

Limiting Abuse and Opportunism by Mortgage Servicers

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Abstract

This article discusses the opportunistic and abusive behavior of some servicers of residential mortgages toward the borrowers whose loans they service. Such abuse includes claiming that borrowers are in default and attempting to foreclose even when payments are current, charging borrowers unwarranted late fees and other kinds of fees, force-placing insurance even when borrowers already have a policy, and mishandling escrow funds.

The causes of such practices and the market forces that can rein them in are discussed. A case study of one mortgage servicer describes its unfair treatment of borrowers and the reforms imposed by federal regulators and other market participants. Both regulatory agencies and ratings agencies appear to have increased their scrutiny of servicers' behavior, and states have passed new legislation to limit abuse. The article concludes with a discussion of proposals for further reform should these steps prove inadequate.

Keywords: Mortgage servicers; Securitization; Subprime and predatory lending

Introduction

Since a growing number of residential loans are packaged and sold on Wall Street, securitization—defined by Shenker and Colletta (1991) as the process of creating liquid, tradable securities by selling interests in a pool of less liquid assets such as residential mortgages—has become an integral part of our mortgage banking system. As securitization increases, so too does the need to protect borrowers whose loans are securitized from opportunism by the commercial participants in the securitization process. This article focuses on

one aspect of securitization—the servicing of residential mortgages—to examine how securitization and servicing affect borrowers, how they can be harmed by unscrupulous or incompetent servicers, and what market and government forces are in place to prevent abusive behavior by servicers.

The article details various servicing abuses, such as attempting to foreclose or charge late fees even when borrowers are current on their payments or force-placing insurance for borrowers who have already provided servicers with evidence of insurance. It also presents a case study to show how one servicer, Fairbanks Capital, acted opportunistically toward its borrowers and how government and market actors reacted to curb such abuse. The article then presents various proposals for further reform.

Securitization and the need for servicing

Securitization has, as noted by Michael Jacobides, “atomized” the mortgage lending industry, with a different entity taking over each stage of the process (2001). Rather than a single firm, such as a credit union, overseeing the entire life of a loan, a different entity handles each aspect of the loan process. A mortgage broker may work directly with the borrowers, a separate company may originate the loan, another may acquire it and package it with other loans, Wall Street firms may sell securities backed by the package of loans to investors, a special purpose vehicle (SPV) such as a trust may hold the loans on behalf of investors or transfer the loans to another entity to do so, a servicer will collect the payments, and a special servicer may attempt to foreclose if payments are not made (Frankel 1999).

The SPV is a passive entity, designed merely to hold the mortgages while other entities do the actual work of collecting payments and distributing them to investors. Trustees are normally passive, too, as long as the payments are collected and the appropriate share is distributed to investors (Schwarcz 2003). Much of the real work of mortgage collection is left to third parties, called servicers, that contract with the trustee to collect mortgage payments and to employ various loss mitigation techniques, such as foreclosure or forbearance, should the borrower default.

In performing these functions, the servicer is normally the sole entity that interacts or communicates with borrowers. How the servicer behaves by and large determines what kind of experience borrowers have as they pay off their loans and whether they are treated fairly. The way a loan is serviced often has a greater effect on the borrower than the way it was originated (Zalenski 2003).

Servicers and their functions

The primary duty of servicers is to collect mortgage payments from borrowers and remit the appropriate portions to the investors holding an interest in the SPV and to the trustee (12 U.S.C. 2605(i)(2) and (3)). The servicer typically has a duty to account for the principal and interest collected and to advance its own funds to make up the shortfall when the borrower does not make a full payment (Morse 2003). The servicer is also responsible for managing the escrow or impound accounts that it holds on behalf of the borrowers and paying property taxes and insurance from those escrowed funds. In addition, the servicer pays guarantors and other service providers, temporarily invests funds as needed, and tracks the performance of the pool of assets it oversees and reports that performance to the trustee (Morse 2003).

