

# The Alternative Mortgage Servicing Compensation Discussion Paper

Comments of

## The National Consumer Law Center

on behalf of its low income clients

and

## The National Association of Consumer Advocates

The National Consumer Law Center<sup>1</sup> (NCLC) submits these comments on behalf of its low-income clients and on behalf of the National Association of Consumer Advocates.<sup>2</sup>

NCLC believes that the existing model for servicer compensation is broken. Current servicer compensation is byzantine. The barriers to entry are high. And servicers are rewarded for bad behavior: servicers stand to profit from default and foreclosure, while modifications are costly.<sup>3</sup>

Unfortunately, the models under discussion by the FHFA do not address adequately the existing weakness in servicer compensation. The first model raised in the discussion paper would continue to provide the bulk of servicer compensation through payment of a percentage of the outstanding principal, or an IO strip, but a portion would be held in reserve to be disbursed to service loans in default. The second model under discussion would pay a fixed amount per loan for regular servicing with an additional fee-for-servicer component.

The proposed changes to servicing compensation do not address the misaligned incentives or harms flowing from those misaligned incentives identified in the Discussion Paper.<sup>4</sup> Nothing in the proposals ties servicer compensation closely to either the actual cost of servicing loans or to the performance of the loans. Servicers will still not be encouraged to keep loans performing. The

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<sup>1</sup> The **National Consumer Law Center, Inc.** (NCLC) is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of eighteen practice treatises and annual supplements on consumer credit laws, including *Truth In Lending* (6th ed. 2007) and *Cost of Credit: Regulation, Preemption, and Industry Abuses* (3d ed. 2005) and *Foreclosures* (2d ed. 2007), as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low-income people, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to deal predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. These comments were written by Diane E. Thompson, Of Counsel.

<sup>2</sup> The **National Association of Consumer Advocates** (NACA) is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

<sup>3</sup> See generally Adam Levitin & Tara Twomey, *Mortgage Servicing*, 28 Yale J. on Reg. 1 (2010); Diane E. Thompson, *Foreclosing Modifications: How Servicer Incentives Discourage Loan Modifications*, 86 Wash. L. Rev. 755 (2011).

<sup>4</sup> *Alternative Mortgage Servicing Compensation Discussion Paper*, Fed. Hous. Fin. Agency 18 (Sept. 27, 2011).

worst and most harmful aspects of the existing model, from the standpoint of homeowners, the servicers' retention of ancillary fees, will be retained.

The FHFA should promote a modified fee-for-service model, coupled with rigorous servicing standards and limited ancillary fees. Such a model could improve servicing for both homeowners and investors.

## Ancillary Fees

Servicers under the current regime profit from their own bad behavior because they are permitted to retain all ancillary fees. Thus, a servicer who imposes force-placed insurance, through an affiliate, which results in the homeowner's default, stands to collect thousands of dollars, through the force-placed insurance and late fees, and thousands more if the loan ends in foreclosure, through title insurance and broker price opinions ordered through affiliates and retained fees from the post-foreclosure REO sale. Servicers' retention of these fees provides a powerful incentive to overcharge homeowners, which results in default.

Servicers' retention of ancillary fees is a major cause of wrongful foreclosure. The National Association of Consumer Advocates, in conjunction with NCLC, conducted a survey of attorneys representing homeowners in foreclosure. Over half of the attorneys reported representing homeowners who had been placed into foreclosure because of improper fees. The ninety-six attorneys from thirty-four states reported representing over 1,200 homeowners who had been placed into foreclosure because of misapplication of payments, improper fees, or force-placed insurance.<sup>5</sup>

Neither proposed compensation model addresses the concerns of consumers. Both models leave intact servicers' ability to retain and profit from default and ancillary fees. Thus, the primary driver of wrongful foreclosure remains unchecked. Such fee-gouging also hurts investors, who ultimately bear the increased losses from elevated rates of default, and, particularly in markets with depreciating housing values, stand to lose as equity is stripped from the collateral.<sup>6</sup>

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<sup>5</sup> Nat'l Ass'n Consumer Advocates & Nat'l Consumer L. Ctr., Servicers Continue to Wrongfully Initiate Foreclosures (Dec. 2010), [http://www.nclc.org/images/pdf/foreclosure\\_mortgage/mortgage\\_servicing/wrongful-foreclosure-survey.pdf](http://www.nclc.org/images/pdf/foreclosure_mortgage/mortgage_servicing/wrongful-foreclosure-survey.pdf).

