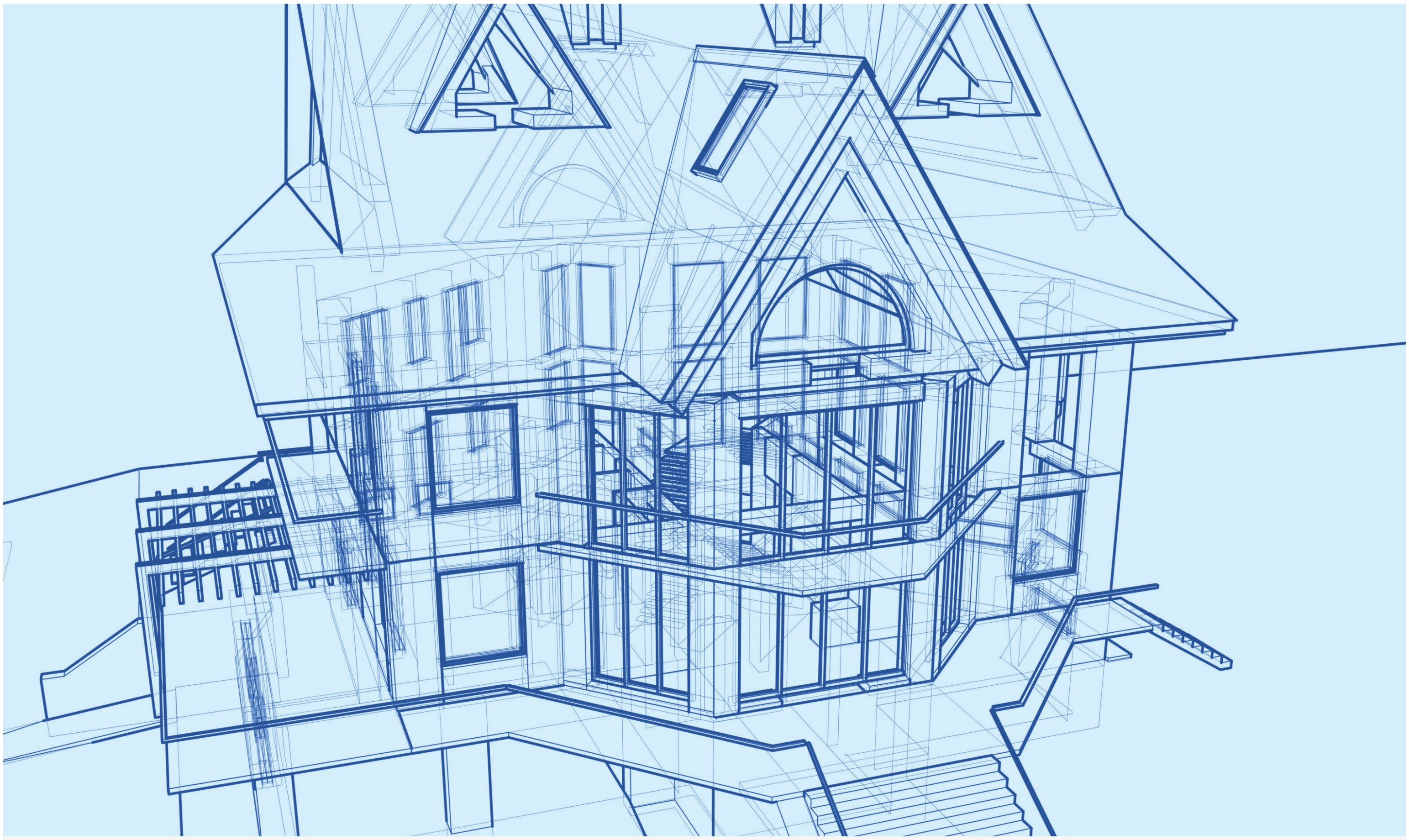

Residential Mortgage Servicing for the 21st Century

White Paper

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Residential mortgage loan servicers have come under heavy scrutiny in the last several years as a record number of homeowners have fallen behind on their monthly mortgage payments and have lost their homes to foreclosure. In response, mortgage lenders, servicers, investors, policymakers and other stakeholders have launched innumerable programs and initiatives to stem the tide of foreclosures that have caused borrowers to lose their homes and communities to deteriorate.

In spite of all of these efforts, the depth and breadth of the credit crisis has been overwhelming for the even the best intentioned mortgage servicers and for the long term, essential changes must be made to the servicing business model.

That is why, in December of 2010, the Mortgage Bankers Association (MBA) launched the Council on the Future of Residential Mortgage Servicing for the 21st Century. The Council was tasked with providing recommendations to industry and government for improving the future state of mortgage servicing.

On January 19, 2011 the Council hosted the Summit on Residential Mortgage Servicing for the 21st Century. The meeting brought together industry leaders, consumer advocates, economists, academics and policymakers to take a detailed look at the issues that have vexed the industry and sought to identify the essential building blocks for the future of loan servicing.

This white paper is the first work product of the Council. It is meant to be an educational tool to provide background information and an environmental scan of the events leading up to the current crisis. It provides information on what a servicer does; how a servicer is compensated; and the perspectives of consumers, regulators, and the legal community with regard to servicer performance in the current crisis and common misperceptions about servicer incentives during the loss mitigation process.

In the coming months, the Council will continue its work focused in three primary areas — servicer compensation, best practices in loss mitigation and customer service, and improvement to the foreclosure process. In the end, it is our intent to come up with workable solutions to ensure that, going forward, all stakeholders will have the tools at their disposal to better align their efforts with what is best for homeowners, investors, and the nation as a whole.

As in any crisis, the problems we face today lead all of us to question the way we do things. Our challenges force us to ask, what went wrong, and they prompt us to search for lessons learned.

MBA, and its members, are committed to being leaders in affecting the necessary changes to the residential loan servicing paradigm. We have invited, and will continue to welcome, all interested stakeholders to join us in this effort. Only together can we restore confidence in our industry and preserve the dream of sustainable homeownership for future generations.

Sincerely,

David H. Stevens
President & CEO
Mortgage Bankers Association

Debra W. Still, CMB
Chairman
Council on Residential Mortgage Servicing for the 21st Century

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Executive Summary

During the last few years, the housing market has been hit with real property value declines in many markets, high unemployment rates, and unprecedented borrower defaults on home mortgages. Servicers of residential mortgages have faced extraordinary challenges in trying to help borrowers avoid foreclosure. The following white paper summarizes some of the key challenges faced by mortgage servicers, lessons learned during the recent housing crisis and issues and opportunities that need to be further explored to improve residential mortgage servicing in the future.

What has been called the "Great Recession" started in the housing market, but soon spread into a broader economic event, where the most notable attribute was a sharp increase in the unemployment rate. This fueled further mortgage loan delinquencies, which remain at historically high levels. Initially, the delinquent loans were predominately subprime mortgages and non-traditional mortgage products. However rising unemployment rates caused many borrowers who lost their jobs to default on traditional mortgage products that had been conservatively underwritten.

The Great Recession brought about the failure or consolidation of many of the country's largest financial institutions and the failure of the vast majority of the subprime segment of the market. It led to unprecedented policy initiatives, both in terms of fiscal stimulus and other government interventions, including monetary stimulus in the form of near zero interest rates and massive purchases of mortgage-backed securities and other assets. It also led to new government-sponsored loan modification programs in an attempt to keep millions of defaulting borrowers in their respective homes. It also brought about a significant decline in the price of homes, especially in the states of Florida, California, Arizona and Nevada. These states had witnessed unusually high price increases before the Great Recession, and non-traditional mortgage products were emphasized. Mortgage servicers scrambled to hire and train additional collection and foreclosure personnel and to develop the infrastructure and software to roll out the government HAMP loan modification programs and revamp proprietary modification programs.

Critics of the government's and mortgage servicers' response claim that the loan modification programs are helping too few borrowers, borrowers are having difficulties reaching the servicers, modifications are taking too long to process, and foreclosures and modification efforts are happening simultaneously. Modification statistics show a different picture whereby just under four and a half million homeowners have been rescued from foreclosure through HAMP and other modification programs. In spite of these successes, the recent "robo-signing" issue put consumer and regulator concerns regarding the servicing process on the front page of the daily newspapers across the country and at the top of policymakers' minds. On another front, the Basel Commission, who recommends changes to risk-based capital requirements for banks worldwide, adopted an annex to existing capital standards that, if adopted by bank regulators in the United States, would place a significant limit on the amount of servicing that could be held by banks. This rule would significantly impact the landscape of the mortgage servicing segment of the industry.

In this environment, on December 8, 2010, MBA announced that it had assembled a task force of key MBA members to examine and issue recommendations for the future of residential mortgage servicing. The Council on Residential Mortgage Servicing for the 21st Century (Council) is being led by Debra W. Still, CMB, President and Chief Executive Officer of Pulte Mortgage LLC of Englewood, Colo. and MBA's Vice Chairman. In announcing the formation of the Council, MBA Chairman Michael Berman, CMB, stated, "The residential mortgage servicing sector has been operating in a time of unprecedented challenges, presenting us with a unique opportunity to explore potential improvements to business practices, regulations and laws affecting the servicing sector and consumers. As the national trade association representing the real estate finance industry, we will bring together industry experts to take a comprehensive look at the current state and ongoing evolution of residential mortgage servicing and make recommendations for the future."

The Council convened a one-day public summit on January 19, 2011, in Washington, DC, titled, "MBA's Summit on Residential Mortgage Servicing for the 21st Century" (Summit). This meeting brought together industry leaders, consumer advocates, economists, academics and policymakers who took a detailed look at the issues that have challenged the industry and started the process of identifying the essential building blocks for the future of servicing.

Keynote speakers at the Summit and the panelists discussed problems and perceptions from their respective vantage points. Many speakers identified the need for a national servicing standard, the need to change the compensation structure to better incent servicers in the area of dealing with non-performing loans (NPLs), and potential changes in laws and regulations related to foreclosures and other facets of servicing.

This white paper is the first product of the Council. It is meant to be an educational tool to provide background information and an environmental scan of the events leading up to the current crisis. The white paper provides information on what a servicer does; how a servicer is compensated; and the perspectives of consumers, regulators and the legal community with regard to servicer performance in the current crisis and their policy recommendations. It also contains an industry analysis of the criticisms against servicers in order to separate real problems from "urban myths."