The final important function of the servicer is loss mitigation, which involves efforts to collect on the mortgage when the borrower has failed to or appears likely to fail to make the mortgage payments on time. Loss mitigation takes many forms, and servicers and borrowers can enter into various sorts of workout agreements, including the following:

1. *Repayment plans*, which are normally informal, oral plans to allow the borrower to make up the missed payments in a few months
2. *Forbearance plans*, which are more formal and often in writing, allowing borrowers up to 12 months to make up any missed payments
3. *Loan modifications*, which change the terms of the loan by, for example, reducing the interest rate or principal, extending the term, or forgiving payments entirely (Fitch Ratings 2003a). Loan modifications act as no-cost refinancing of the loan with new terms (Capone and Metz 2003).

Other forms of loss mitigation include

1. *Short sales*, where investors agree to accept less than the full loan amount so the borrower can sell the house
2. *Deeds in lieu of foreclosure*, where the borrower deeds the house to the holder of the note, sometimes after payment by the note holder (Capone and Metz 2003)
3. *Foreclosure*

Servicers can tailor the loss mitigation strategy to the specific borrower's situation and are ultimately responsible for pursuing the appropriate type of resolution when normal servicing processes need to be altered.

Abuses by servicers

Although predatory lending has received far more attention than abusive servicing, a significant percentage of consumer complaints over loans involve servicing, not origination. For example, the director of the Nevada Fair Housing Center testified that of the hundreds of complaints of predatory lending issues her office received in 2002, about 42 percent involved servicing once the loan was transferred (Burks 2003). While predatory lending and abusive servicing both appear to occur primarily in the subprime market, they are completely separate issues; in other words, a predatory loan can be serviced fairly and a fair loan can be serviced abusively.

To discuss abusive servicing, it is first necessary to define it. Abusive servicing occurs when a servicer, either through action or inaction, obtains or attempts to obtain unwarranted fees or other costs from borrowers, engages in unfair collection practices, or through its own improper behavior or inaction causes borrowers to be more likely to go into default or have their homes foreclosed.¹ Abusive practices should be distinguished from appropriate actions that may harm borrowers, such as a servicer merely collecting appropriate late fees or foreclosing on borrowers who do not make their payments despite proper loss mitigation efforts. Servicing can be abusive either intentionally, when there is intent to obtain unwarranted fees, or negligently, when, for example, a servicer's records are so disorganized that borrowers are regularly charged late fees even when mortgage payments were made on time.

While little scholarly research has been done on the actual practices of servicers, there is significant evidence that some of them have engaged in abusive behavior and that borrowers have frequently been the victims. Some servicers have engaged in practices that are not only detrimental to borrowers but also illegal (Beales 2004). Such abuse has been documented in court opinions and decisions, in the decisions and findings of ratings agencies, in litigation and settlements obtained by government agencies against prominent servicers, in congressional testimony, and in newspaper accounts of borrowers who claim to have been mistreated by servicers. The abusive servicing practices documented in these sources include improper foreclosure or attempted foreclosure, improper fees, improper forced-placed insurance, and improper use or oversight of escrow funds (Winston 2003). Each of these will be discussed in turn.

¹ By improper behavior, I mean behavior that violates state or federal law or regulations governing servicers; that breaches the terms of the note and deed of trust that governs the loan, the pooling and servicing agreement that binds the servicer, or the rules governing servicers created by government-sponsored enterprises such as Fannie Mae or Freddie Mac; or that constitutes recognized unfair and deceptive business practices.

Improper foreclosure or attempted foreclosure

Because servicers can exact fees associated with foreclosures, such as attorneys' fees, some servicers have attempted to foreclose on property even when borrowers are current on their payments or without giving borrowers enough time to repay or otherwise working with them on a repayment plan (Collins 2004).² Furthermore, a speedy foreclosure may save servicers the cost of attempting other techniques that might have prevented the foreclosure.