<sup>6</sup> See, e.g., Jody Shenn, *Mortgage Investors with \$500 Billion Urge End of Practices, Lawyer Says*, Bloomberg News, July 23, 2010, <http://www.bloomberg.com/news/2010-07-23/mortgage-investors-with-500-billion-urge-end-of-practices-lawyer-says.html> (reporting on letters sent to trustees of mortgage pools on behalf of a majority of the investors in the pool); Complaint, Carrington Asset Holding Co., L.L.C. v. American Home Mortgage Servicing, Inc., No. FST-CV 09-5012095-S (Conn. Super. Ct., Stamford Feb. 9, 2009)

(complaint alleges that servicer's practices regarding fees and post-foreclosure sales were costly to investors); Ass'n of Mortg. Investors Press Release, AMI Supports Long Term, Effective, Sustainable Solutions to Avert Foreclosure; Invites Bank Servicers to Join, Nov. 16, 2010 (citing servicers' profit from fees and payments from affiliates as an impediment to loan modifications that would be in the interests of investors); Letter from Kathy D. Patrick to Countrywide Home Loans Servicing, Oct. 18, 2010 (notifying a trust and master servicer of breaches in the master servicer's performance).

The GSEs should monitor these fees for reasonableness, both in frequency and in dollar amount. Monitoring of affiliate charges is essential. Without tight restrictions on excessive fees, ancillary fees will continue to drive foreclosures over modifications.

### No Benefit to Consumers from Competition

While both models may lower barriers to entry, competition among servicers will not necessarily benefit homeowners. Homeowners cannot shop for their servicer. They cannot choose servicers or change servicers in the event of abusive servicing. Competition among servicers is unlikely to result in better servicing from the homeowner's perspective.

### No Incentives to Keep Loans Performing

The proposals on the table appear to reduce the payment for routine servicing and increase the payment for default servicing. In order for this to realign servicers' incentives with the interests of either borrowers or investors, more needs to be done. Rigorous accountability for keeping loans performing must be imposed, along with meaningful loss mitigation requirements when a borrower's default is beyond a servicer's control. The Discussion Paper addresses long-term performance of loans only in its attempts to encourage servicers to keep the principal balance of loans high, without regard to the performance of the loans or the quality of the servicing. This continues the GSEs' pattern of blocking principal reductions, even though they are the most sustainable of all loan modifications<sup>7</sup> and favored by many investors.<sup>8</sup> Even the proposal to impose a net benefit test for refinancing is insufficiently developed to protect homeowners' interests and does not in itself promote responsible servicing. Servicers are not provided strong incentives to keep loans performing.

Both the fee-for-service model and the reserve account model, without meaningful standards, could encourage servicers to push loans into default in order to obtain the additional fees available for default servicing. Under the MBA's proposal, monies from the reserve account would transfer with the servicing, and would be available to pay for default servicing costs. This may, depending on the fee structure, actually encourage servicers to allow loans to go into default just to access the reserve accounts. While mention is made of providing the reserve accounts for performing loans, because the reserve account transfers with the servicing, servicers will have minimal incentives for the long term performance of the loans. Under either model, standards for default servicing are essential to discourage servicers from using default servicing as a profit center. If default servicing is too attractive, servicers have incentives to push loans into default.

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<sup>7</sup> See, e.g., Rod Dubitsky et al., Credit Suisse, Subprime Loan Modifications Update 6–7 (2008); Andrew Haughwout et al., Second Chances: Subprime Mortgage Modification and Re-Default 24 (Fed. Reserve Bank of N.Y., Staff Report No. 417, rev. 2010), [http://www.newyorkfed.org/research/staff\\_reports/sr417.pdf](http://www.newyorkfed.org/research/staff_reports/sr417.pdf); Diane Pendley et al., Fitch Ratings, U.S. RMBS Servicers' Loss Mitigation and Modification Efforts Update II, at 16 (June 2010).

