatory and monitoring structures are inadequate for ensuring alignment of servicer and investor interests, and the market is unlikely to self-correct because neither investors nor affected homeowners have the incentives or the bargaining power to fix the system.

Servicers' incentives diverge from investors on two levels. First, in reference to individual loans, servicers do not have a meaningful stake in the loan's performance; their compensation is not keyed to the return to investors. Second, the servicing industry's combination of two distinct business lines—transaction processing and default management—encourage servicers to underinvest in default management capabilities, leaving them with limited ability to mitigate losses. Servicers' monetary indifference to the performance of a loan only exacerbates this situation.

A. Servicing Compensation

Servicers' incentives in managing individual loans do not track investors' interests. This creates three interrelated problems. First, servicers are incentivized to pad the costs of handling defaulted loans at the expense of

268. N.Y. C.P.L.R. 3408 (McKinney 2010).
269. MD. CODE ANN., REAL PROP. § 7-105.1 (West 2010).
270. CAL. CIV. CODE §§ 2923.52, 2923.53, 2924(a)(2) (West 2010).
271. *Id*. § 2923.6.

investors and borrowers. Second, servicers are not incentivized to maximize the net present value of a loan, but are instead incentivized to drag out defaults until the point that the cost of advances exceeds the servicer's default income. In other words, servicers are incentivized to keep defaulted homeowners in a fee sweatbox, rather than moving to immediately foreclose on the loan. Third, servicers are incentivized to favor modifications that reduce interest rates rather than reduce principal, even if that raises the likelihood of redefault.

1. Servicing Fees Come at the Expense of Investors

Servicers are often competing with investors for loan proceeds. Because servicers get paid out of the proceeds of a loan, they are in conflict with investors when there are insufficient proceeds to pay all parties in full. The conflict is seemingly resolved contractually in the PSA through the investors' subordination to the servicer's claim; the servicer has the senior-most claim on the loan's proceeds.

The problem with this arrangement is that the size of the servicer's claim on the loan proceeds is not fixed. Instead, the size of the servicer's claim is largely in the servicer's control, with no incentive for the servicer to minimize the size of its claim. Servicer compensation structures encourage servicers to inflate the size of their claims, and this arrangement comes at the expense of homeowners initially, but then at the expense of investors to the extent that the homeowners lack equity in the collateral property.

The problem arises because servicers receive cost-plus compensation on defaulted loans without any sort of cost control mechanism. When a loan performs, servicers' compensation is essentially flat-rate. On a performing loan, a servicer receives the fixed-percentage servicing fee and float.

When a loan defaults, however, servicers' compensation switches to a cost-plus basis. The potential incentive misalignments from this form of compensation are so severe that it is prohibited for most federal government contracts.[272] Often, servicers cease to be permitted to collect their servicing fee until the mortgage is liquidated or reinstated, although the fee accrues in the meantime. Instead, the servicer receives compensation for all of its costs as well as for any additional fees it collects (typically through foreclosure), such as late fees. The servicer collects these fees, as well as reimbursement (without time value) for its advances, off the top of foreclosure sales. This means that the servicer has an incentive to levy as many fees as it can, as they will be paid off the top of the foreclosure sale proceeds. It also means that servicers have no incentive to keep down costs; indeed, to the extent that servicers insource

272. *See* 10 U.S.C. § 2306(a) (2006); *see also* 41 U.S.C. § 254(b) (2006) (prohibiting "cost-plus-percentage-of-cost" contracting and only allowing "cost-plus-a-fixed-fee" contracting when the fee is less than 15% of the estimated costs for research and development work, less than 6% of estimated costs for public utility contracts, and less than 10% of estimated cost for other projects).

default management functions, they have an incentive to inflate costs, as the inflated costs are profit margin for them.

Thus, to the extent that a foreclosure sale does not produce sufficient revenue to pay off investors in full, the servicer's incentives are directly in conflict with the investors'. The servicer's fees come at the expense of the investors. In the current market, most foreclosures involve properties in which the homeowner has no equity; investors are already taking a loss. Additional and overpriced servicer fees only increase the margin of the investor loss.

2. Lack of Incentive to Maximize Net Present Value

Servicers' compensation structures also mean that the servicer has no interest in maximizing the value of the loan for investors. Instead, the servicer's interest is in maximizing its fee revenue and minimizing its nonreimbursable expenses. Thus, if a distressed loan is modified, it might increase the net present value of the loan for investors (even accounting for self-cure risk and redefault risk). But the servicer will have to incur nonreimbursable modification expenses and will also receive diminished servicing fee and float income rather than default income.

When a loan defaults, a servicer has two options. It can proceed to foreclosure or it can attempt to modify the loan. If the servicer forecloses, the servicer will get income while the loan is delinquent in the form of late fees and other ancillary fees and, in some cases, servicing fees. The servicer will have to pay servicing advances, however. Although the advances are recoverable, the servicer loses the time value of the advance. The servicer's post-default income on a loan is largely flat-rate, but the cost of the advances increases exponentially and eventually overtakes the post-default income. Thus, in foreclosure, a servicer's cumulative income increases at first, but then decreases, eventually becoming negative. As Figure 12 shows, this cumulative income curve is parabolic. Accordingly, a servicer will want to complete the foreclosure at the apex of the parabola. The timing, however, is not entirely in the servicer's control, as it depends on whether the borrower contests the foreclosure and the speed of the courts.

If the servicer modifies the loan, the servicer will incur the cost of the modification, which is typically not reimbursable. The servicer will also receive its regular servicing fee and float on the reperforming loan ("servicing income"). The servicing fee and float will likely be somewhat diminished as a result of the modification. The servicer will only receive this income for as long as the loan continues to reperform. If the loan redefaults, the servicer will then receive the same default income, as outlined above. Thus, on a redefaulted loan, the servicer will receive servicing income for the time that the loan reperformed as well as default income, but will also incur the costs of modification, and the ultimate REO sale date is delayed by the length of time the loan reperformed.

We can express this algebraically as follows. Let:

> *F* be servicing income on a defaulted loan, including amounts paid out of foreclosure recoveries;
> *A* be the cost of advances;
> *M* be the cost of a modification;
> *R* be the servicing income (servicing fee plus float) on a reperforming loan; and
> *N* be the number of months a loan reperforms before it redefaults or is refinanced.

Accordingly, when a loan is in default, the servicer's net income is $F - A$, and when a loan is reperforming, the servicer's net income is $R - M$. Therefore, if a loan reperforms for N months and then redefaults, the servicer's income is $R_N - M + F - A$.

This means that a modification is value-maximizing for a servicer if and only if $R_N - M + F - A > F - A$.