The last chapter highlights the Council's next steps to set the course for the future of servicing in the 21st century.

In analyzing the issues that surfaced during the Summit, the Council identified three major areas for further study and development of policy recommendations:

- Review of existing servicing standards and practices especially in the area of dealing with large volumes of NPLs, foreclosure practices, and loss mitigation practices, including loan modifications. The Council formed a working group called the National Servicing Standards Working Group to study and make policy recommendations related to a national servicing standard.
- Evaluation of the legal issues related to the foreclosure process, chain of title and other issues. The Council formed a working group called the Legal Issues Working Group to study and make policy recommendations related to legal issues identified during the Summit and any additional statutory or regulatory changes deemed appropriate for servicing in the 21st century.
- Analysis of proposed changes in servicer compensation proposed by the Federal Housing Finance Agency (FHFA), Ginnie Mae, Fannie Mae and Freddie Mac. MBA formed a working group called the Economics of Servicing Working Group to analyze the proposed compensation structure from the vantage of various stakeholders including large and small servicers, depository and non-depository services, investors in mortgages and MBS, and regulators.

The Council looks forward to working with policymakers, consumer groups and other mortgage market participants to work through these issues and develop servicing standards, regulatory and statutory changes, and servicing economics that will improve servicing in the future while also protecting the economics and viability of the servicing business model.

I. Primer on Residential Mortgage Servicing

What Does a Residential Mortgage Servicer Do?

The mortgage servicer is the party that collects monthly mortgage payments from borrowers, remits principal and interest to the investors in those loans, pays property tax and hazard insurance bills from escrow funds collected from borrowers in their monthly mortgage payment, and performs collection, loss mitigation and foreclosure activity with respect to delinquent borrowers.

The servicer may service loans on behalf of itself or an affiliate, it may service as a contractor of the trustee in the case of mortgages included in mortgage-backed securities (MBS), or it may service whole loans for an outside third-party investor. When servicing for trustees of MBS and for outside third parties, the servicer acts as a contractor of the investor. As such, the servicer is guided and controlled by the servicing agreement, which establishes requirements for servicing performing and non-performing loans, including parameters and controls to avoid servicers taking action that is adverse to the investors' interests. The servicer must balance these contractual requirements and restrictions with its interests in serving its borrower customers.

Monthly payments from borrowers go towards paying principal and interest. For borrowers that pay taxes and insurance through the servicer, the monthly remittance also includes a pro-rata portion of the annual or semi-annual real property taxes and hazard insurance bills. These cash receipts are segregated into two types of accounts: 1) principal and interest funds (P&I) are placed in bank accounts in trust for the benefit of investors and; 2) tax and insurance funds (T&I) are placed in bank accounts in trust for the benefit of borrowers. Investor funds are remitted to the investor usually monthly, but sooner for some investors, if the funds represent a payoff of the mortgage. Escrow funds are disbursed by the servicer on behalf of the borrower when tax and insurance bills come due.

Fannie Mae, Freddie Mac, Ginnie Mae and the Federal Housing Administration (FHA) servicing guidelines direct the servicer's collection and loss mitigation activities for servicing on behalf of Fannie Mae, Freddie Mac, Ginnie Mae and FHA. These guidelines provide the servicer and the investor with a clear understanding of the servicing contract and help to promote liquidity in the MBS market. For private label MBS, the pooling and servicing agreements (PSAs) dictate the level of servicing activities, including collection and loss mitigation activities. The servicer's duties are defined by and limited to, those servicer guides and pooling and servicing agreements.

Servicers' maintain records in order to provide detailed accounting of the loan balance and payment activity of the mortgage and for balance and payment activity of the T&I escrow accounts. When servicing MBS, detailed balance and disbursement activity is also maintained at the pool level, and for certain MBS, at the individual investor level.

Appendix B provides a more detailed description of the servicing function.

What Are the Servicer's Revenues and Expenses?

When examining the economics of servicers, it is first important to understand all revenues and costs associated with servicing operations, some of which are often overlooked.

Revenues

During 2003–2010, servicing revenues averaged 36–43 basis points for large prime servicers and 31–39 basis points for small prime servicers. The components of servicing revenues include servicing and subservicing fees net of guarantee fees, ancillary fees such as late payments, and interest earnings on P&I and T&I accounts held in escrow prior to remittances to investors, insurers and tax authorities (float benefit). Since 2007, servicing revenues have been declining. Contributing factors to the decline include: longer foreclosure timelines (during which agency servicers do not receive a service fee); declines in total mortgage debt outstanding; uncollectable excess servicing (any amounts of interest received by the servicer in excess of "normal" servicing fee); and changes in guarantee fees.

Expenses

Servicing costs include more than simply the direct cost to service. The key components of the total servicing costs include direct servicing costs, unreimbursed foreclosure and REO-related servicer expenses, corporate allocations, and various types of interest expenses primarily for advances and prepayments. Fully-loaded total servicing costs averaged 12–18 basis points for large prime servicers and 15–21 basis points for small prime servicers during 2003–2010. Since 2007, all components of servicing costs increased, except for interest expenses. While default-related advances increased during this period, many servicers (particularly those bank-affiliated servicers) have been helped by low short-term interest rates that have kept down the cost of funding such advances.

Net Operating Income and Net Financial Income

Servicing net operating income is defined as total revenues less total servicing expenses. From 2003 through 2010, large prime servicers' net operating income ranged from 22–30 basis points, while small prime servicers' net operating income ranged from 16–19 basis points. Servicing net financial income, on the other hand, incorporates gains and losses on the valuation of mortgage servicing rights net of hedging. During 2003–2010, net servicing financial income has ranged from a loss of 9 basis points to income of 13 basis points for large prime servicers and a loss of 8 basis points to income of 5 basis points for small prime servicers.

II. Environmental Scan

From January 2008 to February 2010, the U.S. economy lost almost 8.8 million jobs. According to FHFA, home prices nationally decreased a cumulative 11.5 percent during the past five years, with much larger cumulative declines of 40 to 50 percent in the states of Arizona, California, Nevada and Florida (known throughout the crisis as the ("Sand States"). Even though construction of new homes remains near 50-year lows, inventories of unsold homes on the market remain high, with nearly four million properties currently listed, as homebuyer demand remains weak. Responding to the downturn, household formation rates fell sharply, with many families combining households and household expense to save money. Consumers cut spending across the board, as they tried to rebuild savings after the shocks to their wage income and the declines in stock market and housing market values.

This "Great Recession" was the most severe economic downturn that the U.S. had experienced since the Great Depression of the 1930s. It led to the failure or consolidation of many of the country's leading financial institutions. It resulted in unprecedented policy initiatives, both in terms of fiscal stimulus and other government interventions, and monetary stimulus in the form of near zero interest rates and massive purchases of mortgage-backed securities and other assets.

The housing and mortgage markets both contributed to and suffered from this crisis. Among the contributing factors: overbuilding, lenient lending standards (particularly with respect to documentation) that favored non-traditional mortgage products, the easing of underwriting standards on the part of Fannie Mae and Freddie Mac, passive rating agencies and regulation, homebuyers chasing rapid home price increases, undercapitalized financial institutions, monetary policy that kept interest rates too low, for too long, and massive capital flows into the U.S. from countries that refused to allow their currencies to appreciate.

Regardless of which factors were the causes, we do know that the nature of the crisis changed over time. Initially, rising rates from the Federal Reserve and suddenly tighter regulatory requirements ("guidance") around subprime and non-traditional loan products stranded borrowers who had counted on being able to refinance loans in late 2006 and into 2007.

As a result, serious delinquency rates on subprime ARM loans increased by 50 percent in 2006 and then more than doubled through 2007. Even before their first reset, these loans were failing at unprecedented rates. The subprime ARMs originated from 2005–2007 have performed much worse than any others in recorded data.

Without access to credit for new buyers, home prices in the overbuilt markets in the Sand States began to nosedive. With investors increasingly beginning to question performance, the private-label MBS market froze in August 2007 and has remained essentially frozen since. To make matters worse, lending to prime, jumbo borrowers effectively stopped. As liquidity left the system, fewer potential buyers could get credit, and home prices declined further. According to the National Bureau of Economic Research (NBER), the economy fell into recession in December 2007.

The unemployment rate in January 2008 was five percent. Eighteen months later, it would be nearly twice as high, following the near collapse of the financial sector in the fall of 2008. From that point, mortgage delinquencies and foreclosures were being driven by joblessness and loss of income. Serious delinquency rates on prime fixed-rate loans were at 1.1 percent in the beginning of 2008. By the end of 2009, they were approaching five percent. These loans were traditionally underwritten, and well documented with no structural features that impacted performance. Borrowers simply couldn't pay if they didn't have a job.

Important policy initiatives were launched through this time period. Servicers began large-scale efforts to modify subprime and non-traditional loans. Initially, these efforts were undertaken by individual servicers, but government and industry efforts led to standardization of processes through the Home Affordable Modification Program (HAMP), which also benefitted proprietary modification programs, which could leverage these standardized processes. Since July 2007, the Hope Now Alliance estimates that just under four and a half million homeowners received permanent loan modifications through HAMP or proprietary modification programs.

For several years, the four states of Florida, Arizona, Nevada and California have dominated the national delinquency and foreclosure numbers, accounting for 40 percent or more of total foreclosure starts in recent quarters and almost 60 percent of foreclosure starts for subprime and prime ARMs. As of the fourth quarter of 2010, more than 14 percent of all loans in Florida were in foreclosure, and almost one quarter of all loans were past due by one payment or more or in the foreclosure process.

Efforts to delay the foreclosure process have typically not been effective over the longer-term. Frequently, there can be a tradeoff between late-stage delinquencies and foreclosure starts, as new regulatory or statutory requirements delay foreclosure starts one quarter, resulting in a temporary increase in the delinquency bucket. In most cases, foreclosure starts have rebounded in subsequent quarters as the backlog is worked through.

In summary, the worst recession in living memory has led to the worst mortgage performance. Servicers have been overwhelmed by national delinquency rates running four to five times higher than what had been typical during the prior 40 years for which MBA has data.

III. Summit for Residential Servicing for the 21st Century (Summit)

On January 19, 2011, MBA hosted a one-day summit in Washington, DC. This meeting brought together industry leaders, regulators, consumer advocates, economists, academics, and government policymakers for a detailed look at the issues that have challenged the industry. The purpose of the meeting was to recognize the issues that need to be examined and to identify the essential building blocks for the future of servicing.

