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THE COVID-19 PANDEMIC HAS WREAKED HAVOC on the mortgage servicing industry, putting significant strain on both mortgage servicers and their borrowers. During this pandemic, mortgage servicers are faced with the difficult task of trying to help the significant population of borrowers who are financially impacted by COVID-19 and with the even more difficult task of trying to do this in a manner that is compliant with applicable state law, federal law, and investor/ Government-Sponsored Enterprise (GSE) requirements.

In two prior articles—"Mortgage Servicing and Forbearance in the COVID Age" and "Mortgage Servicing in the COVID Age: Post-Forbearance"—we outlined a number of compliance challenges arising from mortgage servicers' offerings of forbearance and post-forbearance relief. Unfortunately, the challenges outlined in those articles were by no means exhaustive. And as such, this article addresses additional compliance challenges that servicers must keep in mind as they continue to service loans for borrowers impacted by COVID-19. These challenges, if not thoroughly considered and appropriately handled, could pose significant regulatory and/or litigation risk to mortgage servicers.

Forbearance and Deferral Agreements

One of the most common compliance challenges for servicers of COVID-19-impacted borrowers, relates to the manner in which servicers require borrowers to enter into COVID-19 forbearances and deferrals. Put more simply, during this pandemic, servicers should consider whether or not borrowers must enter into formal, executed forbearance and deferral agreements to effectuate these loss mitigation solutions, or whether something less than a formal, executed agreement is sufficient. Under a COVID-19 forbearance, a servicer generally agrees to reduce or suspend the borrower's contractual monthly payment for a specific period of time and, during the forbearance period, late charges typically do not accrue and foreclosure activity is suspended. Under a COVID-19 deferral, missed payments and, in some cases, other amounts (e.g. servicing advances paid to third parties) are usually deferred to the maturity date as a non-interest-bearing lump sum balloon payment. Notably, the GSEs' forbearance and deferral guidance leaves it up to servicers