The servicer's income on a defaulted loan should be the same regardless of whether that default results in an immediate foreclosure or if it comes after a failed modification attempt. This contrasts with investors' income, as a delayed foreclosure could result in a lower (or greater) foreclosure sale price. The servicer, however, is indifferent to the foreclosure sale price so long as it can recover its fees and advances. If we assume that the servicer's cost of funds is constant and that the time from default to foreclosure will be the same regardless of whether the foreclosure is brought now or at some point in the future after a redefault, then there is no effect on the cost of advances. Therefore, we can simplify our equation to represent that a modification is value-maximizing for a servicer if and only if $R_N > M$.

What this means is that the economics of the modification/foreclosure decision are highly dependent upon the cost of a modification and *whether* and *when* a modified loan redefaults. If the modified loan redefaults before the servicer has recouped the cost of the modification, then the modification is a money-loser for the servicer.

Estimates for the cost of processing a loan modification range from $500 to over $1000 per modification.[273] None of the cost estimates explain their methodology. The variation in modification cost estimates may come from the difficulties in assigning costs to modifications. For example, how should overhead expenses such as office space, utilities, and salaries be counted? These expenses have very little correlation with the number of modifications

273. *See* NOMURA SEC. INT'L, INC., SUB-PRIME MORTGAGE LOAN SERVICING AND LOSS MITIGATION 2 (2007), *available at* http://www.securitization.net/pdf/Nomura/SecRealEstate_18May07.pdf ("The full cost of processing a loan modification can be in the range of $500 to $600."); Piskorski et al., *supra* note 19 (noting that modifications can easily cost over $1000).

performed, making it difficult to assign a pro rata portion to a modification. But using these numbers, let us consider what this means for our stylized $200,000 fixed-rate loan amortized fully over thirty years.

Whereas our previous examples assumed an 8% interest rate, now let us assume a post-modification interest rate of 2%,[274] which makes the monthly payments on the loan $739.24, or an extreme 50% reduction in monthly payments.[275] Let us also assume that the servicing fee is fifty basis points and that the servicer earns 4% on its float. We can thus calculate the income on a reperforming loan. For three months, the income is $259.56; for six months, it is $519.59; and for twelve months, it is $949.55.[276] This means that if a modification costs $1000 ($M$ = $1000), then $M > R_N$ if and only if $N < 13$. In other words, if a default occurs within the first year, the modification is a money-losing proposition for the servicer, irrespective of its value to investors. Alternatively, if a modification costs $500 ($M$ = $500), then $M > R_N$ if and only if $N < 6$.

What this shows is that speed of redefault is of the essence to servicers; if the redefault happens before the servicer can recoup the costs of the modification from additional months of loan performance, then the modification will be a money loser for the servicer. The challenge, of course, for a servicer is that it is difficult if not impossible to tell whether, much less when, a modified loan will redefault. This information problem makes it hard for servicers to tell on a loan-by-loan basis whether a modification is in the servicer's interest.[277]

Figure 15 illustrates a servicer's cumulative net post-default income on this loan with various redefault assumptions. It has six curves. One of the curves (black line with black-filled circles) starts at $0 on the y-axis. This line represents the servicer's cumulative post-default net income on the above styled loan if the servicer forecloses immediately without attempting a modification. The other five curves represent the servicer's cumulative net post-default income on the same loan assuming that there is a modification and

274. This rate is the median post-modification interest rate from HAMP. *See* CONG. OVERSIGHT PANEL, EVALUATING PROGRESS, *supra* note 4, at 45. The post-modification interest rate has only a modest effect on R_N, so the particular rate used is not critical. This constant prepayment rate assumes only voluntary prepayments and is essentially a discounting of servicing revenue.

275. Note that such a reduction affects the servicer primarily through reducing the principal balance of the loan faster and therefore reducing the balance on which the servicing fee is levied quicker. It also has a small effect on monthly float, which in this case would go down from $4.02 (if the loan had a note rate of 8%) to $2.03 (if the loan had a note rate of 2%). Over time, these two factors combined can significantly decrease the servicer's revenue from a loan.

276. The servicing fees in months one through twelve when the loan is reperforming are $83.33, $83.16, $82.99, $82.83, $82.66, $82.48, $82.31, $82.14, $81.97, $81.80, $81.63, and $81.46, respectively. The float income for on a $739.24 monthly payment reinvested at 4% APR for twenty-five days a month (300 of 365 days annually) is $2.03.

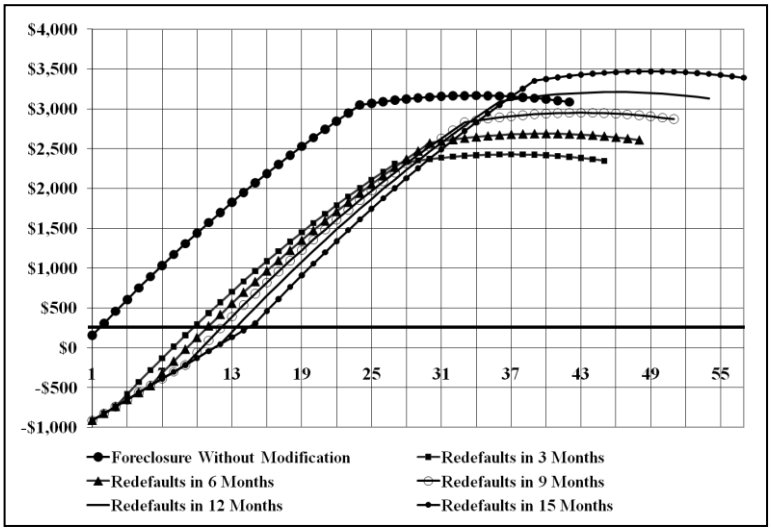
277. If a servicer knows the weighted average time to redefault, however, it is possible to do pool-wide underwriting, but that would mean uniform treatment (modification or no modification) for the entire pool.

a redefault within three, six, nine, twelve, and fifteen months, respectively. These other five curves start at -$1000 on the *y*-axis because they assume an initial $1000 sunk cost to the servicer from performing the modification.

All of the curves show that the servicer's cumulative net income after the loan is in default rises and then falls. The curves are based on assumptions about the length of the foreclosure (twenty-four months) and REO process (eighteen months). The speed through which a loan can be moved through foreclosure and REO has a significant effect on servicer's cumulative net post-default income. The curves are of different lengths because of the varied assumptions about the length of time before a redefault.

Assuming that the length of the foreclosure and REO process is identical in all cases, with only variation in the length of time before redefault, we can see that the cumulative net post-default income on the loan when it goes into foreclosure immediately, without a modification, is greater than that when there is a modification and the redefault occurs within twelve months or less. Only if the redefault occurs later than twelve months (such as the fifteen-month curve in the graph) is cumulative net post-default income from the loan (represented by the rightmost point in each curve) greater than if there were an immediate foreclosure.