MBA hosted three keynote speakers during the Summit:

- The Honorable Sheila Bair, Chairman, Federal Deposit Insurance Commission (FDIC)
- The Honorable David H. Stevens, Assistant Secretary for Housing and Commissioner of the Federal Housing Administration, U.S. Department of Housing and Urban Development
- Richard Neiman, Superintendant of Banks, State of New York

These speakers offered an insight on what regulators and government policymakers think about servicers' performance during the recent crisis and some changes that they believe are necessary for the future.

Panel I: Servicing in Unprecedented Times: Strategies, Direction, and Lessons Learned

This panel included Cindy Gertz, Director of Operations, Office of Homeownership Preservation of the U.S. Department of Treasury, Bryan Palmer, Director at Freddie Mac, Tom Marano, Chief Capital Markets Officer and CEO of Mortgage Operations for Ally Financial, Inc., and J. David Motley, President of Colonial National Mortgage. The purpose of this panel was to review the performance of the servicing industry during the recent crisis, key challenges and possible strategies for the future.

Panel II: Secondary Marketing Perspective

This panel included Honorable Ted Tozer, President of Ginnie Mae, Robert Lee, Senior Vice President of Mortgage Industry Advisory Corporation, Andrew BonSalle, Senior Vice President of Fannie Mae, Tom Deutsch, Executive Director of the American Securitization Forum (ASF), and Richard Dorfman, Managing Director of the Securities Industry and Financial Markets Association (SIFMA). The panel discussed servicing fee alternatives, the secondary market for servicing rights, the state of the secondary markets for non-conforming mortgage products and other issues that could impact servicing in the future.

Panel III: Consumer Perspectives

This panel included Mike Calhoun, President of the Center for Responsible Lending, Patrice Ficklin, consumer advocate and Counsel for Reiman, Dane & Colfax, and David Berenbaum, Chief Program Officer for the National Community Reinvestment Coalition. The panel provided a glimpse of the borrower's views on how servicers performed during the current crisis.

Panel IV: Legal Perspectives

This panel included Laurence Platt, Partner of K&L Gates and Adam Levitin, Associate Professor, Georgetown University Law Center. This panel discussed various legal issues associated with the foreclosure process, including chain of title issues, "robo-signing," and the use of MERS.

Economics of Mortgage Servicing

In this session, Jay Brinkmann, Ph.D., MBA's Chief Economist, and Marina Walsh, MBA's Associate Vice President of Industry Analysis, presented a summary of the trends in economics for servicers during the recent crisis.

The following are summaries of secondary marketing perspectives, regulators' perspectives, legal perspectives and consumer perspectives based upon the Summit's panel discussions and various articles. Following those summaries is the servicer's perspective meant to be both a summary of the servicer's experience during the credit crisis and a counterpoint to some of the "urban myths" about servicers' roles and responsibilities.

IV. Secondary Market Perspective

Several days before the Summit, FHFA announced that it was conducting a study jointly with Ginnie Mae, Fannie Mae and Freddie Mac for a new fee structure that would better align servicer incentives and investor interests when it comes to servicing loans in default. This became a primary focus for the secondary marketing panel during the Summit.

One of the primary drivers for the initiative to change servicing fee structures relates to a pending change in capital rules for banks. On July 26, 2010, the oversight body of the Basel Committee[1] on Banking Supervision (Basel Committee) approved an annex to the Basel accord which is an international agreement that establishes capital standards for financial institutions. The annex specifically guides respective member countries' bank regulators to adopt rules for the treatment of specific assets in determining Tier I capital for regulatory reporting purposes. Under the annex, the following assets may receive only limited recognition when calculating the common equity component of Tier I capital, with recognition for each class of assets capped at ten percent of the common equity component of Tier I capital:

- Significant investments in the common shares of unconsolidated financial institutions (banks, insurance and other financial entities),
- Mortgage servicing rights (MSRs), and
- Deferred tax assets (DTAs) that arise from timing differences.

In addition, under the annex a bank must deduct the amount by which the aggregate of the three items above exceeds 15 percent of its common equity component of Tier I.

1. The Basel Committee is a group of bank regulators from various countries including the United States. It recommends capital guidelines for banks in order to level the playing field for all banks competing world-wide. It recommends policies and principles, but each participating country must develop their own respective rules using Basel as a guideline.

This treatment would be much more onerous than treatment under existing capital rules whereby MSRs are measured at 90 percent of fair market value (FMV) (for capital purposes) and a bank may hold up to 100 percent of capital in MSRs before any reduction from Tier I capital.

The second primary driver for the proposed changes in fee structure is the perception that the present servicing fee structure misaligns the servicer's interest with that of investors. Proponents of this view believe that servicers are overpaid for servicing performing loans and underpaid for servicing non-performing loans. Servicers disagree with this notion. See the Servicer's Perspective section below whereby servicers dispel this "urban myth."

The general themes emerging from the secondary market panel discussion related to the need to increase predictability and flexibility while decreasing volatility and concentration risk. For example, some participants voiced the opinion that an alternative to the existing I / O strip method for calculating servicing fees should be created in order to decrease volatility. A related question arose with respect to who would absorb the volatility in servicing fees in a downturn (i.e. the investor or guarantor). Panelists also said that since the "TBA" market thrives on predictability, care should be taken to be compatible with the TBA guidelines.

In terms of flexibility, the panelists said that servicing rights should incorporate factors that reflect market conditions so that the fee varies accordingly. For example, they mentioned the benefit of having one arrangement for the "low-touch, high-tech" business platform for primary servicers, and another arrangement to accommodate the "high-touch" platform for default servicers. However, care should be taken because the transition from "high-tech" to "high-touch" is very complicated and disruptive. This is a double-edged sword, however, because the market's desire for certainty / predictability runs counter to a flexible approach to calculating servicing rights.

Ideally, the calculation method also should be designed to improve the ability of firms of all sizes/structures to hold servicing rights. Such an improvement will open up the market for servicing rights and address the existing concentration risk associated with a relatively small number of existing firms that are interested in holding servicing rights. Panelists also mentioned the lack of excess capacity in the servicing industry to absorb dramatic changes in volumes of defaulted loans, loan modifications and other transactions. The financial condition of a servicer is a critical factor because moving servicing is not done easily.

Shortly after the Summit, FHFA released a document that illustrated four servicing fee structures that FHFA, Ginnie Mae, Fannie Mae and Freddie Mac were exploring. In the following table, the first column is an example of today's fee structure whereby the minimum servicing fee is 25 basis points, the guarantee fee is assumed to be 20 basis points, and there is five basis points of excess servicing fee to capitalize as part of the MSR or to monetize. The next column presents what the industry has dubbed the "Alternative Minimum Servicing Fee" or "AMSF." Rather than take a fee based upon an interest strip, the servicer would take an unguaranteed interest in both the principal and the interest cash flows. In the table below, that is assumed to be a one percent interest in principal and interest cash flows. The third through fifth columns are various permutations of the existing fee structure. The third column assumes a minimum servicing fee of 12.5 basis points, the fourth column assumes a minimum of three basis points, and the final column assumes no minimum servicing fee. In each of the proposed alternatives, the compensation relates to the servicing of performing loans. The guarantor would pay the servicer or, a special servicer, additional fees for each non-performing loan on the basis of a flat dollar amount per loan per month based upon stage of delinquency.

			Fee for Service Models		
Mortgage Rate Composition (Note A)	Today's 25 basis points	AMSF 1% of P&I	12.5 basis points (MSR)	3.0 basis points (MSR)	0 basis points (MSR)
Treasury	4.20%	4.20%	4.20%	4.20%	4.20%
MBS spread to Treasury	1.30%	1.30%	1.30%	1.30%	1.30%
MBS Current Coupon	5.50%	5.50%	5.50%	5.50%	5.50%
Guarantor revenue					
G Fee	0.20%	0.20%	0.20%	0.20%	0.20%
Mortgage Bank Revenue					
Minimum servicing fee required to be held	0.25%	0.00%	0.125%	0.03%	0.00%
Additional spread to hold or monetize (Note B)	0.05%	0.30%	0.175%	0.27%	0.30%
Total primary/secondary spread	0.50%	0.50%	0.50%	0.50%	0.50%
Borrower rate	6.00%	6.00%	6.00%	6.00%	6.00%

Note A: Source Servicing Compensation Initiative Pursuant to FHFA Directive in Coordination with HUD, Background and Issues for Consideration, February 2011, page 14.

Note B: Under the 1% P&I illustration, the excess servicing would be for the 99% of the loans not held by the servicer.

V. Regulators' Perspectives

During the Summit, the Council hosted three keynote speakers from different government agencies:

- The Honorable Sheila Bair, Chairman, Federal Deposit Insurance Commission (FDIC)
- The Honorable David H. Stevens, Assistant Secretary for Housing and Commissioner of the Federal Housing Administration, U.S. Department of Housing and Urban Development
- Richard Neiman, Superintendant of Banks, State of New York

These regulators offered insight on the government's perspectives on servicer performance during the recent crisis and their recommended changes for the industry. Together they addressed the idea of setting a common standard for the residential mortgage servicing industry, including modifications, the foreclosure process, technology, human resources and adequate supervisory regulation.

- **Standards:** There was a call for the development of a national servicing standard especially as relates to foreclosure and default administration. One model would establish a national servicing standard to be developed in conjunction with the rulemaking process under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) for implementing risk retention and defining the Qualified Residential Mortgage (QRM). Another approach calls for the development of a comprehensive servicing process in a joint federal and state effort one speaker dubbed a "Cooperative Federalism." Representatives from the industry at a later portion of the Summit pointed out that mortgage servicing does have standards through Fannie Mae, Freddie Mac, FHA and VA servicer guidelines.
- **Human Resources:** The regulators stated that servicers need to have adequate staffing to deal with the large volume of borrowers in default. The importance of a single point of contact was emphasized, particularly for borrowers with loans in default or in the process of loan modification. Later at the Summit, it was recognized that improving staffing levels and their skills was key and that the industry had increased staff, though defining what a single-point of contact meant varied.
- **Technology:** The regulators contrasted the industry with itself from several years ago when it used more technology to reduce costs and human resources, while under a less structured environment. The regulators believe that today's challenges require more human contacts than technology.
- **Foreclosure Process:** There were concerns expressed about document irregularities, servicing processes and legal issues, about rights to foreclose and missing documentation, among other matters. This will be discussed further in the legal issues portion of this paper.
- **Regulation:** Generally, there was a sense that mortgage servicers have not been sufficiently regulated. The new Consumer Financial Protection Bureau (CFPB) has the potential to fill that perceived void.

