Are You Ready for the New Foreclosure Processing Regulations?

New regulator guidance provides banks servicing residential mortgages with expectations in effectively assessing foreclosure processing.

The enforcement actions by the federal regulators against the 14 largest mortgage residential servicers for unsafe and unsound practices related to residential mortgage servicing and foreclosure processing have received significant publicity. The focus has understandably been on these large servicers as they account for over 68% of the servicing in the United States. The tremendous volumes of foreclosures in recent years have overwhelmed these large servicers, and as a result, independent audits by the regulators have found a host of issues related to how these servicers handle foreclosures. Major findings include:

- Poor foreclosure management procedures overall (i.e. no updates in light of increased foreclosure activity and no revised procedures in place due to increased volumes. It was no longer, business as usual)
- Inadequate organizational structure, staff levels and qualifications
- No assurances of compliance with various state and local laws
- Critical documents missing (e.g. notes, mortgages), yet foreclosure process continued
- Critical documents not properly endorsed or assigned
- Robo-signing (i.e. signing documents without required knowledge and review)
- Affidavit process not properly supported by loan data from servicer
- Dual-track processing (foreclosure process and loan modification process occurring simultaneously)
- Poor management of third-party service providers (i.e. law firms)

As the results of these audits became known, the media quickly informed the public of issues such as “robo-signing” and “dual-track processing.” Consequently, in 2011, these large servicers had to make significant expenditures to address inadequate foreclosure processes as required by consent orders from the regulators.

Regulatory Guidance

But regulatory activity around foreclosures has not been limited to the nation’s largest mortgage servicers. The Office of the Comptroller of the Currency (OCC) was the first federal regulator to issue additional guidance for financial institutions that they regulate. Specifically, the OCC stated “national banks should conduct a self-assessment of foreclosure management practices. Banks that identify weaknesses in their foreclosure processes through the self-assessment should take immediate corrective action. Banks should determine if the weaknesses resulted in any financial harm to borrowers and provide remediation where appropriate. Examiners will review the self-assessments, corrective actions, and any determinations of financial harm and related remediation in the next quarterly review or examination of the bank.”

The Consumer Financial Protection Bureau, in a press release issued in April 2012, warned financial institutions that they “may be held responsible for the actions of the companies with which they
contract. The Bureau will take a close look at service providers’ interactions with consumers. It will hold all appropriate companies accountable when legal violations occur.”

The OCC has thus far provided the most complete regulatory guidance, which includes a requirement for self-assessments that address the six areas that were noted in the Interagency Review of Foreclosure Policies and Practices, which was issued in April 2011 regarding the consent orders for the 14 largest servicers. The six areas are:

1. **Foreclosure process governance**

   Management should ensure that foreclosure governance processes are sufficient to manage and control operational, compliance, legal, and reputation risk associated with foreclosure activities. Boards of directors should ensure that management has addressed these areas. Depending on the level of activity, this will generally require policies and procedures that provide effective guidance, control, and monitoring of all foreclosure-related activities, including appropriate vendor management and audit and quality-control standards. Management also should ensure sufficient staffing, organizational structure, and training are in place to carry out foreclosure activities in a proper and legal manner.

2. **Dual-track processing**

   Borrowers can be confused when a servicer is working with them to modify their mortgage while continuing with legal proceedings related to foreclosure. To reduce this confusion, management should suspend foreclosure proceedings for successfully performing trial period modifications where they have the legal ability to do so under servicing contracts.

3. **Affidavit and notarization practices**

   Management must ensure that attestations in foreclosure-related affidavits are truthful, accurate, and adequately supported by file documentation, that affiants have sufficiently reviewed the documentation and have adequate knowledge to make the attestations, and that notary practices conform to state legal requirements.

4. **Documentation practices**

   Management must ensure that all required documents supporting lawful foreclosure actions are maintained and have been properly endorsed or assigned. Further, management should ensure the maintenance of a clear audit trail reconciling foreclosure filings to servicer source systems of record. The accuracy of those records should be verified, including statements of total indebtedness and fees charged.
5. **Legal Compliance**

Management must ensure adherence to all laws and regulations related to mortgage foreclosures. In particular, management is reminded that certain borrowers are provided additional foreclosure protections through the Servicemembers Civil Relief Act and bankruptcy provisions.

6. **Third-party vendor management**

Management should properly structure, carefully conduct, and prudently manage relationships with third-party vendors, including outside law firms assisting in the foreclosure process. Management should ensure that third-party vendors have the skills necessary to perform the assigned functions. Roles and responsibilities should be clearly defined and performance should be monitored.