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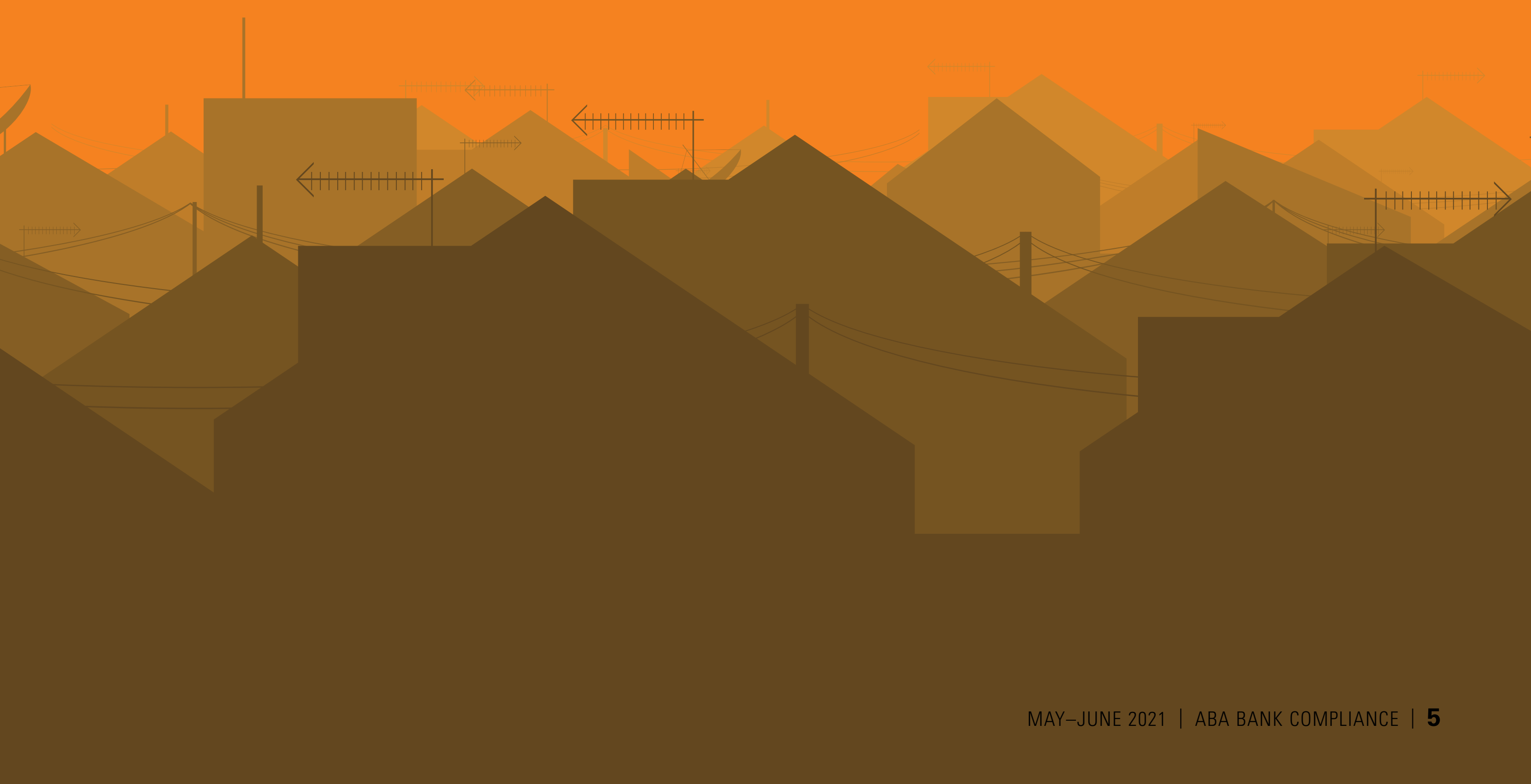
Long Shadow

COVID-19 Continues to Pose Significant Compliance Challenges for Mortgage Servicers



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to determine whether or not a formal, executed agreement should be required of the borrower.

With respect to COVID-19 forbearances and deferrals, it's clear that the safer approach in terms of ensuring these arrangements hold up to challenges by the borrower or other parties, is to have the borrower enter into a formal agreement executed by all parties involved. This is particularly true in light of the statute of frauds which generally requires that certain contracts and modifications to said contracts—including contracts that involve an interest in land and contracts that cannot be performed within one year—be in writing and signed by the party to be charged. Requiring a formal, executed agreement substantially impairs a borrower, regulator, or court's ability to argue that the borrower did not consent to the agreement or that the agreement is not legally binding.

That being said, and particularly as it pertains to forbearance plans, there is a strong argument to be made that forbearances and deferrals do not amend—or at least materially amend—the parties' original mortgage contract and, therefore, a formal, executed agreement is not absolutely necessary under the statute of frauds. Additionally, given the operational challenges and inefficiencies associated with requiring formal executed agreements for each and every forbearance or deferral offered in the middle of a global pandemic, requiring formal, executed agreements is arguably in the best interest of the borrower and the industry on the whole.

In our experience, most servicers do not require formal, executed agreements for forbearance agreements, and, indeed, one could argue that, for federally-backed mortgage loans, the CARES Act does not even allow a servicer to require a formal, executed agreement for a borrower to obtain a payment forbearance plan. The risk of not requiring executed agreements for forbearance plans seems minimal. On the other hand, the approaches for deferral plans are a little more varied.

Some servicers are not requiring formal, executed agreements as they are willing to accept some statute of frauds and other risk in favor of borrower and servicer convenience. But other servicers believe formal, executed agreements are the best course of action. Candidly, there is risk on both sides of this issue in this deferral context and servicers should carefully consider the best approach for them.