Outside of the subjects discussed at the Summit, other government policymakers have shared their own approaches for improving residential mortgage servicing to more effectively deal with borrowers in default.

- U.S. Senator Jeff Merkley (D-OR) proposed a "short refinance" program that would enable homeowners who are facing foreclosure to refinance their mortgages based upon current interest rates and home values. The proposal aims to allow a family to stay in their home while a full appraisal, new underwriting and current lender payoff negotiations are concluded. The refinanced loan would have an FHA guarantee and also establish a third-party review prior to foreclosure in order to enforce existing law. The bill would also: stop "dual tracking" that continues interim foreclosure steps (but not foreclosure sale) while modifications are being evaluated; require that homeowners be provided with a single- point of access when they pursue a modification; and implement a "lifetime bankruptcy option."[1] However, there are many specific details about this proposal that are unclear to MBA and the Council. In addition, filing for bankruptcy can already place a pause to a foreclosure proceeding, so it is unclear how the lifetime option serves a new purpose. It also appears such an option would not be in investors' interests and would limit the availability of credit in the future.

- On October 27, 2010, Joseph H. Evers, Deputy Comptroller for Large Bank Supervision, Office of the Comptroller of the Currency (OCC), in testimony before the Congressional Oversight Panel, reported some favorable trends in home retention actions taken by banks during the second quarter of 2010. During that quarter, servicers implemented 504,292 home retention actions, which included loan modifications, trial performance plans and payment plans. During the same timeframe, servicers implemented 273,419 permanent loan modifications, including modifications under HAMP and other proprietary modification programs. Among the permanent modifications completed during the quarter, term extensions were used in 51 percent of the modifications, principal deferrals were used in 11 percent, and principal reductions were used in two percent of the modifications. The testimony stated that servicers must determine the appropriate mix of actions to take, striking an appropriate balance between the needs of borrowers for affordable and sustainable payments with the rights and interests of investors in those loans. Cumulatively, 46 percent of these modifications remain current or were paid off, another 10 percent were 30 to 59 days delinquent, more than 25 percent were seriously delinquent, and 13 percent were in the process of foreclosure or had completed foreclosure. Further, the testimony reports that more recent modifications appear to be performing better than the earlier modifications. The testimony also points out modifications that reduced the monthly payment by 10 percent or more performed significantly better than modifications that reduced payments by less than 10 percent.

- On December 1, 2010 in a Senate hearing, Federal Reserve Board Governor Daniel Tarullo indicated that it might be wholly appropriate to establish a national servicing standard.[2] This is similar to the ideas from Chairman Bair and Superintendant Neiman presented during the Summit. The Council recognizes that the Seller / Servicer Guides from Fannie Mae and Freddie Mac are national standards and that anything greater than that should be the subject of robust policy discussions.

- Iowa Attorney General Tom Miller told a Senate panel recently that robo-signing is only a symptom of a much larger problem with the mortgage servicing system. He noted the robo-signing investigation by the 50 Attorneys General is also looking at various servicing fees, force-placed insurance, as well as the problems servicers and investors are having showing a proper chain of title and ownership of securitized mortgages. He also expressed concern that modifications are not proceeding at an appropriate pace.[3]

1. Senator Jeff Merkley, *Paving the Way to a Healthy Housing Market.*

2. Cheyenne Hopkins, *American Banker,* "Louder Outcry for U.S. Standard in Loan Servicing," December 15, 2010.

3. Brian Collins, *National Mortgage News,* "It's Hard Out There for a Mortgage Servicer…," December 6, 2010.

VI. Legal Perspectives

The mortgage servicing industry has been under intense legal scrutiny recently, particularly with respect to policies and procedures related to the servicing of nonperforming loans. Although most of the legal challenges have been raised about the nature of securitization, more recently, a ruling by the Massachusetts Supreme Judicial Court voided two foreclosures on legal grounds. The Summit addressed these matters during the Legal Issues panel, which was formatted as a point / counterpoint session between Adam J. Levitin, Associate Professor of Law at Georgetown University in Washington, DC, representing the consumer viewpoint, and Laurence E. Platt, an attorney at the firm of K&L Gates specializing in mortgage banking and consumer financial products, representing the mortgage industry position. Four major legal issues relating to residential mortgage servicing were examined:

1. The sufficiency of foreclosure documentation and attestation policies and procedures;
2. Chain of title issues;
3. Fees and lender-placed insurance; and
4. The MERS mortgage registry system for recording transfers of servicing rights.

A fundamental issue discussed was the role of the trustee. From the consumer viewpoint, the servicer is an indirect agent of the investor through a trustee. However, the servicer can be an agent or contractor, depending on the structure of the agreement. The servicer's legal rights and obligations are controlled by various legal documents.

Chain of Title Issues

The discussion at the Summit summarized the applicable laws related to the perfection of ownership in the mortgage and note. In the midst of this housing crisis, some have questioned the lender's reliance on long-standing case law and the Uniform Commercial Code to transfer notes and mortgages. The two core legal documents in most residential mortgage loan transactions are the promissory note and the mortgage (or deed of trust). In most residential mortgage-backed securities transactions (MBS) the mortgages and notes are sold or transferred to a trust. The principal law governing this transfer of notes is the Uniform Commercial Code (UCC) as adopted in all 50 states and the District of Columbia.[1]

Article 3 of the UCC applies to the transfer of a mortgage note that is deemed to be a negotiable instrument under the UCC. However, Article 9 of the UCC also applies to the sale and assignment of promissory notes.

Moreover, a security interest in the note also results in a security interest in the mortgage.[2]

Under Article 3, negotiable mortgage notes may be transferred to a securitization trust by endorsement and transfer of possession to a trustee. Under Article 9 of the UCC, a security interest may be transferred by an outright sale and assignment to the trust. Most notes are negotiable and are either bearer paper (meaning they are payable to whomever holds the note) or specific paper (the note names the owner of the paper). Most private label MBS provide for both the negotiation by endorsement and transfer of possession under Article 3 and for an outright sale and assignment under Article 9.[3]

Under Article 3 of the UCC, the transfer of a negotiable instrument is commonly accomplished by endorsing the note "in blank," whereby the endorsement does not identify a specific party to whom the mortgage note is payable.[4]

The UCC contains a rule that stems from hundreds of years of common law. The rule is that "the mortgage

1. American Securitization Forum, *Transfer and Assignment of Residential Mortgage Loans in the Secondary Mortgage Market,* November 16, 2010, page 2.

2. UCC § 9-203(g)

3. Ibid, American Securitization Forum, page 3.

4. Ibid, page 3.

follows the note."[5] They are not separate in mortgage practice or application. For example, if someone legally transferred the note, then the rights under the mortgage effectively transfer to the transferee as well, even without the execution of an assignment.

In addition to Article 3, however, a note can be transferred by assignment under Article 9.

Under Article 9, the sale of a mortgage note is deemed to be a secured transaction and the transferee's "security interest" is automatically perfected when it attaches (See UCC § 9-309(4). While security interests are most commonly thought of as the liens obtained by lenders, the UCC defines the term "security interest" to also include "any interest of a … buyer of … a promissory note in a transaction that is subject to Article 9." UCC § 1-201(b)(35).

Before a buyer's "security interest" in a mortgage note can be perfected under Article 9, the security interest must "attach." A security interest attaches when (1) value has been given for the sale, (2) the seller has rights in the mortgage note or the power to transfer rights in the mortgage note to the buyer and (3) either (a) the mortgage note is in the possession of the buyer pursuant to a security agreement of the seller or (b) the seller has signed a written or electronic security agreement that describes the mortgage note. See UCC § 9-203(b).

Consumer advocates assert that the UCC applies to sales between two parties, but since one of the parties in an MBS transaction is a trust then trust law of the state governs the transaction. By this approach, a note would not legally transfer to the trust if the trust required a specific endorsement, but the endorsement was executed in blank, despite possession transferred to the trustee's document custodian. While such a transfer would be valid under the UCC, it was argued that the transfer would be invalid because of the failure to follow specific endorsement pursuant to the trust documents. It was further argued that MBS trust powers are limited to those in the document that create the trust and the Pooling and Servicing Agreement (PSA). Most PSAs are governed by New York law, which provides that a transaction beyond the authority of the trust documents is void.[6] Typically PSAs have two relevant transfer provisions, a recital stating that the notes and mortgages are "hereby" transferred to the trust and a provision that states that, in connection with the transfer, the original notes each containing a chain of endorsements that show the ownership history with the final endorsement in blank will be delivered to the trust.[7]

5. Ibid, page 4.

6. Adam Levitin, *The Big Fail — Securitization Never Occurred,* January 31, 2011, page 2.

7. Ibid, Adam Levitin, pages 2 and 3.

During the point / counterpoint discussion at the Summit, the consumer approach to trust law was illustrated where the notes are assigned in blank with no evidence of intervening endorsements. If the PSA requires all intervening endorsements, trust law would supersede the UCC and, therefore, would invalidate the transfer. This argument is countered because a number of federal and state courts have held that the UCC governs both the transfer of notes to securitization trusts and whether the servicers, as agents for the trustee, have the authority to enforce the notes (and mortgages). In contrast, the consumer argument relies upon a 1928 case *Vincent v. Putnam* that pre-dates the codification of the UCC and the creation of mortgage securitization trusts.[8]

Use of MERS

According to its Web site, "MERS is an innovative process that simplifies the way mortgage ownership and servicing rights are originated, sold and tracked. Created by the real estate finance industry, MERS eliminates the need to prepare and record assignments when trading residential and commercial mortgage loans."

The right to enforce a mortgage loan registered in MERS has been the subject of litigation in recent years. During the point / counterpoint discussion at the Summit, a concern about MERS' legal standing in the context of a securitization was addressed.