Some servicers have been so brazen that they have regularly claimed to the courts that borrowers were in default so as to justify foreclosure, even though the borrowers were current on their payments. For example, in *In re Gorshtein*, 285 B.R. 118 (2002), the court collected three examples of such false claims of default in the servicing of loans and sanctioned the creditors, noting that its decision was "provoked by an apparently increasing number of motions in this Court to vacate the automatic stay filed by secured creditors often based upon attorney affidavits certifying material post petition defaults where, in fact, there were no material defaults by the debtors" (120).³ The court also noted that in each case, the borrower risked foreclosure because of the false statements by servicers and lenders on whether payments had been made.⁴ Other courts have also decried the frequent use of false statements to obtain relief from stay in order to foreclose on borrowers' homes.⁵ In *In re Wines*, 239 B.R. 703 (1999), the court noted the "poor quality of the papers

² For example, in *Hart v. GMAC Mortgage Corporation, et al.*, 246 B.R. 709 (2000), even though the borrower had made the payments required of him by a forbearance agreement he had entered into with the servicer (GMAC Mortgage Corporation), it created a "negative suspense account" for moneys it had paid out, improperly charged the borrower an additional monthly sum to repay the negative suspense account, charged him late fees for failing to make the entire payment demanded, and began foreclosure proceedings.

³ In the *Gorshtein* case, one of the sanctioned creditors, Fairbanks Capital Corporation, was clearly a servicer, and the other two creditors (Washington Mutual Bank F.A. and Chase Manhattan Mortgage Corporation) appeared to be lenders servicing loans they originated, although it is often difficult in many court decisions to distinguish between holders servicing their own notes and third-party servicers.

⁴ In *Gorshtein*, the servicer, claiming that the borrower was behind in her mortgage payments, moved for relief from an automatic stay in bankruptcy in order to foreclose on her house. After the borrower demonstrated that she was current, the servicer withdrew its motion. A year later, the servicer filed a new motion, again alleging that the borrower had failed to make payments for several months, and again the borrower proved that she had made all of her payments and that they had been accepted. The bankruptcy court sanctioned the servicer for its false claims.

⁵ For example, in *In re Asbill*, 1999 WL 33486100 (Bankr.D.S.C. 1999), the court stated: "More and more frequently, in these days of national lenders and frequent assignments of notes and mortgages, this Court is confronted with creditors who file relief from stay motions asserting that debtors are in arrears when in fact, after a reasonable inquiry, it appears that they are current in their payments" (4). In the *Asbill* case, it is unclear whether the holder of the note was servicing it as well.

filed” (709) by a creditor, terming it a “sad commentary on the record keeping of a large financial institution. Unfortunately, it is typical of the products generated by lenders and loan servicers in court proceedings” (709). Unwarranted claims of default harm borrowers even apart from the risk of foreclosure or late fees. Defaults lower credit ratings so that borrowers may find it more difficult to buy a home, get a loan, or even obtain a new job or a promotion (Quercia and Stegman 1992).

Improper fees

Claiming that borrowers are in default when they are actually current allows servicers to charge unwarranted fees, either late fees or fees related to default and foreclosure. Servicers receive as a conventional fee a percentage of the total value of the loans they service, typically 25 basis points for prime loans and 50 basis points for subprime loans (Office of the Comptroller of the Currency 2003). In addition, contracts typically provide that the servicer, not the trustee or investors, has the right to keep any and all late fees or fees associated with defaults. Servicers charge late fees not only because they act as a prod to coax borrowers into making payments on time, but also because borrowers who fail to make payments impose additional costs on servicers, which must then engage in loss mitigation to induce payment.

Such fees are a crucial part of servicers’ income. For example, one servicer’s CEO reportedly stated that extra fees, such as late fees, appeared to be paying for all of the operating costs of the company’s entire servicing department, leaving the conventional servicing fee almost completely profit (Cornwell 2004b). The pressure to collect such fees appears to be higher on subprime servicers than on prime servicers: A working paper put out by the Office of the Comptroller of the Currency (2003) estimates that while subprime servicers charge investors only 25 basis points more than prime servicers do, the true cost of subprime servicing is 40 basis points higher than it is for prime servicing.