Figure 15: Cumulative Servicer Net Income in Foreclosure and Modification with Redefault (No Modification Bounty)[278]



278. Authors' calculations. Figure 15 assumes that when the loan is in default, but not in REO, the servicer may charge a 5% monthly late fee on the monthly payment amount and that the servicer will charge a total of $3533 of junk fees in equal increments over forty-two months post-redefault. *Cf.* Porter, *supra* note 19, at 163 (analyzing bankruptcy cases and finding that the mean difference between a mortgage creditor's claim and the corresponding scheduled debt is $3533). Figure 15 also assumes that servicing advances are made the entire time the loan is in default and in REO.

For actual loans modified in 2008-2009, 24.3% redefaulted and were sixty or more days delinquent within three months, another 15.4% within six months, an additional 10.3% within nine months, and a further 7% within a year. This means that 57% redefaulted and were already sixty or more days delinquent within a year.[279] The high redefault rates within the first year—with almost half within the first three months of the year—greatly reduce servicers' incentive to modify loans absent additional compensation.

The critical point of our model is not the precise cost to servicers of modification or immediate foreclosure, but rather the *relative* costs, which are heavily dependent on the length of time before the property is ultimately sold out of REO. Given these relative costs, a risk-averse or liquidity-constrained servicer will be more likely to move to foreclosure immediately. Conversely, a servicer that is sufficiently liquid might want to "gamble on resurrection" and hope that modified loans will perform long enough to reduce losses or even become profitable.

Our model thus predicts that *servicers will be disincentivized to attempt modifications if they anticipate that a high percentage of modifications will redefault in a relatively short time span after modification.* It is not redefault rates, per se, that likely drive servicer decisions, but *when* the redefaults occur. If redefaults occur after a servicer has recouped its costs of modification, then the servicer will be incentivized to attempt a modification.

From this we can draw a few lessons. First, servicers' compensation structures encourage them to stretch out defaults, but not too long. In other words, servicers want to keep borrowers in a default "sweatbox"[280] to collect late fees and other junk fees, but only until the profit maximizing point. This may explain why servicers often do not vigorously pursue foreclosure at first, but instead allow foreclosure filings to lapse or defaults to linger for a year or more.

After hitting the profit-maximizing point on the cumulative net income curve (or more precisely, just before hitting it), the profit-maximizing servicer should want to foreclose and sell the property as quickly as possible before its cumulative income is eaten away by the rising cost of making servicing advances. Servicers are therefore incentivized to engage in quick foreclosure sales and REO sales, even at low prices, because they are indifferent to the amount of the sale proceeds due to the seniority of their claim while they are sensitive to the speed of the sale.[281] Thus, American Home Mortgage Servicing,

279. U.S. DEP'T OF THE TREASURY, OCC AND OTS MORTGAGE METRICS REPORT: FIRST QUARTER 2010, at 44 (2010), *available at* http://www.ots.treas.gov/_files/482142.pdf.

280. *See* Ronald J. Mann, *Bankruptcy Reform and the "Sweat Box" of Credit Card Debt*, 2007 ILL. L. REV. 375 (describing a credit card lending business model in which the lender desires extended default in order to maximize fee revenue).

281. *See* FITCH RATINGS, U.S. RESIDENTIAL MORTGAGE SERVICER ADVANCE RECEIVABLES SECURITIZATION RATING CRITERIA 4 (2009) ("Modifications can accelerate the recovery rates as servicers will reimburse the advances at the time of modification."); Mason, *supra* note 158, at 5.

was sued for allegedly dumping foreclosed homes on the market at firesale prices because of its own liquidity needs.[282] Once the mortgage servicing sweatbox hits the sweet spot, servicers want to dump the property from their portfolio as quickly as they can.

Second, all else being equal, servicers will be less incentivized to attempt modifications when servicing fee rates are lower, when costs of advances are higher, when principal balances are lower, and when monthly payments are lower (if the cost of advances is greater than the income on float). This means that GSE servicers are less incentivized to perform modifications than private-label servicers because their servicing fees are often half as much.

Third, reducing modification costs or increasing the time that a loan will perform before it redefaults are essential for incentivizing servicers to perform more modifications. This means that if HAMP modification bounties are to be successful at changing servicer incentives, they probably need to be an order of magnitude larger.

Fourth, and most important, a servicer's incentives in handling a defaulted loan have nothing whatsoever to do with the net present value of the loan itself. They are based around the servicer's incentive to maximize its own revenue, or more likely the case, minimize its own losses. Thus, while servicers are sensitive to redefault risk with modifications, their sensitivity is driven primarily by the cost of making advances, not the risk of a decline in the collateral property's value. A portfolio lender would be concerned about a redefault in a declining market because the proceeds of the foreclosure sale (or REO sale) would fall due to the delay caused by the failed workout.[283] Because servicers are the senior-most creditor of the SPV, they are not worried about the loss of property value, as long as there is sufficient value to recover their own claims.[284]

With sufficient junk fees, a servicer can make money in a foreclosure. But even if the servicer does not make money in a foreclosure, a servicer risks incurring a substantially greater loss if it engages in a modification. Lack of servicer compensation for modifications makes risk-averse servicers inclined toward foreclosure.

The choice between modification and foreclosure is a choice between limited fixed-price income and a cost-plus contract arrangement with no oversight of either the costs or the plus components. For mortgage servicers, this creates a very strong incentive to foreclose on defaulted loans rather than modify them, even if modification is in the best interest of the MBS holders.

282. Carrick Mollenkamp, *Foreclosure "Tsunami" Hits Mortgage-Servicing Firms*, WALL ST. J., Feb. 11, 2009, at C1.

283. *See* Adelino et al., *supra* note 21, at 2.

284. Therefore, in a declining market a portfolio lender (and by extension MBS holders) might press for a more rapid foreclosure than a servicer, while in an appreciating market, a portfolio lender might want to delay foreclosure.

The principal-agent conflict between RMBS holders and mortgage servicers is a major factor inhibiting voluntary loan modifications.

3. Implications for HAMP

The problem of modification costs outweighing additional income from the time a loan is reperforming may explain some of the problems of the HAMP, the centerpiece of the Obama administration's foreclosure prevention efforts.