Robo-Signing

A conflict arose in late 2010 over whether employees of mortgage servicers who signed affidavits had "personal knowledge" and properly notarized legal paperwork for foreclosures of residential mortgages. In some cases, servicing employees, with authority over significant portions of the servicing operation, signed the documents based on business records and other staff entrusted with performing due diligence as to the accuracy of the information contained in the motion for summary judgment. Legal questions and concerns surfaced about this practice. The question this panel briefly contemplated was whether the process to support such a practice can be compliant with the legal requirements.

8. Laurence E. Platt, Phoebe Winder and Andrew Glass, "Trust But Verify: Claim That New York Trust Law Voids Mortgage Transfers Does Not Survive Legal Scrutiny," *Newsstand,* December 22, 2010.

Ancillary Fees and Servicer Authority

Lender-Placed Insurance

Residential mortgage servicers may collect late fees and ancillary fees from the borrower where applicable. Consumer advocates are concerned that fees applied to loans in default and that are also subject to lender-placed insurance are unfair to the borrower. Lender-placed insurance is an insurance policy taken out by a lender or creditor when a customer breaches the mortgage contract by failing to carry appropriate insurance on the home that is collateral for the mortgage. The charges for this insurance are passed on to the customer. The requirement for lender-placed insurance is in the mortgage contract, and is permitted by the GSEs and FHA and is provided for in some PSAs for private label MBS. The controversy arises when the lender-placed insurance is entered into with a related party of the servicer or the insurance affiliate of the servicer receives a commission from the insurer. Servicers clarified that lender-placed insurance is necessary to avoid uninsured damage to the property that not only harms the investor, but the borrower and community if properties cannot be repaired. The benefits of lender-placed insurance were made evident with Hurricanes Katrina and Rita and other similar natural disasters. Moreover, it is important to know that servicers invest significant financial resources in ensuring that they renew voluntary insurance whenever possible. However, in many cases, voluntary insurers cancel or do not renew policies on high risk properties, including vacant homes and those owned by delinquent borrowers. If borrowers are unable to obtain substitute insurance in the voluntary market, the servicer will often lender-place the insurance.

Late Charges

Late charges are stipulated in the mortgage note itself and, therefore, are a contractual right of the creditor. Generally, most servicing agreements allow the servicer to keep late charges collected as compensation for the added cost to the servicer for collection procedures and for advancing principal and interest not collected from the borrower to the MBS investor. (See Servicer Perspectives for a more thorough conversation.)

VII. Consumer Perspectives

The Consumer Perspectives panelists included Mike Calhoun, President of the Center for Responsible Lending, Patrice Ficklin, consumer advocate and Counsel for Reiman, Dane & Colfax, and David Berenbaum, Chief Program Officer for the National Community Reinvestment Coalition. The panel was moderated by Jordan Dorchuck, EVP and Chief Legal Officer of American Home Mortgage Servicing Inc. This panel gave perspectives about servicing practices from the borrower's point of view, especially as it relates to default servicing. In general, the consumer group panelists expressed the sentiment that servicers have lost the trust of consumers.

One suggested solution by members of this panel was to look back to the Savings and Loan collapse in the early 1990s and establish a contemporary version of the Resolution Trust Corporation (RTC) to acquire troubled mortgages. According to their perspective, establishing such an entity would put these loans in the hands of a party other than the current investor and servicer, who they claim do not have the same priorities as the borrower. Of course the RTC was intended to address the liquidation of failed thrifts, not assets of going concerns.

In addition to this proposed solution, during this panel several key issues were addressed:

- **Incentives:** Consumer advocates believe there is an under-incentive to modify mortgages in spite of the various fees under the Home Affordable Modification Program (HAMP). However, because the mortgage servicing business accumulates small fees through a high number of transactions, some consumer advocates believe the existing servicing fee structure fails to help the borrower.
- **Standards:** Consumer advocates favor a minimum national standard while granting the authority to states to set higher standards.
- **Transparency:** The point was raised that servicing standards need to be more transparent. The consumer advocates would support such transparency as a requirement in a national servicing standard.
- **Modifications:** The discussion addressed several issues and misconceptions about modifications. HAMP modifications are not being executed at the rate the Obama Administration had hoped. However, proprietary (non-HAMP) modifications are being executed at a very successful pace. Panelists highlighted the fact that certain loan products, namely Option ARMs, increased principal that contributed to higher defaults. Second mortgages complicate the modification process especially where home values are declining. It is also notable that some panelists perceive that there is no economic difference to the investor between principal reduction modifications and short sales; despite the fact that short sales divest the borrower of his or her home, creating a built in deterrent to strategic default.
- **Foreclosure Process:** Dual tracking, whereby the foreclosure process runs parallel with the loan modification process, was also discussed as a problem area for residential mortgage servicers. The rules from Fannie Mae, Freddie Mac and Ginnie Mae set a schedule for when the steps of foreclosure take place and when foreclosure actions can be paused or terminated upon loss mitigation. While in the past, some agencies prevented solicitation of borrowers for loss mitigation after foreclosure was initiated, this policy was changed because of the positive effects ensuring loss mitigation during the foreclosure process. Allowing loss mitigation conversations and outreach during foreclosure, however, has lead to the dual tracking concerns. It was suggested that those rules should change.
- **Borrower Contact:** The panel discussed homeowners' complaints of getting to a "real person" when they call their mortgage servicer, and even if they reach a live person, often that person had little if any knowledge of their unique situation or any efforts already in progress. The consumer advocates emphasized the need for a "single point of contact" for borrowers in the loan modification process.

VIII: Servicer's Perspectives

Three of the recommendations that panelists echoed throughout the Summit were 1) servicer compensation is not properly designed to incent the servicer to perform loan modifications, 2) servicers need to eliminate dual tracking of loan modifications simultaneously with the foreclosure process, and 3) servicers need to establish a single point of contact between the borrower and the servicer. The following is the servicers' perspective related to these three issues.

Basic Economics of Servicing Delinquent Loans

There have been numerous studies on the servicer's incentives: Sigtarp Study;[1] Federal Reserve of Philadelphia,[2] and the National Consumer Law Center.[3] These studies provide hypothetical cost-benefit analyses for both borrowers and servicers. These studies will be cited in the discussion below.

In each study, however, the assumptions used do not accurately reflect current servicing practices or fail to accurately state the costs and revenues inuring to the servicer with regard to a delinquent loan. Also, during MBA's Summit, it became evident that the servicer's costs and recovery of costs are not well understood. This chapter provides greater explanation of the servicer's financial responsibilities and recovery opportunities and limitations. We outline the key components of the major revenue and costs associated with:

1. Bringing the loan current through HAMP
2. Bringing the loan current through a proprietary modification
3. Foreclosure

Reinstatement of Servicing Fee Income

Most importantly, a modification reinstates the servicing fee income. The single greatest financial incentive supporting modifications over foreclosures for servicers is the reinstatement of servicing income. Assuming a borrower remains current under the modified terms, the servicer will continue to receive the servicing fee income monthly over the life of the loan. In contrast, such income ceases during the period of delinquency. In the case of private label securitizations (PLS), the servicing fee would ultimately be reimbursed to the servicer when the REO property is sold, but without interest. In summary, foreclosures result in an early termination and, in the case of PLS, deferment of servicing fee income, while modifications result in the reinstatement and continuation of same. In the case of GSE and FHA servicing, the servicer loses the servicing fee income during the period of delinquency and permanently when the loan is foreclosed. A continuation of the servicing fee income, under a loan modification, provides retention of value of the servicing asset that is otherwise written off upon foreclosure.

Advances

The Sigtarp study, as well as the Federal Reserve of Philadelphia study, recognizes the cost of advancing principal, interest, taxes and insurance with respect to delinquent loans held in securitizations.

In the case of PLS, servicers generally must advance principal and interest to bondholders from the due date of the first unpaid installment until the property is liquidated through the sale of REO. Likewise, servicers may be required to advance tax, insurance and other costs. According to Lender Processing Service's (LPS's)

1. Special Inspector General, Troubled Asset Relief Program, Quarterly Report to Congress, October, 26, 2010.
2. Federal Reserve Board, Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang, & Eileen Mauskopf, The Incentives of Mortgage Servicers: Myths and Realities, Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, 46 (2008).
3. National Consumer Law Center, Inc., Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicing Behavior: Servicing Compensation and Its Consequences (2009).

Mortgage Monitor Report, "As of February 2011, the average length of time a loan in foreclosure is delinquent was nearly 537 days." In addition to the foreclosure time line, servicers must advance until the REO is sold, adding about another 116–176 days.

Alex Villacorta, Ph.D. and Director of Research and Analytics at Clear Capital explains, "The most recent data as of April 2011 indicates that for the distressed segment, marketing times are 56 days-on-market, compared to 65 days-on-market for the same time period in 2007."

Ed Delgado, AMP, and Chief Executive Officer of the Five Star Institute, further adds that, *"It's feasible that an additional 60–120 days may be added to the time frame to ready the property for listing and the time to close the sale."*

A servicer may not be reimbursed for a portion of advances. For example, FHA curtails a portion of interest advanced, and many investors curtail a portion of the foreclosure legal fees advanced by the servicer.

In the case of PLS, these advances are reimbursed at 100 percent, but the servicer incurs the cost to carry these advances (borrowing / capital costs) for the entire delinquency and REO periods. It should be noted that in addition to the obvious financial cost to carry these advances, there is a significant allocation of capital required to carry them as well. This is particularly impactful to smaller servicers

However, if the borrower obtains a modification, the advancing costs would cease upon the execution of the permanent modification. The borrower is brought current by capitalizing the principal, interest, taxes and insurance (PITI) arrearages (meaning the arrearages are added to the balance of the loan). The servicer recovers any PITI advance incurred up to the date of modification at 100 percent. Reimbursement from the pool occurs usually within 60 days of modification. The quicker the modification can be completed, the less the advance cost to the servicer. As a result, the servicer is incented to modify the loan to reduce the interest costs and capital allocation associated with carrying advances. What appears to be missing in the studies to date is the recognition that modifications typically occur much sooner in the delinquency cycle than a foreclosure.

Incentive Payments

One of the key benefits of government loss mitigation and modification programs is the payment of incentive payments. HAMP provides servicers with a $1,000 incentive payment for completing a HAMP modification and an annual "pay for success" fee for a period of three years if the borrower remains current.