Because borrowers typically cannot prove the exact date a payment was received, servicers can charge late fees even when they receive the payment on time (U.S. General Accounting Office [GAO] 1989). Improper late fees may also be based on the loss of borrowers’ payments by servicers, their inability to track those payments accurately, or their failure to post payments in a timely fashion. In *Ronemus v. FTB Mortgage Services*, 201 B.R. 458 (1996), under a Chapter 13 bankruptcy plan, the borrowers had made all of their payments on time except for two; they received permission to pay these two late and paid late fees for the privilege. However, the servicer, FTB Mortgage Services,

misapplied their payments, then began placing their payments into a suspense account and collecting unauthorized late fees. The servicer ignored several letters from the borrowers' attorney attempting to clear up the matter, sent regular demands for late fees, and began harassing the borrowers with collection efforts. When the borrowers sued, the servicer submitted to the court an artificially inflated accounting of how much the borrowers owed.⁶

Some servicers have sent out late notices even when they have received timely payments and even before the end of a borrower's grace period (Brennan 1998, 2000). Worse yet, a servicer might pocket the payment, such as an extra payment of principal, and never credit it to the borrower (Guttentag 2004). Late fees on timely payments are a common problem when borrowers are making mortgage payments through a bankruptcy plan (Carter et al. 2002).

Moreover, some servicers have also added false fees and charges not authorized by law or contract to their monthly payment demands, relying on borrowers' ignorance of the exact amount owed (Bernstein 1998). They can collect such fees or other unwarranted claims by submitting inaccurate payoff demands when a borrower refinances or sells the house (Isaac 2001; Medine 2000). Or they can place the borrowers' monthly payments in a suspense account and then charge late fees even though they received the payment (Renuart 2003). Worse yet, some servicers pyramid their late fees, applying a portion of the current payment to a previous late fee and then charging an additional late fee even though the borrower has made a timely and full payment for the new month (Meredith 2003). Pyramiding late fees allows servicers to charge late fees month after month even though the borrower made only one late payment (Sheldon and Carter 2003).

Servicers can turn their fees into a profit center by sending inaccurate monthly payment demands, demanding unearned fees or charges not owed, or imposing fees higher than the expenses for a panoply of actions (Isaac 2001; Medine 2000). For example, some servicers take advantage of borrowers' ignorance by charging fees, such as prepayment penalties, where the note does not provide for them (Guttentag 2004). Servicers have sometimes imposed a uniform set of fees over an entire pool of loans, disregarding the fact that some of the loan documents did not provide for those particular fees (Cornwell 2004a). Or they charge more for attorneys', property inspection, or appraisal

⁶ The servicer's behavior was so egregious that the court ordered the borrowers' debt be reduced by \$10,000, and the servicer's records were in such disarray that it ordered the servicer to start a new completely new ledger for the borrowers' account (*Ronemus* at 461).

fees than were actually incurred.⁷ Some servicers may add a fee by conducting unnecessary property inspections, having an agent drive by even when the borrower is not in default, or conducting multiple inspections during a single period of default to charge the resulting multiple fees (Renuart 2003).

The complexity of the terms of many loans makes it difficult for borrowers to discover whether they are being overcharged (Medine 2000). Moreover, servicers can frustrate any attempts to sort out which fees are genuine. In *McCormack v. Federal Home Loan Mortgage Corp.*, 203 B.R. 521 (1996), when the borrower challenged Chase Manhattan Mortgage Corporation's insistence on collecting disallowed attorneys' fees and mortgage payments that had been cured in a bankruptcy, the servicer subjected the borrower to what the court called a "barrage of totally meaningless and in fact misleading print-outs" that was "truly outrageous and egregious conduct" (525). The servicer repeatedly promised to correct its errors, but did not do so.⁸

Improperly forced-placed insurance

Mortgage holders are entitled under the terms of the loan to require borrowers to carry homeowners' insurance naming the holder as the payee in case of loss and to force-place insurance by buying policies for borrowers who fail to do so and charging them for the premiums (Kider and Halpern 2002; Zalenski 2003). However, some servicers have force-placed insurance even in cases where the borrower already had it and even provided evidence of it to the servicer (Brennan 2000). Worse yet, servicers have charged for force-placed insurance without even purchasing it.⁹ Premiums for force-placed insurance are often inflated in that they provide protection in excess of what the loan

