Analysis of *Ongoing Implementation*, the Report of the Monitor of the National Mortgage Settlement

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On February 21, 2013, Joseph A. Smith, Jr., Monitor of the National Mortgage Settlement, released his third report, *Ongoing Implementation*, detailing the progress the five largest mortgage servicers have made in meeting their obligations under the settlement with 49 state attorneys general and the Administration.[1] The report shows that hundreds of thousands of borrowers have had a significant amount of principal forgiven through the first ten months of the settlement. In this paper we review the reported results, offer analysis and then pose questions that remain outstanding.

The settling banks have reported engaging in the following home retention and other activities under the settlement between March 1, 2012 and December 31, 2012:

TOTAL: $45.83 billion to 554,000 borrowers, averaging almost $83,000 per borrower

- Home retention activities: $24.7 billion in principal forgiven or interest payments saved for 323,000 borrowers, averaging $77,000 per borrower:

  --Completed and active trial first-lien modification forgiveness and second lien modifications and extinguishments: $22.5 billion in principal forgiveness for 266,263 borrowers, averaging $84,459.65 in principal reduction per borrower

    --Completed first-lien modification forgiveness: $7.4 billion in principal forgiven for almost 71,000 borrowers ($6 billion of new modifications and $1.4 billion of forgiveness of existing modification forbearance amounts), averaging $105,000 per borrower

    --Active first-lien trial modifications in progress: $3.5 billion in forgiveness for 25,000 borrowers, averaging $139,000 per borrower

    --Completed second lien modifications and extinguishments: $11.6 billion forgiven for 170,000 borrowers ($11.3 billion extinguished and $250 million forgiven by modification), averaging $68,000 per borrower

[1] *Ongoing Implementation: A Report from the Monitor of the National Mortgage Settlement* (Office of Mortgage Settlement Oversight Feb. 22, 2013), available at https://www.mortgageoversight.com/wp-content/uploads/2013/02/Ongoing-Implementation.pdf.

--Savings from refinances completed: $2.2 billion in borrower interest savings for 56,000 borrowers, averaging $39,000 of savings per borrower[2]

- Short sales: $19.5 billion in principal balance deficiencies forgiven for 169,000 borrowers, averaging $116,000 of forgiveness per borrower

- Other programs: $1.6 billion for 63,000 borrowers, averaging $25,000 per borrower

Analysis and Outstanding Questions

Gross figures versus servicer credits toward $20 billion obligation

The above figures represent the gross dollar amounts of forgiveness or savings that borrowers have received, or in the case of refinances, will receive. The settlement has a schedule that translates each type of activity into a range of credits towards the nearly $20 billion that the mortgage servicers are required to provide under the settlement. For example, principal forgiveness on first liens for portfolio loans of 175% LTV or less is credited at $1 for each dollar of write-down, but a modification of a second lien that is more than 180 days delinquent is credited at only 10 cents for each dollar of write-down. Forgiveness of deficiencies on short sales is credited at 45 cents per dollar for portfolio loans and 20 cents for investor loans.

In addition, at least 60% of the total credits must be used for principal reductions for first and second liens combined,[3] at least half of which (a total of 30%) must be used for principal reduction on first liens alone. By contrast, no more than 10% can be used for deficiency waivers, no more than 12% on anti-blight activities, and no more than 5% on transitional funds.

> *The report does not provide information about how the gross settlement amounts translate to the specific crediting formulas under the settlement because the Monitor's work with individual servicers to verify their results follows the reporting of the gross amounts. Accordingly, we are not yet able to determine the extent to which the servicers are meeting their credit requirements under the settlement. However, it appears based on the gross numbers reported and credit formulas that the Monitor will apply that the servicers are making substantial progress in meeting their credit requirements.*

First Lien Modifications

The settlement requires the banks to aggressively provide affordable modifications through principal reduction to get credit for first-lien modifications. Servicers only get credit for these modifications once the borrower has paid on a modification for the trial period of three months.

[2] Savings from refinancing equals the interest rate dollar savings per year times the multiplier servicers use in their SEC filings (7.85), which roughly equals the number of years the loans are expected to be outstanding.
[3] The amount can be reduced by 10 percentage points if refinances exceed certain benchmarks, but that does not appear to be contemplated based upon the principal reduction data received thus far.

The settlement requires that principal reduction through first-lien modifications total at least 30% of the $17 billion of consumer credits required that are separate from the $3 billion in required refinance savings, or $5.1 billion; to date, servicers have completed $10.9 billion of forgiveness in gross dollars for 96,000 families (including trial modifications).

> *Two major questions regarding first-lien modifications remain: will servicers, investors and policymakers learn from this experience whether principal reduction is a more effective modification technique than simple interest-rate reduction, term extension and/or deferment of principal, and, if so, will they continue or expand the use of principal reduction beyond the settlement's requirements?*

<u>Second Liens</u>

Second liens have been a major obstacle to loan modifications that keep families in their homes, and therefore have been a major cause of foreclosures. Modifying first mortgages cannot keep borrowers in their homes if they still cannot afford second mortgages. Similarly, seconds often prevent the sale of a house that would have equity but for the second lien or prevent short sales when the holder of the second lien does not grant timely permission to modify or extinguish it. Often, the only way to get rid of a second lien is through foreclosure. In addition, debt collectors attempting to collect on delinquent second liens or deficiencies associated with foreclosed seconds, as well as credit scores damaged by foreclosure or delinquency, can prevent families from getting back on their feet.

Thus, extinguishing, or to a lesser degree, modifying second liens can be very beneficial to borrowers. Under the agreement, if a mortgage servicer modifies a first lien and another participating bank services a second lien on the same property, that bank must modify or extinguish the second to help make the combined mortgages affordable. To date, second lien restructurings have heavily favored extinguishment: the servicers have extinguished $11.34 billion in second liens versus providing only $250 million in modifications.