Periodic Billing Statements

Another common compliance challenge relates to the manner in which servicers are to provide periodic billing statements for borrowers on a forbearance or deferral, and the specific content of any such billing statements. As a preliminary matter, it should be noted that, even if a borrower is on a forbearance and his/her payment is arguably $0 for some period of time, a periodic billing statement likely still must be sent to the borrower each month. This is because of TILA's periodic billing statement requirements and, more particularly, the definition of a "billing cycle" which does not seem to permit servicers to refrain from sending statements even if the borrower's payment is temporarily suspended. And given that a deferral is generally a permanent loss mitigation solution that results in the borrower beginning, or continuing to make his/her monthly mortgage payment, periodic billing statements for borrowers who have entered into a deferral likewise must be provided each month.

That said, things get a little more complicated in terms of the content of any such periodic billing statements. For borrowers on a forbearance, which is likely to be considered a temporary loss mitigation solution under TILA's periodic billing statement rules, TILA provides servicers with two options—either send statements that reflect the terms of the parties' mortgage contract and generally do not account for the forbearance—or send statements that are updated and account for the forbearance plan in terms of the Amount Due, Explanation of Amount Due, etc.

The latter approach is arguably the better approach and less likely to cause borrower confusion and frustration. However, it comes with operational challenges in that a servicer has to substantially alter certain sections of its billing statement for a certain period of time which can lead to mistakes and compliance issues as and against TILA's strict content and formatting requirements. To the extent you choose the former approach, it's worth considering whether to include some sort of cover letter or disclaimer on the statement recognizing the forbearance plan and noting to the borrower that many fields in the statement do not account for the ongoing forbearance plan. And under either approach, servicers should pay careful attention to whether the delinquency information of 12 CFR § 1024.41(d)(8) should be provided, given that a borrower on a forbearance plan is likely (and technically) in default.

For borrowers on a deferral, which is usually going to be considered a permanent loss mitigation solution that, in essence, permanently modifies the terms of the parties' original mortgage contract, the periodic statements should reflect the terms of the deferral plan (i.e. the modified contract). This means that, upon entering into the deferral, the periodic billing statements will likely need to show the borrower current and otherwise account for the new deferral arrangement.

One problem, however, is that TILA does not provide any guidance on whether, or how, a servicer should outline the borrower's deferred lump sum balance that is due at maturity (or payoff, refinance or sale). This just seems to be a gap in the coverage of TILA's periodic billing statement provisions. However, we believe it's prudent to include this deferred balance somewhere on the statement, in the interest of transparency and so as to mitigate risks that the borrower will ultimately challenge that balance and his/her payment of the same. In our experience, many servicers simply include a "Deferred Balance" line item in the "Account Information" section required by 12 CFR § 1024.41(d)(7). This seems like a sound approach and would not run afoul of any of the content or formatting requirements of TILA.

Automatic Forbearances

A third compliance challenge servicers face is whether and in what situations to automatically enroll/extend borrowers in forbearance. Importantly, neither the CARES Act nor GSE guidance require servicers to automatically enroll borrowers in forbearance. Instead, federal requirements generally contemplate obtaining borrower consent prior to forbearance enrollment. Most servicers have also historically been reluctant—for good reason in our view—to change or alter repayment terms unilaterally. These concepts began to be tested when some consumer advocacy groups—including the New York Attorney General—started calling on servicers to automatically enroll borrowers in forbearance. This put considerable pressure on servicers, forcing many in the industry to reevaluate whether it made sense to start enrolling borrowers automatically.