The "pay for success" fee is the lesser of $1,000 or one-half of the reduction in the borrower's annualized monthly payment. HAMP also provides a $500 incentive for modifying an imminent default (current) borrower. The GSEs, FHA and VA also provide incentives for successfully modifying a loan (or performing other loss mitigation actions). Proprietary modifications arranged in PLS generally do not provide for incentive payments to complete loss mitigation. As a result, servicers are incented to offer borrowers HAMP modifications because of the significant servicer incentive fees.

Balance Sheet Impact — Servicing Asset

A key economic factor in favor of loss mitigation and modifications is that the fair market value of the servicing asset is preserved if the loan cures. Servicers are required to write-off the value of the servicing asset upon completion of foreclosure. Servicing is usually purchased for or valued at (thus reflected on the balance sheet) a range of values depending on the characteristics and note rate compared to current market note rates. Typically this could range from a multiple of 2.5–4 times the annual servicing fee. A modification preserves the servicing asset to the extent it remains current.

Late fees

Many of the studies to date do not accurately state servicing practices with regard to late fees. Accordingly, it is important to point out these key servicing practices:

1. Late fees are waived on HAMP modifications.
2. Late fees are often waived in non-HAMP (proprietary) modifications.
3. Late fees are not usually capitalized or added to the principal balance of the loan in a modification.
4. Late fees, if not waived, remain as an assessed fee on the account (not capitalized), meaning they are not added to the loan balance, do not impact the amount of interest accrued and can only be collected when the loan pays off voluntarily in the future.
5. The Federal Trade Commission and Federal Reserve rules, prohibit the pyramiding of late fees, which means a borrower's non-payment of a late fee cannot create a late payment. Borrowers often wait until pay-off (many years in the future) to pay late fees.
6. Interest is not charged on late fees.
7. Late fees are not reimbursed in foreclosure.
8. Some PLS PSAs require pass through of the late fees to the trust.

Late fees, therefore, do not drive foreclosure or loss mitigation. While there is some minor benefit of reinstating the loan if late fees are assessed on the account, the fact that late fees are not collected for many years and are limited in amount, do not contribute significantly to a servicer's incentive to modify or foreclose.

Third-party fees

Typical third-party fees include foreclosure attorneys fees, bankruptcy attorneys fees, inspections fees, property preservation costs, foreclosure filing fees, sheriff fees, title fees (to identify interested parties per state law) and property valuation fees (to determine bid price).

Fees paid to third parties for the performance of a variety of functions are reimbursed from the trust on PLS in theory at 100 percent. Third-party fees exclude late fees. The timing of reimbursement of third party fees is the same as for reimbursement of PITI advances, meaning if the loan goes to foreclosure, these fees are not reimbursed until the REO property is sold in the case of PLS. The servicer incurs the interest / carry cost of paying for third-party costs for the number of months the loan is delinquent and in REO status. Moreover, the longer the loan remains delinquent the more events occur that require third-parties (e.g. initiation of foreclosure, title abstract, BPO, recurring preservation costs, etc.) and their related costs.

If the loan self cures or cures through modification, these third-party fees cease and the servicer is able to get reimbursed shortly after reinstatement through execution of the modification — rather than waiting until foreclosure and sale of REO. These fees are capitalized into the mortgage balance, and the trust refunds the amounts paid by the servicer. The servicer would like to avoid paying these third-party charges sooner if not altogether. A modification can achieve this objective because a modification can occur, if eligible, before the borrower is even delinquent.

While some servicers use affiliated parties to conduct certain activities (such as appraisals), such a practice is not uniform across the industry. Such activity is permissible and legal.

Loss of Float

The servicer earns the benefit of float on remittance funds held for investors and tax and insurance escrow funds. While that float has diminished over the years as a result of technology and because of a sustained period of relatively low interest rates, servicers do continue to benefit from float. The float period for remittance funds varies. When the loan is delinquent the servicers cannot earn float because the borrower has not remitted any funds on which to earn float. When a loan reinstates through modification and begins paying, float income returns.

Cost to Service

The servicer incurs general costs to service both a current and delinquent loan. Current loans are much easier to service and thus less costly. Today, servicing fees do not increase if the loan becomes delinquent, however most government programs provide for incentive payments for successful loss mitigation. Needless to say, by the time the borrower has reached foreclosure, servicers have made numerous efforts to contact the borrower and provide loss mitigation. As a result, the cost of the foreclosed borrower is far higher in terms of total staffing costs than a borrower who does not reach foreclosure, but self cures or cures through a modification or some other loss mitigation alternative.

For more information see Appendix C, *Myths About Servicer Incentives*.

Dual Tracking

Consumer groups continue to advocate for the elimination of so-called "dual tracking." Dual tracking occurs when the servicer continues intermediate foreclosure processes while discussions regarding loss mitigation are underway. Interim foreclosure processes, such as publications, notices, hearings and the like are required by state law or the courts, and would continue during this evaluation process to avoid unnecessarily delaying foreclosure should the borrower not qualify. It is important to realize, however, that servicers will not go to foreclosure sale (e.g. the borrower will not lose the house) if the borrower has provided a complete application package sufficient to evaluate the borrower for loss mitigation and provided such information is given in a reasonable time before the foreclosure sale date.

Successful loss mitigation, however, requires diligence and priority on the part of the homeowner. Homeowners should submit full application packages as soon as possible and prior to initiation of foreclosure. Moreover, servicers should not be expected to stop foreclosure processes or even a foreclosure sale if the borrower waits until the last minute (such as a week before the foreclosure sale) to request assistance. Some courts do not allow a foreclosure sale to be stopped within 7–10 days of the foreclosure sale date.

The halting of the foreclosure process is difficult due to investor and state timelines. Fannie Mae, Freddie Mac, FHA and VA all require servicers to meet various foreclosure timelines. Failure to meet these timelines, without a granted waiver, results in penalties to the servicer. For example, FHA requires that servicers initiate foreclosure within six months of the date of default. Failure to meet this strict deadline, without a waiver, means the servicer does not get reimbursed for much of its interest claim.

Moreover, state law often provides that various steps must occur at specific times or costly steps, such as newspaper publication, must be restarted at significant cost to the GSEs, government agencies and ultimately taxpayers in the case of government programs. As stated previously, some courts prevent the servicer from postponing the foreclosure sale date more than once or within 7–10 days of a scheduled foreclosure sale.

Delays have significant monetary impact on investors and servicers. Delays extend the period of necessary advances a servicer must pay, increases costs to government agencies due to additional claim filings for those advances and additional property preservation costs. Moreover, delays in foreclosure can result in the loss of equity in the property if market values are declining. Loss mitigation should be allowed to continue during the foreclosure process. Ironically, once a foreclosure proceeding begins, servicers frequently find a borrower is more likely to respond to correspondence concerning their home. A delay by the borrower in seeking assistance, however, should not be at the expense of the investor or servicer.

Single Point of Contact

Many regulators and consumer advocates are promoting a single point of contact to simplify communications between consumers and servicers during the loss mitigation process. The Council supports clear and helpful communication with the borrower. However, the Council is concerned that a single point of contact may have unintended consequences, potentially leaving consumers more frustrated and with greater delays. There is no unified definition of "single point of contact." A plain English definition would imply that a single person would be assigned to each borrower and that the borrower would communicate only with this person. This is not feasible in the current environment and would create numerous problems as servicer call volumes fluctuate significantly throughout the day, week and month.

First, a single point of contact eliminates the specialty training necessary to deliver accurate and timely assistance to borrowers, given that borrower assistance may range from questions regarding payment history or escrow processes to modifications, forbearances, short sales, deeds in lieu of foreclosure, or foreclosure. A single person cannot be expert in each of these highly complex and regulated areas. The result will be delays, miscommunication and errors.

Second, given the current environment, it will be impossible to have appropriate staff to meet fluctuating demand. By the sheer reality of the situation, borrowers may be subject to significant delays and longer response times if limited to one individual. Even if the borrower is able to talk to other knowledgeable team members, the Council is concerned that the borrower will decline and request a return phone call from the single point of contact. The borrower will suffer delays and frustration with regard to his or her issue.

Third, a single point of contact raises concerns regarding staff departures, work schedules, business travel, vacations, illness, etc.

The reality is a single point of contact can never be truly a single person. In its purest sense a single point of contact disrupts a servicer's efforts to provide the best service in a specific area of expertise. Borrowers must have the ability to communicate with other staff familiar with the borrower's account, and servicers must have the flexibility to structure staff the best way to achieve the principle of superior customer service.

IX. Issues for Further Study and Development of Principles and Policy

In analyzing the issues that surfaced during the Summit, the Council identified three major areas for further study and development of policy recommendations.

- **National Servicing Standards** — Review of existing servicing standards and practices especially in the area of dealing with large volumes of non-performing loans, foreclosure practices and loss mitigation practices, including loan modifications. The Council formed a working group called the National Servicing Standards Working Group to study and make policy recommendations related to a national servicing standard. This group is focusing on standards related to NPL servicing including loss mitigation, loan modification processes, the feasibility of single point of contact for borrowers in default, and the feasibility of pausing foreclosure during loss mitigation. This working group consists of members of MBA's existing Loan Administration Committee working with representatives from the Council.

- **Legal Issues** — Legal issues related to the foreclosure process, chain of assignments and endorsements and other issues. The Council formed a working group called the Legal Issues Working Group to study and make policy recommendations related to legal issues surfaced during the Summit and any additional statutory or regulatory changes deemed appropriate for servicing in the 21st century. This group consists of industry attorneys on MBA's existing Legal Issues Committee, the Council, and within MBA's policy staff.

- **Economics of Servicing** — Analysis of proposed changes in servicer compensation proposed by the FHFA, Ginnie Mae, Fannie Mae and Freddie Mac. MBA formed a group called the Economics of Servicing Working Group to analyze the proposed compensation structure from the vantage of various stakeholders including large and small servicers, depository and non-depository servicers. This working group consists of volunteers from the Council along with other volunteers serving as experts on standing MBA committees. The work group brings together secondary marketing experts, servicing asset specialists, industry accounting and tax experts, and servicing executives from companies representing small and large servicers, depository companies and non-depository servicers, and specialty servicers.

Each of the working groups intends to publish deliverables that will convey their findings and policy recommendations.