⁷ Servicers mislabel fees to ensure payment. In *In re Tate*, 253 B.R. 653 (2000), the court found that the servicer, NationsBanc Mortgage Corporation, labeled its attorneys' fees as "bankruptcy fees" and its attorney a "bankruptcy technician" so that it would not have to seek the bankruptcy court's approval of its attorneys' fees. One servicer apparently charges customers repetitive fees for the same service, for example, labeling the same charge "a legal fee, a foreclosure fee, an attorney's fee, and a disbursement fee" when the borrower refinanced (Bergquist 2003b, 17). Worse yet, the servicer allegedly charged these fees to the new mortgage holder in the refinance, making it less likely that the borrower would notice the decrease in the proceeds and contest the duplicative fees (Bergquist 2003b). If borrowers fail to notice or contest these fees and merely pay them, servicers reap an unearned reward.

⁸ In *McCormack*, the court awarded \$10,000 in punitive damages to the borrower for the servicer's conduct.

⁹ For example, in *Terdik v. Homeside Lending, Inc.*, 2002 WL 596804 (Cal. App. 6 Dist. 2002, unpublished), a servicer discovered only after it had foreclosed on the borrowers' residence for failure to pay for force-placed insurance that its predecessor servicer, Hamilton Financial Corporation, had not in fact purchased some of the force-placed insurance.

terms require (Brennan 2000). A common claim by borrowers in lawsuits over insurance is that lenders' force-placed insurance that was not authorized by the loan documents and was more than was needed to safeguard the lender's secured interest in the home (Sandler 2003).¹⁰ When a servicer force-places insurance, a borrower who continues making a normal payment covering principal and interest without an added amount for the increased insurance costs can be charged late fees or even face foreclosure (Collins 2003c).

Improper use or oversight of escrow funds

One of the benefits of servicing mortgages is controlling escrow accounts to pay for insurance, taxes, and the like and, in most states, keeping any interest earned on these accounts (Harney 2004). Borrowers have complained that servicers have failed to make tax or insurance payments when they were due or at all (GAO 1989). The treasurer of the country's second largest county estimated that this failure to make timely payments cost borrowers late fees of at least \$2 million in that county over a two-year span, causing some to lose their homes (Sichelman 2002). If servicers fail to make insurance payments and a policy lapses, borrowers may face much higher insurance costs even if they purchase their own, non-force-placed policy. Worse yet, borrowers may find themselves unable to buy insurance at all if they cannot find a new insurer willing to write them a policy (Patel 2003).

Case study of a servicer, Fairbanks Capital Corporation

Many of the complaints and lawsuits against servicers have been focused on perhaps the most notorious servicer, Fairbanks Capital Corporation, which at the beginning of 2003 was the largest subprime servicer in the country (Collins 2003d). By studying the growth of Fairbanks, its abusive practices, and the various forces that have acted to reform it, we can better understand the tension between the forces that lead servicers to abuse borrowers and those that might act to restrain servicers and protect borrowers.

Fairbanks was formed in 1989 and grew rapidly by buying subprime servicers and the servicing portfolios of other companies ("Rival Hires HomeEq Exec" 2003). It was rated by credit agencies as highly qualified to service

¹⁰ Servicers have also been sued based on allegations that they force-placed exorbitantly priced insurance to receive a kickback, either cash or in-kind services, from the insurance company (*Norwest Mortgage, Inc. v. Superior Court*, 85 Cal. Rptr. 2d 18, 20–21 (Cal Ct. App. 1999)) (Sandler 2003; Zalenski 2003).

subprime and nonperforming loans. As part of its growth, Fairbanks acquired the servicing rights to a portfolio originated by ContiMortgage (Conti), a troubled subprime lender. According to Fitch Ratings, that portfolio had been plagued by inflated property values and faulty underwriting, as well as by ineffective loss mitigation techniques (2002).