Not surprisingly, many industry participants voiced concerns about enrolling borrowers in loss mitigation options without their consent, particularly given the potential impact forbearance might have on a borrower's credit score and creditworthiness. These concerns are valid in our view and were recently echoed in a special edition of the CFPB's Supervisory Highlights report based on the Bureau's recent COVID-19 Prioritized Assessments. Among other things, the report cited servicers for "[e]nrolling borrowers in automatic or unwanted forbearances" and "automatically plac[ing] borrowers' accounts into forbearance without their knowledge or approval." (See files.consumerfinance.gov/f/documents/cfpb_supervisory-highlights_issue-23_2021-01.pdf.) Accordingly, servicers should be cautions of enrolling borrowers in automatic forbearances moving forward, and servicers that previously engaged in such practices would be well-served to review affected accounts to determine if remediation is necessary.

A related issue, and one that is equally if not more relevant to servicers today, is whether servicers that cannot reestablish contact with the borrower should automatically extend forbearance plans nearing the end of their initial term. As a quick backdrop, the CARES Act provides that borrowers may request up to 180 days of forbearance and thereafter may request an extension of the forbearance period up to another 180 days.

Federal GSE guidance clarifies that servicers may provide an initial forbearance period, and any extended forbearance period, in increments that are separate or shorter than 180 days.[1] Based on this guidance (and historical industry practice), a number of servicers decided to implement forbearance plans in increments of 90 days or less. While federal requirements are clear that the borrower must request an extension of the forbearance plan beyond the initial 180-day term, guidance is less clear on how to handle situations where the borrower and servicer agreed to a shorter initial term.

In instances where the servicer clearly communicates to the borrower that he or she has the right to 180 days of forbearance and the parties expressly agree to a 90-day period, there is probably minimal risk in letting the forbearance expire if the servicer cannot reestablish contact. In instances where the borrower accepts an initial 90-day term with limited context or explanation, however, there is likely some risk to allowing the forbearance to expire as those borrowers may be expecting the full protection of the law.

Because of this, some servicers have elected to provide automatic extensions for these shorter periods and will typically extend the forbearance automatically up to 180 days before requiring a new request. To avoid pitfalls in this area, servicers should review their specific offerings, disclosures, letters, etc. to ensure they are abundantly clear regarding when forbearances will be automatically extended, if ever.

Default-Related Correspondence

Another common compliance challenge involves whether to send traditional default-related correspondence to borrowers that are either in forbearance or protected by a foreclosure moratorium.

With regard to forbearances, there seems to be general agreement within the industry that most routine collection notices should be suppressed while a borrower is in forbearance. Although there is no express federal prohibition against sending such notices, most industry participants, including the CFPB,[2] seem to agree that they could be inconsistent and confusing to borrowers. While it is likely prudent to suppress routine collection notices, questions remain regarding other notices required by applicable law. For example, certain states require servicers to send default/loss mitigation notices by a particular date of delinquency.

The CFPB's mortgage servicing rules also require an early intervention notice by the 45th day of delinquency, and those notices are likely to contain the CFPB's model clause indicating that the longer a borrower waits, or the further the borrower falls behind on payments, the harder it will be to find a solution. Finally, as referenced previously in this article, when a borrower is more than 45 days delinquent, the CFPB's periodic billing statement requirements in Regulation Z mandate that each monthly statement contain "[a] notification of possible risks, such as foreclosure, and expenses, that may be incurred if the delinquency is not cured."[3]

Federal requirements generally contemplate obtaining borrower consent prior to forbearance enrollment.

Because most borrowers on forbearance will technically be in default, there's a strong argument that servicers still need to send these delinquency-based notices (or some version thereof). Servicers should review their letter portfolios to determine which notices are required by applicable law and assess whether modifications are needed to reduce confusion and potential regulatory exposure.

A separate but related question is whether servicers are allowed to send breach letters and other state-mandated pre-foreclosure notices to borrowers protected by a foreclosure moratorium. With a few limited exceptions at the state and local level, most foreclosure moratoriums, including the moratoriums enacted by the GSEs, prohibit "initiating" a judicial or non-judicial foreclosure (or some slight variation thereof).