MBA's Council notes that numerous stakeholders have put forth their respective versions of a national servicing standard, and various consumer attorneys have put forth their respective opinions on some of the key legal issues. Further, FHFA, Fannie Mae, Freddie Mac and Ginnie Mae have made public their proposals for servicing fee structure changes. MBA asks that these constituents allow the Council the opportunity and sufficient time to complete its studies of the issues so that these potentially sweeping changes to the servicing industry and landscape are fully vetted.

The Council looks forward to working with consumer groups, regulators, and secondary marketing and servicing market participants to improve the future of the servicing industry so that servicers can continue to fulfill their contractual duties to mortgage and MBS investors while also serving consumers in a responsive and compassionate manner.

Appendix A:
A Primer on Servicing

Introduction

When a borrower gets a mortgage, there might be an assumption that the lender will hold the loan and handle the collection of borrower payments and other administrative matters. In reality, the lender now has two different assets that can be transferred and sold: the loan itself (often sold in the secondary market through the GSEs, Ginnie Mae or private conduits) and the rights to service the loan (mortgage servicing rights or MSRs). In many cases, the entity that owns the loan is not the entity that services the loan.

Mortgage servicers are responsible for the day-to-day management of the loan and administer the loan until it is either paid off or transferred to another servicer. Major duties include collecting and crediting borrower monthly loan payments, operating a call center to answer borrower inquiries, remitting payments to investors, administering escrow accounts, and handling collection and loss mitigation activities in the event of borrower default. Mortgage servicers may hold the MSRs but subcontract out the servicing function or portions of the servicing function to an outsource provider, a "subservicer," or in the case of default, a "special servicer."

Loan servicers are governed by investor guidelines; state, federal and local laws; insurers and guarantor requirements, borrower expectations and their own standards. The loan servicer must be adept at organizing and executing the numerous details involved in the life cycle of a loan. Note that loan servicers may service for many different investors such as Fannie Mae, Freddie Mac, Ginnie Mae, private investors and their own company. The same can be said for different localities and states, and private mortgage insurers.

The Evolution of Loan Servicing

Fifty years ago, loan servicing was a back-office function often performed by the company that originated the loan to the borrower. But with the advent of the secondary mortgage market, the growth of the role of Fannie Mae and Freddie Mac, and the proliferation of different mortgage products particularly in the 1990s and early 2000s, the loan servicing operation became a more complex array of functions.

Accounting rules also changed and mortgage servicing rights, once considered a natural hedge to production operations and required to be capitalized on the balance sheet only when they were acquired from an outside third party, were required to be recorded on the balance sheet at allocated cost or fair value, at the servicer's option. MSRs are likened to an "IO strip with operating risks and expenses." Accordingly, their value fluctuates as interest rates change and prepayment speeds increase or decrease. Due to this MSR volatility, many servicers implemented complex hedging programs over the past 15 years.

Loan servicing further evolved when the biggest credit crisis since the Great Depression hit in 2007 and continues into 2011. During this period, mortgage defaults soared and more demands were placed on servicers by investors, borrowers, consumer groups, agencies, local and state governments, and politicians, among many other stakeholders. Sometimes, these demands conflicted and servicers struggled to balance contractual duties to investors with borrower and policymaker expectations. Servicers also struggled with right-sizing their loss mitigation and other default functions to accommodate the deluge of defaults. Servicers continue to struggle with meeting these unprecedented challenges today, and have experienced reputational, legal and other risks as they work with stakeholders to clearly define their responsibilities.

The Major Functions of Loan Administration

The issue of specific national standards for servicing is currently being debated. Nonetheless, there are major functional areas of servicing that are relevant to most pooling and servicing agreements as well as current agency guidelines. The major functions that together contribute to the "direct cost to service" are outlined below.

Customer Service — Includes activities associated with customer inquiry — whether verbal (via customer call center), written or web-generated. Other duties include year-end processing, customer statements, updating customer records, ARM recalibration research and handling assumption or non-default related modification requests.

Escrow — Includes activities associated with escrow analysis and payments associated with real estate taxes and insurance. Escrow analysis includes analyzing the borrower's escrow account to ensure that the payment is sufficient to pay all escrow items and handling escrow refunds. The tax function includes tax payments from escrow accounts, tax search for non-escrow accounts, tax service maintenance (check tax service reports, reconcile bills, and request payment), special assessments, and research. The insurance function includes insurance payments from escrow accounts, reviews for coverage on non-escrow accounts, force placing insurance when necessary, insurance claim processing, mail processing and research. The types of insurance include hazard insurance, mortgage insurance (FHA, Private Mortgage Insurance, Veterans Administration), optional insurance (life insurance, disability insurance, and other employee related expenses), flood insurance and blanket fire insurance.

Default — Includes collections, loss mitigation, foreclosures, bankruptcy and real estate owned functions required under servicing agreements. Collections involve following investor guidelines and internal guidelines to cure defaults in order to maintain low delinquency rates. The servicer also provides reports to agencies and investors related to delinquent loans. Loss mitigation involves efforts to mitigate losses through a workout program or alternatives to foreclosure (forbearance, modification, deed-in-lieu, short sale) when appropriate. The foreclosure function involves following state law (whether judicial or non-judicial proceedings) and also following procedures dictated by the type of loan (i.e. FHA, VA, conventional). It also includes all claims processing. The bankruptcy function involves protecting the loan asset by monitoring bankruptcy actions, ensuring compliance with federal bankruptcy code, and ensuring property preservation of the property involved in the bankruptcy action. The real estate owned function involves post-foreclosure sale activities, conveyance, property preservation and property management if required as part of the servicing agreement with the investor.

New Loan Set Up and Transfers — Includes boarding new loans on the servicing system and non-payoff-related transfers out, such as transfers of a subservicing portfolio or servicing rights sale.

Payoffs — Include activities associated with payoffs and lien releases. This would include all of the activities relating to discharge, satisfaction and / or reconveyance of the mortgage / deed-of-trust upon payment in full of the mortgage loan.

Investor Reporting — Includes accurately accounting for, reporting and remitting the payments to end investors, including reconciliation of all custodial accounts.

Cashiering — Includes receiving and posting payments (on-site, on-line, ACH and lockbox), ensuring accurate application of the payments to the customers' accounts, the end investors' accounts, and the company's corporate accounts. Cashiering also includes payment processing for payoffs, daily system balancing, custodial accounting and research.

Servicing Technology — Includes personnel and all technology directly related to servicing, such as service bureau, vendor supported or proprietary systems.

Administration — Includes management and administrative staff who oversee the operations of the entire servicing department; record retention and retrieval; bulk sales and acquisitions; MSR risk management; maintaining servicing policies and procedures; servicing compliance; and servicing performance measurement and strategy functions.

Appendix B: Trends in Servicing Revenues and Expenses

The following provides a "deeper dive" into the trends of servicing revenues and expenses in recent years.

Servicing Revenues. Servicing revenues, averaging 36–43 basis points for large prime servicers and 31–39 basis points for small prime servicers during 2003–2010, are comprised of:

- **Servicing and Subservicing Fees,** include excess servicing and are net of guarantee fees passed-through to Fannie Mae, Freddie Mac, Ginnie Mae and / or a private conduit. In general, servicing fees are about 25 basis points for prime fixed, 37.5 basis points for prime adjustable, 44 basis points for government loans (19 basis points for the Ginnie II program) and 50 basis points for subprime loans. From 2006–2010, net servicing fees have declined. Contributing factors may include longer foreclosure timelines (during which agency servicers do not receive a service fee), and changes in guarantee fees and uncollectable excess servicing (any amounts of interest received by the servicer in excess of "normal" servicing fee). Subservicing fees include those fees, usually in the form of a fixed dollar amount per loan per month, collected by a servicer who handles the servicing operations functions but does not own or manage the servicing asset.
- **Ancillary Income,** the majority of which are late fees, loss mitigation incentive payments, quick pay or speed pay charges and not sufficient funds (NSF) charges. Other types of ancillary income are payoff statement charges, fax charges, insurance commissions, biweekly payment fees, advertising supplement fees and modification fees. During 2003–2010, ancillary fees were generally in the range of 3–6 basis points for prime servicers.
- **Interest Earnings** on principal and interest (P&I) and taxes and insurance (T&I) held in escrow prior to remittances to investors. Also during the period 2003–2010, escrow earnings ranged from less than one basis point to as high as seven basis points.

  From 2007–2010, escrow earnings have continued to decline as the results of low short-term interest rates, higher delinquency rates on borrower payments and declining industry-wide mortgage debt outstanding in recent years. In fact, the decline in interest revenues was the key driver of net interest losses in servicing. Based on MBA data, net escrow earnings (interest revenues less interest expense) were negative during the past three years among the large prime servicers despite declines in interest expense in basis points.

Servicing Costs

Servicing costs include more than simply the direct cost to service. Fully-loaded total servicing costs averaged 12-18 basis points for large prime servicers and 15–21 basis points for small prime servicers during 2003–2010. The key components of the total servicing costs include:

- **Direct Servicing Costs.** These include the personnel, occupancy and equipment, outsourcing and other miscellaneous expenses associated with servicing a loan and include performing the servicing duties stipulated in servicer guides or pooling and servicing agreements (PSAs) and in accordance with federal and state law. The following functional areas of servicing are covered in direct cost to service: customer service, set-ups and transfers, lien releases, servicing systems, default (collection, loss mitigation, bankruptcy and certain foreclosure and REO functions), escrow, investor reporting and accounting, cashiering and servicing administration. During the eight-year period 2003–2010, direct servicing costs generally averaged between 5–8 basis points for large prime servicers and 12–17 basis points for small prime servicers. Higher direct cost to service and lower productivity (loans serviced per servicing employee) from 2007–2010 is a function of higher default rates and evolving servicer responsibilities driven by changing expectations of borrowers, regulators, investors and other stakeholders.

- **Unreimbursed Foreclosure and REO-related Expenses.** During the foreclosure process, certain default-related types of fees are incurred by the servicer and often are reimbursed by the investor. Generally, reimbursable expenses include attorney fees, foreclosure costs and expenses (eviction costs, posting costs, certified mail, recordation etc), tax and insurance advances, utility payments and property preservation and inspection fees. Servicers submit a request for reimbursement from the investor. For example, Fannie Mae's Cash Disbursement Request (Form 571) outlines the types of reimbursable expenses.