When Fairbanks took over the Conti portfolio, it quickly reduced the timeline to foreclose on properties in default by more than 100 days, from 246 to 144. Fairbanks reportedly began to pursue foreclosure aggressively, starting when a borrower had missed only two payments, or at day 62 of delinquency (Cornwell 2003). One ratings agency concluded that Fairbanks had achieved a great deal in stabilizing the losses that were inevitable in Conti's portfolio, stating that the company was highly qualified to service subprime and nonperforming loans (Fitch Ratings 2003a).

Along with this growth came accusations of abusive servicing. Fairbanks was accused of failing to recognize forbearance agreements entered into by a previous servicer, claiming that payments had been missed when they had actually been made, and bungling tax records (Pesquera 2002c). Fairbanks was also accused of improperly foreclosing on houses based on false claims of missed payments (Pesquera 2002a) and charging for insurance even during periods when it did not service the loan in question (Pesquera 2002b).

Fairbanks was sued on the basis of allegations that it force-placed insurance policies where coverage was already in effect, that it attempted to coerce borrowers to use a payment system that provided Fairbanks with additional fee-based income, and that it overcharged borrowers and used foreclosure threats to pressure borrowers into paying (Jurgens 2003). In one lawsuit, a West Virginia judge issued a temporary injunction barring Fairbanks from conducting any foreclosure actions in the entire state (Collins 2003a). In *Williams v. Fairbanks Capital Corporation*, 2001 WL 1804312 (Bankr. D.S.C. 2001), Fairbanks filed for relief from an automatic bankruptcy stay, claiming that the borrower had failed to follow the consent order and apparently claiming that she had not made her payments. However, she had in fact followed the consent order, Fairbanks's own records were defective, and the court sanctioned the company.

In another lawsuit, *In re Pearl Maxwell*, 281 B.R. 101 (2002), the borrowers were an 83-year-old woman who had little education or financial means and her granddaughter. Fairbanks acquired the servicing rights to the loan and then, while the woman and her granddaughter were attempting to discover how much they owed and arrange a short payoff, the company began foreclosure proceedings. During attempts by the borrowers to determine how much they owed, Fairbanks made six completely different representations of

the amount, ranging from about \$122,000 to about \$364,000. Later, Fairbanks admitted that the borrowers did not owe any of the sums it had represented as their debt. The court stated that “in a shocking display of corporate irresponsibility, [Fairbanks] repeatedly fabricated the amount of the [borrowers’] obligation out of thin air” (117).

The increasing media scrutiny garnered by Fairbanks drew the attention of various federal regulators, spurred on by two U.S. senators. In March 2003, one senator asked the Inspector General of the Department of Housing and Urban Development (HUD) to begin an investigation into Fairbanks’ practices, and it did (Collins 2003a). After the other senator asked Fannie Mae and Freddie Mac to investigate Fairbanks, Fannie Mae refused to allow Fairbanks to service any of its new loans until that company implemented remedial actions. Fannie Mae found that Fairbanks’ problems included “inadequate internal controls, inadequate customer responsiveness and dispute resolution practices, and the improper assessment of certain fees and charges” (Heller 2003, 4). Fannie Mae and Fairbanks reached an agreement that required the company to alter its practices and to make refunds to customers that it had previously overcharged (Heller 2003).

In response to the lawsuits and media reports, Fairbanks argued that it was being blamed for the problems inherent in the portfolios that it had acquired, such as Conti’s. Such portfolios, Fairbanks claimed, presented special problems because they had not previously been serviced properly and because subprime borrowers present special challenges, such as their precarious financial condition and the lack of escrow accounts for taxes and insurance in these mortgages (Collins 2003a). Furthermore, Fairbanks argued that because many of the loans it acquired were already delinquent, it would naturally receive a greater number of complaints (Mitchell 2003). In May 2003, according to an executive at Fairbanks, about 30 percent of its 600,000 home loans were more than two payments behind, and 45,000 of its loans were in foreclosure (Harney 2003).

This kind of national scrutiny made it increasingly likely that ratings agencies, the guardians of securitization, would step in. Standard & Poor’s (S&P), for example, initially placed Fairbanks on a credit watch, citing “increased regulatory scrutiny” (Collins 2003b, 1). In April 2003, S&P lowered its rankings for Fairbanks from “Strong” to “Below Average,” though it listed the company’s outlook as stable. S&P issued a public report about Fairbanks, citing numerous site visits, a review of related information, and meetings with the management (2003).