<sup>8</sup> See, e.g., *The Need for National Mortgage Servicing Standards: Hearing Before the S. Subcomm. on Hous., Transp., & Cmty. Dev.*, 112th Cong. 4 (2011) (written testimony of Laurie Goodman, Senior Managing Director, Amherst Securities Group, LP)

The FHFA Discussion Paper acknowledges that even in the current environment servicers were generally paid enough to cover default servicing and “chose” not to invest in the technology to engage in effective default servicing prior to the foreclosure crisis.<sup>9</sup> Nothing in these proposals changes that dynamic. Servicers cannot pay for investments in technology with either a post-hoc, fee-for-service or a reserve account they can access only once defaults escalate. Thus, unless the fees for default servicing are inflated above actual cost, there remains little incentive to invest in the technology and no penalty for failing to do so. And if fees for default servicing are inflated above actual cost, then the FHFA will have created a perverse incentive for poor servicing.

These limitations reflect the inherent difficulties of encouraging modifications through compensation. Without rigorous standards for loss mitigation, allowing loans to go into default and proceed through foreclosure likely will continue to be the servicers’ avenue of choice. Presumably, the FHFA is relying on the Servicing Alignment Initiative (SAI) to provide those standards. As we have discussed elsewhere, the SAI is inadequate to this task<sup>10</sup>

## **Capitalization of Fees**

The shift to a modest per-loan fee will remove some of the impetus for servicers to capitalize fees in a loan modification (and, if the GSEs permitted it, would make the servicers neutral as to principal reductions—a welcome change).

## **Conclusion**

The changes in servicing compensation posited by the FHFA do not go far enough to change the existing dynamic. Neither proposal encourages servicers to maintain loans in performing status and both allow servicers to strip wealth from homeowners. By permitting servicers to retain ancillary fees without rigorous oversight, the FHFA proposes to leave untouched the most damaging aspect of the current compensation structure. Other changes might have some modest salutary effects, but the bulk of improvements in servicing are left to the FHFA’s Servicing Alignment Initiative to carry. The SAI is itself inadequate. The SAI does not go far enough in addressing dual track—the practice of proceeding with a foreclosure even while negotiations for a loan modification are underway—and penalizes servicers who assist homeowners with loan modifications once a foreclosure has been initiated.<sup>11</sup> The SAI’s standard loan modification is more expensive and less sustainable than HAMP modifications and perpetuates practices from the unsustainable lending that caused the crisis in the first place.<sup>12</sup> In both the SAI and the proposed changes to servicing

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<sup>9</sup> *Alternative Mortgage Servicing Compensation Discussion Paper*, Fed. Hous. Fin. Agency 6 (Sept. 27, 2011).

<sup>10</sup> See generally *The Need for National Mortgage Servicing Standards: Hearing Before the S. Subcomm. on Hous., Transp., & Cmty. Dev.*, 112th Cong. 31-35 (2011) (written testimony of Diane E. Thompson, Of Counsel, Nat'l Consumer Law Center) (discussing weaknesses of the FHFA’s SAI).

<sup>11</sup> See Fannie Mae SVC-2011-08R (Sept. 2, 2011); Freddie Mac Guide Bulletins 2011-11(Implementation Requirements), 2011-16 (Standard Modification, *see also* Guide Chapter B65, Workout Options), 2011-17 (Post Referral Solicitation Requirements), & 2011-19 (Update).

<sup>12</sup> For example, the current modification interest rate is 5%, Fannie Mae, Announcement SVC-2011-08R at 28 (Sept. 2, 2011), although the current Freddie Mac primary mortgage market survey rate is 3.91%. See [www.freddiemac.com](http://www.freddiemac.com).

compensation, the FHFA has left homeowners out in the cold while continuing to show “undue deference to the Enterprises”<sup>13</sup> and the servicers themselves.

A modified fee-for-service model, with rigorous loan modification standards, tight restrictions on ancillary fees, and perhaps an extension of the bonuses available under the SAI for performing loans, might move the market towards improved servicing for homeowners and investors alike. The models on the table do not.

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Similarly, the front-end DTI may reach 55% , Fannie Mae, Announcement SVC-2011-08R at 27 (Sept. 2, 2011), far in excess of the 31% front-end DTI that has supported HAMP loan modifications with low redefault rates..

<sup>13</sup> *Oversight of the Federal Housing Finance Agency Part II: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 112th Cong. 2 (2011) (testimony of Steve A. Linick, Federal Housing Finance Agency Inspector General).