HAMP pays servicers an incentive fee of $1000 for every HAMP trial modification that converts to permanent modification status.[285] A loan modification may convert only after an eligible borrower makes successful payments at the modified rate for three consecutive months and completes all paperwork. To date, just under 39% of attempted HAMP modifications have been converted to permanent modifications.[286] That means for the other 61%, servicers have expended the effort and money necessary for a modification, but not yet received any incentive payment. Accordingly, the incentive payment for a permanent modification is, on an average-per-loan basis, only $386.54. HAMP also provides the servicer with additional success payments of up to $83.33 per month for up to three years if the permanent modification continues to perform.[287]

HAMP incentive payments have the effect of increasing R_N. As before, M=$1000. Now, however, it is necessary to add $386.54 + ($83.33*N) to our previous calculation of R_N. Thus for $R_{N=3}$, our HAMP adjusted value is $896.09 ($259.56 + $386.54 + ($83.33*3)). $R_{N=3} < M$ even with HAMP adjustments. But when N is increased to 4, the calculus changes. The income on the loan performing for four months is $346.40, to which HAMP incentive payments ($386.54) and performance payments ($83.33*4) must be added. Thus, $R_{N=4}$ = $1066.26, so $R_{N=4} > M$. HAMP incentive payments shift the fulcrum point from thirteen months to four months.[288] In essence, HAMP is relieving

285. *Home Affordable Modification Program Compensation*, HOME AFFORDABLE MODIFICATION PROGRAM: ADMIN. WEBSITE FOR SERVICERS, https://www.hmpadmin.com/portal/programs/docs/hamp_servicer/hampcompensationmatrix.pdf (last updated Nov. 9, 2010).

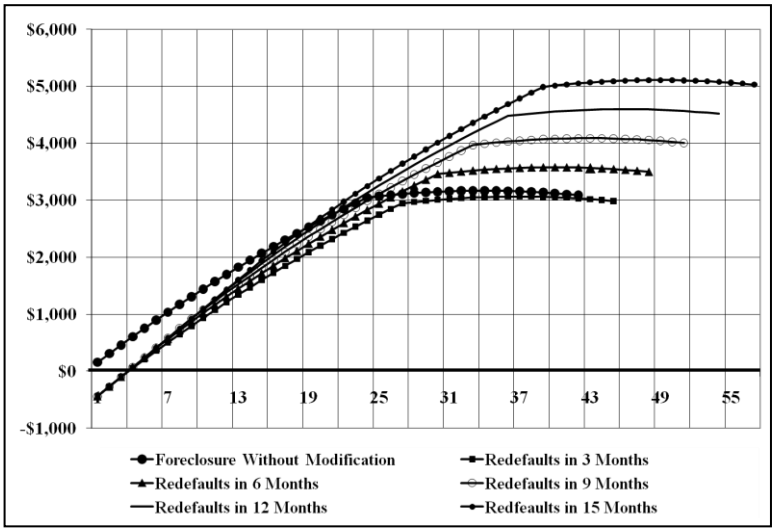
286. MAKING HOME AFFORDABLE PROGRAM: SERVICER PERFORMANCE REPORT THROUGH SEPTEMBER 2010, *supra* note 5, at 2 (noting that of the 1,282,912 trial modifications that began before the end of June 2010, 465,898 (38.6%) had become permanent by the end of September 2010).

287. *See Home Affordable Modification Program Compensation*, *supra* note 285, at 2 (stating that for first-lien mortgages, if the modification reduces the borrower's monthly household expenses by at least 6%, "the servicer accrues, on a monthly basis, the lower of $83.33 or 50% of the difference between Monthly Housing Expense Before Modification and Monthly Housing Expense After Modification").

288. Some servicers are required under PSAs to continue to pursue foreclosures while engaged in modification negotiations. Not only can this be frustrating and confusing to borrowers, who take it as a lack of good faith on behalf of the servicer, but it affects the servicer's cost structure in a way that further militates against modification. If the servicer successfully negotiates a modification, then all expenses on pursuing the foreclosure are lost; these expenses do not appear to be reimbursable. *See*

servicers of nine months of redefault risk. Note, however, that HAMP does not eliminate redefault risk for servicers; it merely shortens the window.

Figure 16: Cumulative Servicer Net Income in Foreclosure and Modification with Redefault (with HAMP Modification Bounty)[289]



Even under HAMP, the key issue remains what level of redefaults servicers anticipate and when they think redefaults will occur. If servicers anticipate high redefault levels at the very beginning of the permanent modification, they may hesitate to pursue the modification. (The quality of a loan modification of course affects the likelihood of redefault too.) Thus, the key problem for servicers is an interaction between an informational problem and their compensation. If servicers were compensated differently, they would be incentivized to make greater efforts to overcome their informational problem and would not be incentivized to act based on whether *their* compensation from a modified loan while it reperforms outweighs the cost of the modification.

Lorraine Woellert & Meera Louis, *Fannie, Freddie Defend Foreclosures Amid Criticism*, BLOOMBERG, Dec. 1, 2010, *available at* http://www.bloomberg.com/news/2010-12-01/foreclosures-should-not-pause-during-loan-workouts-freddie-mac-aide-says.html (discussing the "dual track process of pursuing foreclosure and loan modification at the same time"); *see also* Alan Zibel, *Banks Told To Stop Foreclosures During Mortgage Modification*, WALL ST. J. BLOGS (Dec. 1, 2010, 1:15 PM), http://blogs.wsj.com/developments/2010/12/01/banks-told-to-stop-foreclosures-during-mortgage-modification (noting that the Acting Comptroller of the Currency "has directed banks to halt foreclosure proceedings if borrowers are starting loan-assistance programs, if legally possible").

289. Authors' calculations. Figure 16 makes the same assumptions as Figure 15, but it includes a $1000 HAMP bounty paid in month one and an $83.33 perfoming loan payment made to the servicer every month while the loan is performing.

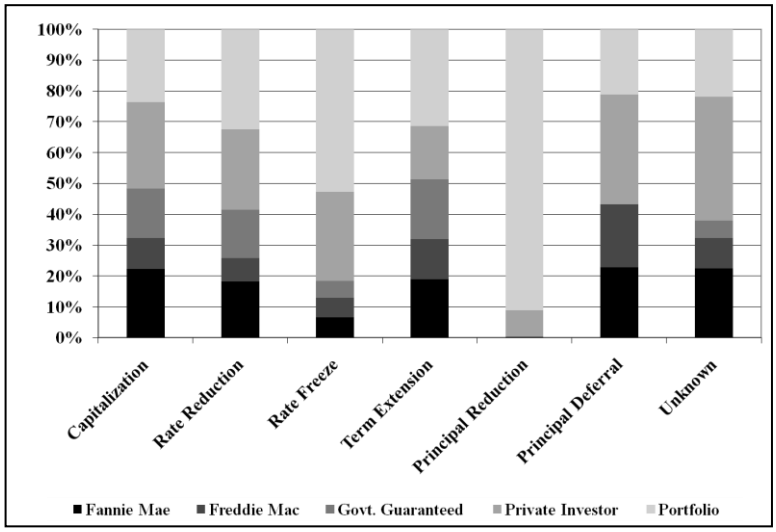
4. Incentives To Favor Particular Forms of Modification

Servicers' compensation structures also encourage them to favor certain forms of modification over others. A modification can reduce monthly payments by reducing the interest rate, reducing the principal, extending the term of the loan, or changing the amortization (to create a balloon at the end). Servicers are not indifferent in choosing these methods. While any method will reduce monthly payments and thus reduce float income in a given month, servicers are generally disinclined to reduce principal. When the principal balance of a loan is reduced, the servicing fee is also reduced, as it is a percentage of the principal balance outstanding. Moreover, if the borrower has sufficient equity in the property, the borrower may simply refinance the mortgage, and the loan will leave the servicer's portfolio. On the other hand, a servicer's servicing fee income would actually increase over time if the amortization were adjusted to create a principal balloon at the end of the loan.