To justify the lowered rankings, S&P further stated that it found a pattern of what appeared to be Fair Debt Collection Practices Act violations and

examples of inaccurate payoff quotations, substantial instances of erroneous property inspection fees, and apparent violations of the Real Estate Settlement Procedures Act (RESPA) (failing to process escrow refunds in a timely manner) (2003; see also Zalenski 2003). S&P was also concerned about the number of borrowers who had lender-placed insurance, “indicating a possible control issue” (Zalenski 2003, 7) over force-placed insurance. It found that foreclosure statistics for Fairbanks were “outside of industry tolerance levels, and do not necessarily reflect reasonable efforts to exhaust loss mitigation opportunities” (Zalenski 2003, 7). Last, S&P noted the increasing amount of consumer litigation filed against Fairbanks, as well as HUD and Federal Trade Commission (FTC) investigations (Zalenski 2003).

Fairbanks responded to this ratings change by accusing S&P of basing its ratings on outdated information. The company claimed that new recording and monitoring systems had already been put into place and that its collectors had received new training (“Servicer Snaps Back” 2003). In May 2003, Fitch Inc., another rating agency, also downgraded Fairbanks, citing uncertainty about its “financial viability, management stability, and operational strength” (Bergquist 2003a, 10). Moody’s Investor Service, a third ratings agency, downgraded Fairbanks as well, citing the FTC and HUD investigations and noting that Fairbanks fell short of expectations in resolving borrowers’ disputes and processing cash. Ironically, Moody’s also cited as a concern the possibility that new policies to improve customer service and respond to regulatory pressure could slow default timelines and increase losses to investors, yet another reason to downgrade the company (2003).

Ratings agencies appeared concerned that the difficulties and publicity plaguing Fairbanks could taint the entire subprime servicing industry. As a likely result of this concern, ratings agencies began to change the way they monitored servicers, carefully tracking their costs and loss mitigation timelines. They also began to request more information from servicers, including data on customer service, escrow management, and cashiering (Cornwell 2003).

Fairbanks responded to the regulatory and media pressure by making sweeping changes in its management team, announcing that it was taking corrective action by forming a special unit to review loans that have been referred for foreclosure and another unit to handle disputes with customers (Collins 2003d, 1). It even went so far as to hire as consultants two of the most persistent critics of its operations, giving them the task of drafting a Bill of Rights for customers. Fairbanks, moreover, pointed to improvements, such as a decrease in its abandoned call rate from 7.6 percent to under 2 percent. Abandoned calls are those in which callers on hold hang up rather than continue to wait to speak to a company representative (Mitchell 2003).

On November 12, 2003, Fairbanks entered into an out-of-court settlement with FTC and HUD. As part of that agreement, Fairbanks, without admitting to any wrongdoing, agreed to create a \$40 million fund for the borrowers affected by its practices. Perhaps more important, the company agreed to a set of best practice guidelines for mortgage servicing. It would

1. Post payments, even most partial payments, on the date they were received
2. Disburse escrow funds for taxes and insurance on time
3. Accept confirmation of existing insurance if provided in a reasonable form and not force-place insurance when Fairbanks knew a policy was already in place or did not take reasonable efforts to find it
4. Send at least two written notices to borrowers telling them how they could demonstrate that they have a policy and waiting a certain period for a response before force-placing insurance
5. Maintain and adequately staff a toll-free phone number and have an address, both dedicated to communications with borrowers
6. Respond to qualified written requests, acknowledging most borrowers' disputes and investigating them in a timely manner

Fairbanks also agreed to refrain from

1. Pyramiding late charges by charging new late fees based on the borrower's failure to pay a previous late fee
2. Misrepresenting the amount owed or whether a fee is allowed under contract or law
3. Taking any action aimed at foreclosure unless and until it reviews the loan records of the borrower and determines that three full monthly payments have been missed, confirms that the borrower has not been the victim of any illegal practices by Fairbanks, investigates any disputes Fairbanks may have with the borrower, and notifies the borrower of the results of that investigation