What does it mean to "initiate" a foreclosure? A fairly straightforward (and in our view compelling) answer would be that foreclosure is initiated when the servicer makes the first notice or filing required by applicable law for any judicial or non-judicial foreclosure process. This date—commonly referred to as "first legal"—is the date Regulation X generally marks as the beginning of the foreclosure process. Under a more conservative interpretation, one could argue that foreclosure is initiated on the date the servicer sends the first state-required pre-foreclosure notice or even the date the servicer sends the first contractually required breach letter.

Notably, a number of state Attorneys General wrote to the GSEs in April 2020 asking them to endorse this very approach. While servicers can take some solace in the fact that the GSEs did not formally respond to these requests, there is still some risk in sending any notice that serves as a prerequisite to foreclosure to a borrower covered by a moratorium. As such, we encourage servicers to review their letter/pre-foreclosure practices to ensure they are in line with the company's desired risk tolerances.

Generally speaking, there are two methods mortgage servicers (and their investors) use to calculate past due interest.

Interest Accrual During Forbearance

One compliance challenge that has arguably flown under the radar is the manner in which past due interest is calculated for the time period a borrower is in forbearance. As a refresher, the CARES Act provides that no interest shall accrue during a forbearance "beyond the amounts scheduled or calculated as if the borrower made all contractual payments on time and in full under the terms of the mortgage contract . . . ."[4] While most observers believe this requirement was aimed at prohibiting servicers from charging interest penalties or default rates of interest during the forbearance period, the rule has led to uncertainty regarding the manner in which past due forbearance interest should be calculated for payoffs, reinstatements, loss mitigation, and other milestones.

Generally speaking, there are two methods mortgage servicers (and their investors) use to calculate past due interest. The first method, which is often used when calculating payoffs, uses the actual unpaid principal balance on the account to calculate the amount of past due interest. For this method, the servicer simply takes the unpaid principal balance existing as of the date of default and calculates interest on that amount for the entire delinquency period.

The second method, which is more commonly used for reinstatement and modification calculations, uses the scheduled (or amortized) unpaid principal balance to calculate the amount of past due interest. For this method, the servicer calculates past due interest using the scheduled/amortized balance, effectively giving the borrower credit for principal payments they did not make. Not surprisingly, the difference in these two calculation methods has a tangible financial impact on the borrower when interest is calculated at payoff, reinstatement, etc.

On its face, the CARES Act seems to suggest that a servicer is prohibited from using the actual principal balance method to calculate past due interest for the time period the borrower is in forbearance. Indeed, there is a strong argument that a servicer using the actual principal balance method would not be calculating interest "as if the borrower made all contractual payments on time and in full" because that method does not account for the decrease in principal associated with those assumed payments. Unfortunately, many servicers use the actual principal balance method to calculate past due interest at payoff. Servicers that use this approach at payoff (or at any other milestone) and do not alter their practice for borrowers participating in a CARES Act forbearance run the risk of charging interest amounts in excess of what the CARES Act allows.

Conclusion

Assisting COVID-19-impacted borrowers in a manner that is compliant with all applicable legal and regulatory requirements is a significant challenge and must be handled with care. Simply put, the interplay between the COVID-19 pandemic and mortgage servicing results in a fair amount of tension and ambiguity. Servicers should carefully consider the above-described compliance challenges and ensure they are comfortable with their processes in this regard. Failure to do so could result in regulatory and/or litigation risk during a time in which the scrutiny over mortgage servicers is already incredibly high. ■

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Endnotes

1. Note that recent GSE guidance now allows for further extensions of the forbearance period beyond the previous 360 day total (under certain circumstances).
2. See CFPB Supervisory Highlights COVID-19 Prioritized Assessments Special Edition at Page 7 (noting that some servicers sent collection notices to borrowers in forbearance indicating their accounts were past due and that negative credit reporting and late fees could result).
3. 12 CFR § 1026.41(d)(8)(ii).
4. Public Law 116-136, Section 4022.