The data reported in Figure 17 are consistent with servicer compensation affecting the type of modifications that occur. Figure 17 shows the percentage breakdown of different types of modifications by different types of mortgagees. It reflects 582,363 mortgage modifications that were made by fifteen major servicers during 2009. These servicers cover approximately 65% of the first lien market.[290] It is impossible to control for heterogeneity between securitized and portfolio loans, but there are two notable disparities in the data that seem unlikely to be solely a function of heterogeneous loan portfolios.

290. U.S. DEP'T OF THE TREASURY, OCC AND OTS MORTGAGE METRICS REPORT: THIRD QUARTER 2009, at 4 (2009), *available at* http://www.occ.treas.gov/ftp/release/2009-163a.pdf.

Figure 17: Percentage of Type of Mortgage Modification by Type of Investor, 2009[291]



First, portfolio loans account for 38% of total modifications, but 92% of principal reductions. In contrast, PLS loans account for 30% of modifications and 8% of principal reductions. There were only 138 principal reductions on agency and GSE loans in this period. The low rate of principal reduction modifications on securitized loans is consistent with servicers being disincentivized to reduce principal, although some of the lack of principal reduction modifications may be attributable to PSA restrictions on principal reduction.[292]

In contrast to the overrepresentation of portfolio loans in principal reduction modifications, PLS loans are overrepresented for principal deferral modifications. PLS accounted for 44% of principal deferral modifications, while portfolio loans represented another 29%. The high use of principal deferrals in PLS modifications is also consistent with PLS servicers wanting to maintain higher principal balances and increase their servicing income. Portfolio lenders might be incentivized to do this too, to avoid a charge-off of the loan. At the very least, though, the striking disparity between principal

291. *Id.* at 25; *see also* U.S. DEP'T OF THE TREASURY, OCC AND OTS MORTGAGE METRICS REPORT: FOURTH QUARTER 2009, at 27 (2010), *available at* http://www.occ.treas.gov/publications/publications-by-type/other-publications/mortgage-metrics-q4-2009/mortgage-metrics-q4-2009-pdf.pdf; U.S. DEP'T OF THE TREASURY, OCC AND OTS MORTGAGE METRICS REPORT: SECOND QUARTER 2009, at 25 (2009), *available at* http://www.occ.treas.gov/ftp/release/2009-118a.pdf; U.S. DEP'T OF THE TREASURY, OCC AND OTS MORTGAGE METRICS REPORT: FIRST QUARTER 2009, at 23, 27 (2009), *available at* http://www.ots.treas.gov/_files/4820471.pdf. These reports cover approximately 65% of the first-lien market.

292. *See* sources cited *supra* note 102.

reduction and principal deferral rates indicates that securitization very much matters when it comes to loan modification.

B. Why the Market Will Not Self-Correct

The contractual design of mortgage securitization effectively makes servicers' principal-less agents; there is no party with the ability and incentive to monitor a servicer's actions. The principal-agent problem in mortgage servicing is unlikely to correct itself because both types of parties with an economic interest in servicing performance—mortgage investors and mortgage borrowers—are unlikely to bargain for adequate servicing of defaulted loans.

Mortgage investors lack the information and capacity to effectively monitor servicer performance, and tranching and insurance often removes their incentive to do so. Investors have limited ability to evaluate servicers before investing. Reg AB forces some information disclosure, but the information is of little value. The heterogeneous nature of PLS makes it difficult to compare different servicers' effect on MBS performance. It is impossible to separate out the quality of the servicing from the quality of the underlying loans. Ratings agencies rate servicers not on actual performance, but on a variety of operational capability categories. These factors are all combined into a servicer rating that indicates whether a servicer is adequate or not; the servicer rating does not provide a meaningful measure of the value provided by a particular servicer. Therefore, MBS investors cannot accurately value the quality of loss mitigation provided by a particular servicer.

Even if investors could accurately gauge servicers' performance, investors are not investing in mortgage servicing by itself, but in mortgage servicing combined with MBS. Servicing is a subsidiary part of this investment bundle. Accordingly, market discipline on servicers is weakened.

MBS investors also have little ability to monitor servicers once they have invested. Investors simply lack sufficient data with which to evaluate servicer performance. The only information investors have on servicers' performance is from the data that servicers provide MBS trustees. The MBS trustees turn this data into monthly reports to investors.[293] The reports provide information on the overall performance of the pool of loans held by the MBS trust, but do not provide an investor with enough information to second-guess servicer actions on individual loans. Even if investors could, however, there is little incentive for an investor to examine servicer performance on individual loans. The amounts at stake are relatively small for investors and any benefit from a change in servicer behavior would be spread out among all investors (or at least among all investors in the lowest in-the-money tranche). Freeriding and small benefits discourage investor monitoring.

293. Investors cannot even be sure of the accuracy of the information provided, as trustees are entitled to rely upon the data provided to them by servicers. *See supra* note 222.

MBS investors therefore rely on trustees to protect their interests, but MBS trustees have very limited contractual duties and little incentive to be more diligent. Vigorous monitoring could jeopardize trustees' close business relationships with servicers and ultimately result in costs for the trustee if the servicer had to be replaced and the trustee had to step in as standby servicer.

Tranching and insurance further limit investors' incentives to monitor servicers. The credit tranching that is the signature of PLS means that most PLS investors are not concerned about credit risk; 90% of PLS tranches were AAA-rated, which means investors did not anticipate credit losses when they purchased the PLS.[294] As Goldman Sachs CEO Lloyd Blankfein observed, "[i]n January 2008, there were 12 triple A-rated companies in the world. At the same time, there were 64,000 structured finance instruments . . . rated triple A."[295] The lower-rated mezzanine tranches were largely resecuritized into CDOs, producing yet more AAA-rated securities.[296]

Only the junior-most tranches would normally be concerned with credit risk. These tranches were typically held by the servicer and were often resecuritized into net interest margin securities ("NIMS"), which were themselves insured by a third-party monoline insurer like MBIA, Ambac, FGIC, or Syncora, which would further insure itself through reinsurance and credit default swaps, which were themselves often securitized.[297] Ultimately, someone held a long position on the mortgages, but that party would be so removed from the servicer that it could not monitor or control the servicer, and therefore could not have reasonably been relying on the servicer as a form of insurance.