However, depending on the loan type and any perceived servicer errors, such costs might not be reimbursed and would thus affect a servicer's net operating income. The most common issues:

1. **Servicer Error:** Claimable (with third party investor) but unreimbursed expenses due to servicer error, such as interest loss / penalties due to missed investor deadlines or other penalties due to non-compliance with investor requirements.
2. **Property Preservation and Inspection Costs, Add-Ons:** These include unclaimable (and unreimbursed) non-personnel expenses that the servicer deems prudent to perform but that are not reimbursed by investors. Such add-on expenses may include additional third-party inspections or property preservation work beyond the scope of the servicing agreement.
3. **Other:** Other unreimbursed costs that generally are mortgage-product specific, such as one-third of attorney fees, interest advances and other default-related expenses for FHA loans, and losses from VA Buydowns, VA No Bids and Non Conveyance of HUD loans.

Unreimbursed foreclosure and REO-related expenses have ranged from less than half a basis points to 1.5 basis points more recently.

Corporate Allocation

Another expense that needs to be incorporated into total servicing costs is corporate allocation for human resources, legal, company-wide technology support, corporate finance and treasury, and executive management. Corporate costs have historically added 1–2.5 basis points to the total cost of servicing from 2003–2010. The corporate load factor (corporate costs per servicing employee) generally ranges from $20,000 to $30,000 per servicing employee among large prime servicers in the current servicing environment.

Interest Expense

There are five types of non-recoverable interest expense that servicers incur:

1. Interest expense on advances of principal and interest and taxes and insurance.
2. Interest expense on advances related to foreclosure and property preservation.
3. Interest expense on MBS prepayments, also referred as compensating interest. In the event that there is an interest shortfall resulting from a borrowers' prepayment date and the date that security holders are paid, the servicer picks up the cost.
4. Interest expense on assets, which includes interest expense to fund the servicing asset and other fixed assets.
5. Escrow expense or interest paid to borrowers in states that require it.

For the period 2003–2010, interest expense ranged from 4–8 basis points. In recent years, advances related to principal and interest payments as well as other default-related advances has increased but servicers have been helped by low short-term interest rates that kept down the cost of funding such advances.

MSR-Related Gains and Losses

Servicing net operating income is defined as total revenues less total servicing expenses (earlier outlined). From 2003 to 2010, large prime servicers' net operating income ranged from 22–30 basis points, while small prime servicers' net operating income ranged from 16–19 basis points for the same period.

But net operating income only provides half the story. Under the current fair value accounting rules, mortgage companies that own mortgage servicing right assets (MSRs) are required to adjust earnings to account for changes in the value of MSRs. In addition, servicers must report the amortization (or time decay) for these assets. Thus, we introduce the most volatile portion of a servicer's income statement: MSR-Related Net Losses.

Valuation of MSRs is complex, and has a subjective component due to necessary assumptions used in valuation models and therefore a Level III asset under the accounting rules for fair value. These assumptions may vary by company and valuation firm, but generally speaking, asset valuation incorporates factors such as projected prepayment speeds, default rates, contingent liability for indemnifications, repurchases and / or mortgage insurance rescissions, and customer cross-sell, among others. MSR net losses not only include MSR amortization and the gain / loss on the valuations of MSRs, but the gain / loss on MSR hedging instruments and gain / loss on the bulk sale of MSRs. Overall, MSR *net losses* for 2003–2010 ranged from 9–34 basis points for large prime servicers and 12–26 basis points for small prime servicers. The highest losses were experienced among the largest servicers during the 2003 refinancing boom. Since then, complex hedging instruments were put in place in an attempt to reduce volatility and net losses have not been as severe during the more recent refinancing periods. Once the MSR-related items are taken into account, we arrive at pre-tax net servicing financial income. During 2003–2010, net servicing financial income has ranged from a loss of 9 basis points to a gain of 13 basis points for large prime servicers and a loss of 9 basis points to a gain of 5 basis points for small prime servicers.

Appendix C:
Myths about Servicer Incentives

During MBA's Summit, it became apparent that that regulators and consumer advocates make certain claims regarding the servicing business that the industry views as "myths." The following dispels those myths.

Dispelling the Myths about Servicer Incentives to Foreclose over Performing Loss Mitigation

Myth	Response
Servicers refuse to grant loan modifications	The HOPE NOW Alliance shows that modifications continue at a substantial pace. Below are key data from HOPE NOW's year end 2010 report: • Servicers completed nearly 1.76 million modifications in 2010 versus 1.07 completed foreclosure sales • Since July 2007, servicers have completed just under four and a half million modifications. • Loan modifications with reduced principal and interest payments accounted for approximately 81% (one million) of all proprietary modifications. • Modifications with initial fixed period of five years or more accounted for 84% (609,000) of all proprietary modifications.
Servicers, unlike homeowners and investors, do not generally lose money on a foreclosure.	Servicers lose money due to: • The loss of servicing income. In the event of foreclosure, Fannie Mae (FNMA), Freddie Mac (FHLMC), Federal Housing Administration (FHA) do not reimburse or otherwise pay the servicing fee that is not collected when the loan is delinquent. • The loss of the servicing asset, e.g. future income stream (all investor types). • Cost of advancing principal, interest, tax and insurance (PITI), foreclosure and property preservation costs (all investor types). • Non-recovery of interest advanced (FHA). • Non-recovery of foreclosure attorney fees advanced (FHA only reimburses 2/3 attorney fees). • Risk of principal loss due to investor put-backs or denied MI claims even when loans were underwritten to their standards (FNMA, FHLMC, FHA, PLS). • Unreimbursed property preservations costs or inability to convey properties (FNMA, FHLMC, FHA). • Credit losses (including principal, interest, tax and insurance advances, and loss of fees paid to third parties) exceeding amount of Department of Veterans Affairs (VA) guarantee. • Unrecoverable non-sufficient funds (NSF) or late fees when there is a foreclosure; investors will not pay them. Recovery of such fees is only possible when there is a third-party foreclosure sale and the full debt is paid, including late fees. • Loss of principal due to decline of property value in the case of bank portfolio loans.

Dispelling the Myths about Servicer Incentives to Foreclose over Performing Loss Mitigation (Continued)

Myth	Response
Servicers have an incentive to foreclosure because principal, interest, tax and insurance advances will be reimbursed immediately, unlike in a modification.	Servicers are reimbursed advances upon completing a modification (within 1–45 days of execution). Modifications always occur earlier than a foreclosure and thus stop servicers from incurring the costs associated with making advances sooner. Reimbursement of PITI comes from the principal and interest cash flow of the trust. The servicer's reimbursement is at the top of the waterfall, meaning the servicer's advances, which may have been from their own funds, get reimbursed first before bond holders receive any interest or principal payments. The modification brings the loan current, clears the advances, and the servicer no longer advances unless the borrower re-defaults on the modified loan. With respect to private label securities, servicers typically make advances throughout the period of delinquency. Reimbursement for such advances normally occurs subsequent to the foreclosure sale and\or liquidation of the property.
Modifications are expensive for servicers and the reason why servicers do not like to perform them. Modifications incur fixed overhead costs, including staffing and physical infrastructure, technology and out-of-pocket expenses (property valuations, credit reports). Whereas, with a foreclosure, servicers lose no money.	Servicers have costs (overhead) associated with performing loss mitigation; however, similar costs are incurred in managing the foreclosure process. In addition, modifications result in a more timely reimbursement of advances (as referenced above) and the reinstatement of servicing fee revenue from the performing modified loan. Moreover, servicers are compensated for the increased costs of loss mitigation through incentives fees. FNMA, FHLMC, FHA, VA and Home Affordable Modification Program (HAMP) provide incentives for successful loss mitigation. As stated above, servicers lose substantially more money on a foreclosure than a modification. Regardless of the overhead costs for performing loss mitigation, servicers have a contractual obligation to perform loss mitigation according to investor contracts and standards or risk having their servicing terminated.
Servicers have an incentive to push borrowers into delinquency, and delay curing the delinquency, in order to collect late payment fees. The servicer profits more if the loan is late then if the loan is brought current.	The cost to advance principal, interest, tax and insurance and, the hard costs and overhead (staffing, notices, and phone calls) to manage delinquent loans often outweigh the late fees. Also servicers have no ability to control the borrower in such a manner. Rather, servicers make efforts to avoid delinquencies by offering a grace period after the due date for borrowers to make their monthly payments. Servicers also employ "effective date" crediting to ensure that a payment received in the lock-box (by the cut-off time) will be credited as of the date of receipt.

Dispelling the Myths about Servicer Incentives to Foreclose over Performing Loss Mitigation (Continued)

Myth	Response
The servicer may have to waive various fees to achieve a modification, but will always collect them if the loan goes to foreclosure.	Servicers will often waive late fees and NSF fees in order to make a modification or to bring the borrower current. Late fees and NSF fees are generally not collected from the trust or investors upon foreclosure. Servicers, therefore, have no incentive to go to foreclosure in an effort to recover these fees.
Servicers often do not know how to proceed with a modification due to the varying interests of bond holders in different tranches.	Bond holders in different tranches do have different interests. Some would benefit from faster foreclosures. Others would benefit from a longer timeline. Regardless, most contracts with investors provide that servicers must take actions that are expected to yield the greatest net recovery for the trust not individual security holders.
Servicers do not want to reduce principal because they suffer a reduction in servicing income	The decision to reduce principal is at the sole discretion of the investor. To date, FNMA, FHLMC and FHA do not permit principal write downs. It may not be in the interest of investors (using a net present value test) to permanently reduce principal to achieve the same affordability as a reduction in rate, a principal deferral, or extension of term. In the latter cases, affordability is provided without a permanent impairment to the asset. Servicers do not make the decision to offer principal reduction modifications.
Servicers benefit from holding a partial payment in a suspense account because the delinquent payment accrues interest.	Although a borrower is contractually obligated to pay a late fee for being delinquent, *the delinquent payment does not accrue interest.* Rather the interest due remains the same regardless of when it is paid. To Illustrate, if a borrower makes one payment after 90 days of delinquency, that payment is applied to the oldest payment outstanding. The amount of interest paid on that payment is the same as if it was paid on time. Proposals to apply partial payments would change the contractual terms of the mortgage and note which is not permitted. The result would cause balloon payments, challenges to acceleration and enforcement of the mortgage, technical defaults under the mortgage contract, and a change in loan type from an amortizing loan to a daily simple interest loan which is not permitted under the mortgage documents.

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