If your bank is regulated by the OCC, you may be determining the steps your organization needs to do to prepare for compliance with these requirements. Many organizations may initially feel that the issues related to the 14 large servicers do not apply to them. After all, many banks do not have large numbers of foreclosures, and as such, may feel that their foreclosure processes are being properly controlled. With no big backlogs of foreclosures, it is reasonable to believe that issues such as robo-signing and dual-track processing would only apply to the large servicers.

But taking a deeper look into an organization’s foreclosure processes, no matter how large or small the operation, can uncover some surprises. Many banks that retain servicing rights outsource servicing functions to mortgage servicing processors and law firms. While the functions are outsourced, the responsibility of processing foreclosures in accordance with laws and regulations cannot be outsourced.

As such, it is critical to comply with the OCC’s directive on performing an assessment of the foreclosure processes. The OCC, in its recent examinations, is advising banks to complete this assessment and document their issues and processes. Any issues that are identified in the assessment must be addressed with effective corrective action. If a bank has not performed an assessment, and the OCC finds deficiencies in the foreclosure processes, the bank may face the possibility of significant penalties and consent orders.

The assessments required by the OCC can be discussed in four parts:

1. Review of the bank’s internal policies/procedures over foreclosure management practices
2. Conducting an independent review of foreclosure activity (i.e. foreclosure file review)
3. Review of the bank’s third party selection and monitoring procedures (i.e. vendor management)
4. Audit of external law firms involved in the processing of the bank’s foreclosures

**Internal Policies/Procedures Review**

Policies and procedures documenting the foreclosure process must be updated to reflect the current practices in place considering any increases in foreclosure activity. The policy revisions should include references to additional external sources utilized to process the foreclosure portfolio as well as specific
bank responsibilities for monitoring the overall status to ensure compliance with various federal and state regulations. Approval by the board of directors should be evident.

**Foreclosure File Review**

This part of the assessment is intended to verify that the procedures and controls identified in the internal policies and procedure review are actually working as intended and report any deviations from these procedures and controls.

The first step is to determine the total population of foreclosure files in the time period being reviewed (typically January 1, 2009 to current period). The foreclosure files should include completed, in process, and terminated foreclosures (terminated foreclosures are those where foreclosure proceedings are terminated due to short sale; deed in lieu of foreclosure, etc.). Depending on the bank, the number of files can vary from a handful to thousands. If the number of files is very large, sampling methods can be used to base conclusions on the total populations of foreclosures. If sampling methods are going to be used, it is important that the population be segmented to ensure the sample covers all the areas needed to be reviewed. For example, each state where the bank conducts business should be included in the sample in quantities sufficient to make an effective conclusion about the handling of foreclosures in that state.

If the bank is using an outside servicer, typically the mortgage / servicing records and the foreclosure documentation will be housed in the servicer’s systems. In this case, a request will have to be made to the servicer to provide these documents for review. It is important that this request is very specific to the document types required for this review. Preferably, these documents should be delivered in an electronic and searchable imaged file format. Each file should be organized in a “stacking order” so that documents can be easily found and reviewed. Poorly organized and labeled files require more time to review and search for missing documents.

It is important to assemble a qualified team of auditors to review the files. These auditors should be experts in reviewing mortgage / servicing documents. The audit team should be overseen with strong management, and depending on the size of the file review, should have a quality assurance review built in to the process to ensure files are being reviewed accurately and consistently.

The main focus of the file review is to test for errors, misrepresentations, and deficiencies in the foreclosures as they relate to compliance with foreclosure laws. Foreclosure laws are very complicated and each state and local municipality has its own unique requirements. While foreclosure laws have similar features across many of the states, it is important to understand the differences in the laws in each state in which your organization conducts business. Many banks trust their outside attorneys / servicers to handle foreclosures according the law of the state. While these law firms are experts in foreclosure law, mistakes are still being made in the handling of foreclosures.

The file review should include verification of the following:

(a) **Proper documentation of ownership** - whether at the time the foreclosure action was initiated or the pleading or affidavit filed (including in bankruptcy proceedings and in defending suits brought by borrowers), the foreclosing party or agent of the party had properly documented
ownership of the promissory note and mortgage (or deed of trust) under relevant state law, or was otherwise a proper party to the action as a result of agency or similar status;

(b) Compliance with applicable laws and mortgage terms –
   a. whether the foreclosure was in accordance with applicable state and federal laws, including but not limited to the SCRA (Servicemembers Civil Relief Act) and the U.S. Bankruptcy Code;
   b. whether, with respect to non-judicial foreclosures, the procedures followed with respect to the foreclosure sale (including the calculation of the default period, the amounts due, and compliance with notice periods) and post-sale confirmations were in accordance with the terms of the mortgage loan and state law requirements;

(c) Loss mitigation activities - whether a foreclosure sale occurred when an application for a loan modification or other loss mitigation was under consideration; when the loan was performing in accordance with a trial or permanent loan modification; or when the loan had not been in default for a sufficient period of time to authorize foreclosure pursuant to the terms of the mortgage loan documents and related agreements;

(d) Fees and Penalties –
   a. whether a delinquent borrower’s account was only charged fees and or penalties that were permissible under the terms of the borrower’s loan documents, applicable state and federal law, and were reasonable and customary;
   b. whether the frequency that fees were assessed to any delinquent borrower’s account (including broker price opinions) was excessive under the terms of the borrower’s loan documents, and applicable state and federal law.