The exception here would be the servicer itself. To the extent that the servicer bears the credit risk on the securitization, such as through a retained residual or credit-enhancing tranche, the servicer will be incentivized to maximize the value of the mortgages.[298] But because of the tranching, the servicer only bears the credit risk to the extent that its tranche(s) are in-the-money.

The servicer's interest in the securitization may end up out-of-the-money for reasons beyond the servicer's control. Servicers cannot prevent defaults, only help cure some through modification. For example, if a mortgage is underwritten on a fraudulent basis or the homeowner is unemployed, there is relatively little the servicer can do to save value beyond the foreclosure sale price. Thus, if the cumulative defaults in a securitization pool are too high—

294. Manuel Adelino, Do Investors Rely Only on Ratings? The Case of Mortgage-Backed Securities (Nov. 24, 2009) (unpublished manuscript), *available at* http://www.cob.ohio-state.edu/fin/dice/seminars/adelino_jmp.pdf.

295. Lloyd Blankfein, *Do Not Destroy the Essential Catalyst of Risk*, FIN. TIMES, Feb. 8, 2009, at 7.

296. *See* Gelpern & Levitin, *supra* note 20, at 1100.

297. GILLIAN TETT, FOOL'S GOLD 51, 97 (2009).

298. There might be idiosyncratic valuations due to liquidity concerns, however.

and they might be for reasons beyond the servicer's control, not least because of serial mortgage performance correlations—then the servicer's tranches will be the first to be "out-of-the-money." Once the servicer's tranches are out-of-the-money, the entire incentive alignment scheme fails due to the "*Titanic* problem." At that point the servicer's incentives are guided solely by its other forms of compensation—servicing fees, float, and ancillary fees.

Homeowners are unlikely to assert market discipline on servicing. For starters, homeowners lack a direct contractual relationship with servicers; any disciplinary pressure would, therefore, be oblique, through homeowners demanding a price discount on their mortgages based on the servicer and the terms of its contract. Yet, homeowners lack sufficient information to exert market discipline through demanding mortgage discounts to account for servicing risk. Many homeowners do not know about securitization, much less its implications for the management of their loan upon default. Even if homeowners are knowledgeable and concerned about management of their loan upon default, they cannot know or choose whether their loan will be securitized, who will be the servicer, and what contractual provisions will govern the servicing of their loan. Moreover, homeowners are unlikely to care because they do not anticipate defaulting. Few individuals take out a mortgage while anticipating that they will default. Homeowners are likely to exhibit a significant optimism bias when taking out a mortgage.

Homeowners' inability to price for servicing risk can be observed from the nearly universal lack of negotiation between borrowers and lenders regarding free assignability of the mortgage. Free assignability is a standard term.[299] If homeowners were worried about servicing risk, they would bargain over assignability. Imperfect information, information asymmetries, and cognitive biases mean that homeowners do not exert market pressure to correct the principal-agent problem in servicing by demanding a discount in mortgage rates to compensate for the servicing externality.

Homeowners are unlikely to price in servicing risk in their borrowing, and it is precisely those homeowners who are financially distressed and need debt restructuring who are least able to avail themselves of the limited legal rights they have. Neither RESPA nor TILA nor the FDCPA give homeowners much protection when dealing with servicers.

Neither of the parties directly affected by mortgage servicers' behavior has the incentives or the ability to fix the principal-agent problem in mortgage servicing. Yet, this principal-agent problem has rendered dysfunctional the loss mitigation component of the servicing, and this has been a critical factor in the current foreclosure crisis.

299. The standard mortgage documentation for Fannie and Freddie simply mentions that the mortgage can be sold at the lender's sole option.

Foreclosures that fail to maximize value for the mortgages investors create significant negative externalities. The most immediate negative externality is on homeowners (and their families) who lose their homes. This results in second-order negative externalities on the homeowners' neighbors who see their housing values decline as a result of the foreclosure.[300] The community in which the property is based can suffer too, as the decline in neighboring property values reduces property tax revenue for local government,[301] while simultaneously increasing local government burdens. Foreclosed properties are often magnets for crime and fire, which increase burdens on local fire and police services.[302] Foreclosures also have unquantifiable but serious social costs because so many social relationships, such as school, medical care, religious congregations, friendships, and employment are geographically based, and are sometimes rent asunder by the relocation of foreclosed homeowners and their families.[303] Foreclosures may even present public health problems as untended swimming pools on foreclosed properties fill with stagnant water and become mosquito breeding grounds, such that one study has linked foreclosures with the spread of the West Nile Virus.[304]

The foreclosures driven by the servicing industry's principal-agent problem also contribute to a collective action problem akin to a bank run.[305] When foreclosures rise, the real estate market becomes flooded with properties, which pushes down home prices. Declining housing prices make defaults more likely and make other creditors more likely to foreclose in order to salvage what is left of their investment. A negative feedback loop can emerge that begets more foreclosures and greater losses for lenders. Thus, the principal-agent problem in servicing imposes losses on mortgage investors both directly and indirectly.

Private contractual arrangements have created the agency cost and negative economic and social externalities of residential mortgage servicing. Private contractual arrangements are also unlikely to resolve these problems. Many of the tools for limiting agency costs already exist in the securitization marketplace, but have not been adapted for residential mortgage securitizations. Part IV considers whether certain transaction structures should be required with an eye toward mitigating the principal-agent problem.

300. *See* sources cited *supra* note 9.

301. *See* GLOBAL INSIGHT, *supra* note 10; Kroll, *supra* note 10.

302. *See, e.g.*, APGAR & DUDA, COLLATERAL DAMAGE, *supra* note 9, at 6; Immergluck & Smith, *supra* note 11, at 855–56.

303. *See* Adam J. Levitin, *Helping Homeowners: Modification of Mortgages in Bankruptcy*, 3 HARV. L. & POL'Y REV. ONLINE 1, 1 (2009), http://www.hlpronline.com/Levitin_HLPR_011909.pdf.

304. *See* William K. Reisen et al., *Delinquent Mortgages, Neglected Swimming Pools, and West Nile Virus, California*, 14 EMERGING INFECTIOUS DISEASES 1747 (2008).

305. *See* Garrett Hardin, *The Tragedy of the Commons*, 162 SCI. 1243 (1968).

IV. Reforming Mortgage Servicing: Require Special Default Servicers

In light of the costs of the principal-agent conflict in mortgage servicing on investors and the negative externalities it imposes on homeowners, communities, and the housing market as a whole, government intervention in the servicing market is appropriate and necessary. Intervention in the servicing market should aim to reduce the principal-agent conflict by better aligning servicer and investor incentives, by improving investors' ability to monitor servicers, and by giving homeowners some ability to exert market pressure on servicers.