> *An issue about extinguishing second liens through the settlement has been raised: is it legitimate for a servicer to get credit for modifying or extinguishing a second lien if the servicer of the first mortgage forecloses simultaneously or shortly thereafter?*

On the one hand, there are several reasons why providing credit should still be considered legitimate. The settlement provides only limited credit for delinquent seconds—10 cents on the dollar if the second is more than 180 days delinquent, which is likely where the borrower is so troubled that they lose their house. And extinguishing a second is helpful even if the borrower cannot pay the first, as it may permit the borrower to sell the house rather than go through the foreclosure process, or it may prevent harassment by debt collectors.

The settlement clearly permits some proportion of the relief to be provided to families who are unable to stay in their homes, such as through short sales or deficiency waivers. In addition, the settlement provides incentives for first lien modifications over second lien modifications by providing more credits per dollar of forgiveness for first lien modifications than for seconds. In addition, the Monitor will evaluate compliance with the servicing metrics, which includes testing whether the servicer accurately determined whether borrowers are eligible for first-lien modifications. If a servicer is found to have a pattern of wrongly rejecting first-lien modifications, it could face potential fines up to $1 million and $5 million and restitution for impacted borrowers.[4]

> *The Monitor's first two reports on the servicers' performance under their servicing metrics are scheduled to be submitted to the court in May and November of 2013. These reports may shed light on the question of whether servicers are providing first-lien modifications to borrowers who apply and are eligible for them, even when an associated second lien is being modified.*

On the other hand, the major impetus for the form the settlement took and the major purpose for modifications is for borrowers to be able to keep their homes. Waiving seconds when the first lien is being foreclosed on does not accomplish this goal. It clearly was not intended to be a major part of the relief provided.

> *The issue of receiving credit for extinguishing or modifying second liens on homes where the first lien is foreclosed on should be carefully reviewed by the Monitor to ensure that borrowers can receive a tangible benefit before awarding servicers credit, particularly in instances where the servicer claiming credit owns both the first and second liens.*

<u>Short Sales</u>

Waiver of deficiencies for short sales are a significant portion of the total *gross* forgiveness and savings reported in the first 10 months of the settlement, though they do constitute a minority—43 percent—of the total. Home retention activities—modifications of first and second liens, including three-month trial modifications for first liens, as well as refinance interest savings—total $24.6 billion, or nearly 54% of the *gross* total, and almost twice as many borrowers have received home-retention relief (323,000) as short sales (169,000). Short sales as a percentage of the total consumer forgiveness has been dropping over time—from 63% in the first report to 43% in the latest.

Because servicers receive between 20 and 45 cents of credit for every dollar in short-sale deficiency waivers, the credits for short sales will be between $3.9 billion and $8.7 billion. The cap for short sales that can be counted under the settlement is 40% of the $17 billion in forgiveness, or $6.8 billion. In any case, Tom Miller, Attorney General of Iowa and one of the key negotiators of the current deal, stated in a recent editorial, "[i]t is likely that the servicers won't need credit from short sales to fulfill their $17 billion consumer relief requirements" because they will have met the entire $17 billion in credits through principal forgiveness modifications and other activities.[5]

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[4] *See* Exhibit A.IV.A.1-2, available at https://www.mortgageoversight.com/wp-content/uploads/2012/03/Servicing-Standards.pdf; *see also* Exhibit E-1 (Enforcement Metrics), and specifically Metric 1.B ("Incorrect Mod denial") at p. 1-3 and Metric 6.B. ("Loss Mitigation") at p. 1-10, available at https://www.mortgageoversight.com/wp-content/uploads/2012/03/Consent_Judgment_WellsFargo_4.11.121.pdf.

[5] Tom Miller, "Mortgage Settlement Is Beating Goals, Proving Doubters Wrong," *American Banker* (Mar. 7, 2013).

In substance, a short sale is preferable to foreclosure. Short sales permit families to move when they are under water—meaning that their mortgage balance is greater than the value of their house—because of changes in job or family circumstances. Short sales spare borrowers from having to face debt collectors and spare neighborhoods from vacant houses and negative spillover effects during a long foreclosure process. It is worth noting that that the servicers get credit by forgiving a deficiency after a short sale only in states that permit deficiency judgments.

It is important for servicers to approve short sales when sought by a homeowner, both for the borrower, and because short sales provide a better return for loan investors than foreclosure auctions. But it is also important that servicers avoid steering borrowers who might qualify for a principal reduction modification into short sales, especially when a principal reduction modification could provide the same write-down while keeping a family in its home.

> *The Monitor's reports on the servicers' performance under the servicing metrics will include reviews of whether servicers are fully considering borrowers for first-lien modifications who apply and are eligible for them, and whether they are otherwise complying with rules around timelines, documentation gathering and appeals. This review will shed some light, therefore, on whether servicers are providing modifications for eligible borrowers, rather than incorrectly denying modifications and moving to options where the borrower loses their homes, either through foreclosure or short sale.*

<u>Who Benefits from the Settlement?</u>

> *Concerns have also been raised about what groups have received the benefits that the servicers are providing through the agreement, particularly based on demographic criteria such as race, ethnicity, income, and geography (below the state level). Communities of color have been hit disproportionately hard by foreclosures generally because of discriminatory targeting of abusive loans, so understanding how modifications are distributed is important. The settlement, unfortunately, does not require public reporting of granular data on the demographics or geography of relief activity. Further, the servicers have not provided this important information. This lack of data reporting is clearly a shortcoming of the settlement.*