(e) Borrower harm - whether any errors, misrepresentations, or other deficiencies identified in the Foreclosure Review resulted in financial injury to the borrower or the mortgagee.

Vendor Management

The regulators expect the board of directors and management to properly oversee and manage third-party relationships, as defined in OCC Bulletin 2001-47. Banks should adopt a risk management process that includes:

- A risk assessment to identify the bank’s needs and requirements;
- Proper due diligence to identify and select a third-party provider;
- Written contracts that outline duties, obligations, and responsibilities of the parties involved; and
- Ongoing oversight of the third parties and third-party activities.

Once a vendor has been selected and approved, contract considerations should include, but not be limited to:
• **Scope of arrangement** - Outsourcing contracts should specifically identify the frequency, content, and format of the service or product to be provided.
• **Performance measures or benchmark** - Performance measures should define the expectations and responsibilities for both parties.
• **Responsibilities for providing and receiving information** - Management information reports received from the third party should be timely, accurate, and comprehensive enough to allow the bank to adequately assess performance, service levels, and risks.
• **The right to audit** - Banks should make certain that they have the right to audit third parties (and their subcontractors) as needed to monitor performance under the contract.
• **Cost and compensation** - For the bank and the third party, the contract should fully describe compensation, fees, and calculations for base services, as well as any charges based upon volume of activity and fees for special requests.
• **Confidentiality and security** - Service providers must do all they can to keep information confidential and secure.

After entering into a contract or agreement with a third party, management should monitor the third party with respect to its activities and performance. Performance monitoring may include, as appropriate, the following:

• Monitoring financial condition
• Monitoring controls
• Assessing the quality of service and support

If a bank is to manage third-party relationships successfully, it must properly document its oversight program. Proper documentation will facilitate the monitoring and management of the risks associated with third-party relationships. Proper documentation typically includes:

• A list of significant vendors or other third parties
• Valid, current, and complete contracts
• Regular risk management and performance reports received from the third party (for example, audit reports, security reviews, reports indicating compliance with service-level agreements)
• Regular reports to the board, or delegated committee, of the results of the ongoing oversight activities

*Review of External Law Firms*

Depending upon the bank’s foreclosure volume and number of external law firms used for the process, many institutions use a scorecard mechanism to track the progress and overall results of each law firm engaged. The scorecard approach requires a quality assurance review such that each foreclosure is tracked to ensure that required documentation was completed in order to comply with specific federal and state regulatory timelines. The scorecard approach can be initiated at either the bank or the servicer responsible for foreclosure processing.
In order to demonstrate the bank’s commitment to ensuring proper foreclosure processing, a review of all law firms involved should be an integral part of an institution’s foreclosure management oversight.

**Final Thoughts**

The OCC has been the first regulator to provide detailed guidance on managing and reviewing foreclosure processes. Other federal and state regulatory agencies are expected to issue their own guidance. If your bank is not regulated by the OCC, it still is prudent to conduct a self-assessment to determine how prepared your organization is for an examination of your foreclosure processes.

The new requirements are not intended to be a one-time event, but rather an ongoing process in each organization. Bank management should have effective risk assessment and risk management processes in place to assure that risks are identified, managed and mitigated on an ongoing basis. Specific areas to be reviewed would include loan modifications, disposition of bank-owned real estate, bankruptcy, compliance with SCRA, and foreclosure processing.

This new guidance should be incorporated into each bank’s compliance committee and compliance program to ensure the bank is adhering to the applicable laws and regulations. The compliance committees are responsible for the development and implementation of compliance programs (including training of bank personnel), action plans, policies and procedures, and strengthening operating processes to ensure compliance and correct deficiencies.

Finally, as we have seen from the consent order to the 14 largest servicers, non-compliance can be extremely costly to the organization. For example, the consent orders require an “outreach” to borrowers that were involved in a foreclosure with these banks. These large servicers must attempt to contact an estimated four million borrowers through multiple mailings and a nationwide advertising program. While few banks have similar numbers of borrowers, having effective foreclosure processes in place will certainly help avoid the pain and expense of dealing with a consent order from your regulator.