Theoretically, there are two ways to overcome the servicer incentive misalignment problem. First, if a servicer's entire economic interest depended on the return on a loan, like a portfolio lender, the servicer's interests would be completely aligned with the trust's. This could be accomplished by compensating servicers with a "vertical" untranched interest in the MBS pool. This sort of arrangement would involve dividing the MBS into a servicer's interest and an investors' interest. The investors' interest would then be tranched, but the investors' interest would, as a whole, be *pari passu* to the servicer's interest. Such vertical slices are used in credit card ABS, where the card issuer is generally required to retain at least a 7% untranched "seller's interest" in the asset pool.[306]

Compensating servicers with an untranched interest in the entire MBS pool presents problems. First, there is the risk that the servicer will hedge its interest by entering into interest rate and credit default swaps. This risk can be addressed contractually, but it would be very difficult to monitor compliance. Second, and perhaps more importantly, servicers do not want to incur credit risk; that is not their business. They are primarily in a transaction processing business, not an investment business. To the extent that servicers are willing to accept untranched interests as compensation, however, it is a superior model to the current compensation structure.

Second, a servicer could be compensated so as to be neutral relative to different loss mitigation options. If the servicer has no economic interest in the outcome of a particular loss mitigation approach, but does have an interest in burnishing its reputation for maximizing returns for the trust, there would not be an incentive problem. In order for a servicer to have no economic interest whatsoever in the loss mitigation outcome, it would first be necessary to separate the loss mitigation function of servicing from the transaction processing function. Compensation for transaction processing can shift loss mitigation incentives, and ultimately loss mitigation is an incompatible business with transaction processing.

306. FITCH IBCA, ABCS OF CREDIT CARD ABS 3 (1998), *available at* http://www.securitization.net/pdf/abcs.pdf.

As it happens, these two approaches can be combined, and they already are in CMBS. The market for CMBS is a completely private-label securities market. It features a very different servicing structure than the RMBS market, however. The CMBS market features a special servicer, in addition to the primary servicer. While special servicers are the norm for CMBS, they are the exception for RMBS. For CMBS, the special servicer is responsible only for defaulted loans and is compensated based on the return on the defaulted loans. The CMBS special servicing function thus ensures that the primary servicer is able to focus solely on transaction processing, while the special servicer is a loss mitigation specialist.

CMBS transactions feature special servicers in part because of path dependence and in part because of differences in the underlying assets that affect the cost effectiveness of special servicing. The CMBS market developed its distinct servicing structure because it began as a private-label market: in order for investors, particularly the junior "B-piece" investors who purchase the unrated lower tranches, to feel comfortable with the structure, it was necessary to give them control over servicing. Private-label RMBS, on the other hand, were an outgrowth of the GSE securitization market. Just as the GSEs do not generally use special servicers, neither do PLS.

The differences between commercial and residential real estate also affect servicing. The collateral pool supporting CMBS is "chunkier" than that supporting RMBS. Whereas an RMBS deal might include 5000 to 10,000 mortgage loans, a CMBS deal will have a pool of dozens or perhaps hundreds of mortgages, and some CMBS are deals for trophy properties (like the ill-fated August 2001 World Trade Center CMBS issuance). Commercial mortgages are substantially larger than typical residential mortgages. A single commercial real estate loan can easily be fifty to one-hundred times as large as a residential loan. Accordingly, a default on any single property in a CMBS deal is much more significant than a default on any single property in an RMBS deal, and the loss mitigation outcome for any individual property is much more significant for the CMBS transaction. Additionally, commercial property borrowers can modify their mortgages in bankruptcy,[307] unlike most residential mortgage borrowers. CMBS transactions, therefore, require a servicer with expertise in loan restructuring to handle defaults, and investors want the servicer to handle the restructuring without regard to its own bottom line.

For example, consider a CMBS primary servicer required to make advances on a single defaulted $20 million loan at 6% interest. That servicer would be paying out $100,000 per month in interest-free advances to the trust. If the servicer received fifty basis points per year as a servicing fee, on the trust's total balance, say $200 million, the servicer would earn $1 million per

307. *See* 11 U.S.C. § 1123(b)(5) (2006) (permitting Chapter 11 debtors to modify the rights of holders of secured claims other than holders of claims secured by real property that is the debtor's principal residence); *id.* § 1322(b)(2) (continating an analogous provision for Chapter 13 debtors).

year in servicing fees, but have to pay out over a year $1.2 million in (recoverable) advances, which, if repeated for multiple properties, could potentially create a serious liquidity problem for the servicer.

As a result, such a servicer would have a strong incentive either to cut too generous a deal with the defaulted borrower to reinstate the loan and stop making the advances, or to attempt to foreclose as quickly as possible, so as to stop making and recoup the advances. Neither might be optimal for the trust and thus the CMBS investors (setting aside changes to their interests due to tranching).

Accordingly, CMBS deals take care to separate the role of the regular or master servicer, which is responsible for making advances, from that of the special or default servicer. Delinquent loans in CMBS pools are automatically transferred from the primary servicer to the special servicer when they run sixty days delinquent.[308] This structure removes any discretion from the primary servicer about loss mitigation.

CMBS special servicers receive a small servicing fee (in the range of twenty-five basis points) on defaulted loans. This provides the CMBS special servicer with some cash flow when it is handling a workout, but not enough to encourage special servicers to stretch out defaults. CMBS servicers are also compensated so as to be indifferent to the ultimate outcome; their only concern is maximizing value. CMBS special servicers receive a "workout fee" or a "liquidation fee" depending on how a defaulted loan is dealt with; both fees are set at 1% of the return on the loan. This, then, is functionally a 1% untranched interest, not in the entire CMBS pool, but in the defaulted loans. The CMBS market thus makes primary servicers largely indifferent to pool performance, while making special servicers' compensation depend on the effectiveness of the servicers' loss mitigation efforts.

Differences in reimbursement provisions for CMBS and RMBS make CMBS servicers much more neutral among loss mitigation options. Unlike RMBS servicers, CMBS special servicers are not reimbursed for their out of pocket expenses, excluding certain foreclosure expenses like legal fees,[309] which limits the ability to pad on junk fees in foreclosure. And both the CMBS special servicer and the primary servicer are entitled to receive interest at the prime rate on any servicing advances they make.[310] This situation makes

308. *See, e.g.*, COBALT CMBS Commercial Mortg. Trust 2007-C2, Pooling and Servicing Agreement (Form 8-K) EX-4.1 §§ 1.01, 3.22 (Apr. 2, 2007), *available at* http://www.secinfo.com/dRSm6.u13m.c.htm (defining "Servicing Transfer Event" and "Specially Serviced Mortgage Loan") [hereinafter COBALT 2007-C2].

309. *See, e.g., id.* § 3.11(d) ("The Master Servicer and the Special Servicer shall each be required to pay out of its own funds all expenses incurred by it in connection with its servicing activities hereunder . . . and neither the Master Servicer nor the Special Servicer shall be entitled to reimbursement for such expenses except as expressly provided in this Agreement.").

310. *See, e.g., id.* § 3.12(b) ("The Master Servicer, the Special Servicer and the Trustee shall each be entitled to receive interest at the Reimbursement Rate in effect from time to time, compounded annually, accrued on the amount of each Servicing Advance made thereby (with its own funds) for so

servicing advances much less onerous and therefore less of a factor in shaping servicer decisions.

Finally, unlike RMBS special servicers, CMBS special servicers can be effectively disciplined by CMBS investors. The CMBS special servicer is chosen by the holder of the majority of the lowest-priority tranche that is in the money, and the special servicer can be dismissed without cause on minimal notice.[311]

RMBS servicers could adopt features of the CMBS servicers' compensation structure. Separating the transaction processing function from loss mitigation would make RMBS workouts more likely to maximize value for RMBS investors, with positive externalities on homeowners and communities. RMBS also would benefit from separating the obligation to make advances, which serves to ensure the timely payment of principal and interest on the RMBS to investors, from the workout role. This would better align servicer incentives.

Compensation for the special servicer would still present some issues. Compensation of RMBS special servicers with a percentage of the total return could be problematic because the cost of a residential mortgage workout relative to the loan amount outstanding is much higher than for a commercial mortgage workout, since residential mortgages are much smaller than commercial mortgages. This might mean that a higher percentage fee would be required, making special servicing relatively more expensive.

Attempting to mandate a particular compensation structure for special servicers—flat-rate, fixed-fee-per-loan, cost-plus-percentage, cost-plus-fixed-fee, cost-plus-flat-rate, and the like—is probably not a wise legislative pursuit. Servicers know far more about the costs of their business than anyone else, so it is difficult to design an optimal compensation system. Congress could easily end up designing a system that creates unintended problems. Moreover, there is likely to be reluctance in Congress to mandate compensation structures. Requiring an independent special servicer to manage defaulted loans—and leaving the compensation structure unregulated—is likely to be an easier political sell.

Such an arrangement could be further improved by limiting servicers' ability to levy ancillary fees that are not shared with investors. Ancillary fees collected by servicers should be remitted to the trust, rather than retained by servicers. If the servicers had to share the ancillary fees with investors (as well as the increased default risk caused by aggressive fees), they would be less

long as such Servicing Advance is outstanding . . . ."); *see also id*. § 1.01 (defining "Liquidation Expenses").

311. *See, e.g.*, *id*. § 6.09. Often the initial special servicer will be an affiliate of the B-piece investor that holds the junior-most position in the CMBS. Some RMBS investors are attempting to replicate the benefits of controlling the servicer. *See* Yoon, *supra* note 237 (noting one investment fund's strategy of obtaining a supermajority of over two-thirds of the voting rights in an RMBS trust, thus giving it the ability to effectively appoint the servicer and thereby control loan modifications).

eager to push ancillary fees. CMBS permit special servicers to retain any loan modification fees that borrowers pay, as well as late fees;[312] the ability of CMBS special servicers to charge additional fees is only likely to impede negotiated workouts.

The separation of servicing roles could add cost to mortgage servicing because of the addition of extra parties, and that cost would likely be spread among all mortgagors (higher interest rates) and investors (lower returns). On the other hand, separating the two roles of servicers might result in a more efficient servicing market, as different servicers have different strengths, and this would allow them to play to their strengths.

For example, in recent years, large national financial institutions have become involved in mortgage servicing. These institutions benefit from the scalability for transaction processing, but lack deep expertise in consumer loan workouts. Smaller servicers that got their start in the collections business are more skilled with loan workouts, but cannot benefit from economies of scale like national banks and thrifts can. By requiring a division of the transaction processing and loss mitigation functions, those market players with a strength in transaction processing could focus on that, while other servicers with a strength in loss mitigation could specialize in that area. The result would play to the strengths of both types of servicers, and the lack of tying between distinct services could drive down costs.

The indeterminacy of the cost impact of splitting up servicer roles could perhaps best be addressed by providing a choice to securitization sponsors. Either servicers' roles would be split and a percentage of compensation would have to be in the form of untranched interests in the trust, or, if there were only one servicer, a higher percentage of its compensation would have to be in the form of untranched interests in the trust.

In any arrangement, there would be some important technical questions to resolve, such as when a loan would be handed off to the special servicer, which party bears the risk of making servicing advances, and the structure of the rest of the special servicer's compensation. Nonetheless, by requiring a special servicer and by requiring that the special servicer have a substantial part of its compensation depend on the loan's performance, much of the servicer incentive problem would be alleviated.

It bears emphasis that changes to the servicing market could result in higher mortgage costs. This reality is a policy tradeoff, much like a mandatory insurance scheme. Many homeowners would never see any benefit from improved servicing as they do not default. A minority, however, might receive substantial direct benefits if they are able to keep their homes because of a workout, and this, in turn, would have positive spillovers on other homeowners. Given the catastrophic costs to families from losing their homes, and given that

312. *See, e.g.*, COBALT 2007-C2, *supra* note 308, § 3.21(h).

loss of a home is often the consequence of economic conditions beyond the homeowner's control (such as loss of a job due to illness or divorce or a marketwide downturn), it is reasonable to impose the "insurance" costs of improved servicing on everyone. The costs are likely quite low, and almost all mortgagors could benefit from the "insurance" in theory.

Conclusion

This Article presents the first comprehensive overview of the residential mortgage servicing business and shows that mortgage servicing suffers from an endemic principal-agent conflict between investors and servicers. Securitization separates the ownership interest in a mortgage loan and the management of the loan. Securitization structures incentivize servicers to act in ways that do not track investors' interests, and these structures limit investors' ability to monitor servicer behavior. Monitoring proxies, such as ratings agencies and trustees, are themselves subject to perverse incentives and are limited in their ability to monitor servicer behavior.

As a result, servicers are frequently incentivized to foreclose on defaulted loans rather than restructure the loan, even when the restructuring would be in the investors' interest. The costs of this principal-agent conflict are not borne solely by MBS investors. The principal-agent conflict in residential mortgage servicing also has an enormous negative externality for homeowners, communities, and the housing market.

The principal-agent problem in residential mortgage servicing could be addressed by restructuring servicing compensation. Other types of securitizations use measures that mitigate the principal-agent conflict between servicers and investors. There are costs to applying these measures to residential mortgage securitization, which are likely to be borne partly by borrowers in the form of higher mortgage costs. Yet, correcting the principal-agent problem in mortgage servicing is critical for mitigating the negative social externalities from uneconomic foreclosures and ensuring greater protection for investors and homeowners.