Fairbanks also agreed to reclassify as current some accounts that had been classified as delinquent because of nonpayment of taxes, insurance, or fees. Any borrower who gains redress under the settlement waives any claims

against Fairbanks for servicing behavior.¹¹ While this set of best practices is binding only on Fairbanks and not on other servicers, it seems likely to have been designed to give the rest of the industry an indication of what behavior could subject servicers to FTC investigation (Harney 2003). Despite this settlement, Fairbanks continued to have problems. For a time, it was reportedly “hemorrhaging contracts” (Muolo 2004, 1), and its servicing portfolio declined by 17 percent from the year before; in addition, its receivables were 13 percent less in the fourth quarter of 2003 than they were in the third (Muolo 2004). Fairbanks also later agreed to \$1.65 million to settle claims by Florida regulators that it had charged inappropriate fees, such as unwarranted late fees, or force-placed insurance (“Fairbanks Refunds Florida Borrowers” 2004).

However, in May 2004, S&P upgraded Fairbanks’s rating, finding that the company had made significant improvements to its servicing, instituting a “borrower-centric culture in [the] loan resolution area” and improving its compliance with federal debt collection laws (2004). S&P found that Fairbanks had altered its foreclosure timelines to allow for “more intense loss mitigation” earlier in the process and improved its payment posting, thus reducing delays in posting borrowers’ mortgage payments (2004). At about the same time, the company also received more positive ratings from two other agencies (“Fairbanks Gets an Upgrade” 2004). After receiving these upgrades, Fairbanks changed its name to Select Portfolio Servicing, Inc. (2004). While Fairbanks/Select may still have flaws, it appears that the action by FTC and HUD, coupled with downgrades by ratings agencies, have induced the company to improve servicing.

Although at its worst Fairbanks was the most notorious servicer, it was not the only one that generated litigation, consumer complaints, or regulatory scrutiny. Another large servicer, Ocwen Federal Bank, FSB, also recently entered into a settlement with the federal Office of Thrift Supervision (OTS) requiring Ocwen to create a consumer ombudsman, meet with consumer groups to discuss mortgage servicing issues, conduct consumer satisfaction surveys, and establish a written complaint resolution procedure. Further, the servicer agreed to take additional steps to ensure that it was not force-placing insurance unnecessarily, that it would not charge for notice of default letters or forbearance agreements, and that it would take steps to have accurate and timely pay-off quotes.¹² These settlements do not contain official findings of

¹¹ The complaint filed against Fairbanks by FTC and HUD as well as the order preliminarily approving the stipulated final judgment and order can be found at FTC 2003.

¹² A copy of the Ocwen/OTS agreement can be found at OTS 2004.

fact or admissions by the servicers of abusive practices. However, the fact that government regulatory agencies sought these agreements, that the servicers agreed to take remedial steps, and that Fairbanks also agreed to create a \$40 million fund for its borrowers is an indication that abusive practices are a significant concern.

Opportunism by servicers

The Fairbanks Capital case study provides evidence of servicers' ability to take advantage of the borrowers whose loans they service, as well as of the forces that can rein in such opportunism. A central cause of this opportunism is the inability of borrowers either to choose or to control their servicers. Borrowers have almost no choice in determining which servicers handle their loans. Companies obtain the right to service a loan either by originating it themselves, then retaining the servicing rights, or by purchasing the rights or the servicer that held them (DeZube 2003; Donatacci 2003; GAO 1989). Because they have little control over which servicers they must deal with or what those servicers do, borrowers have few nonlegal sanctions they can employ to deter servicer opportunism.

Opportunism has been defined by economist Oliver Williamson as "self-interest seeking with guile" (1975, 26). Opportunism may arise when one party realizes that the other cannot effectively retaliate if the first party unexpectedly changes the course of its dealings to exact a transfer of wealth (Butler and Baysinger 1983). It can also stem from information asymmetries, since the party that holds the information advantage can selectively or inaccurately present information to the other party (Shell 1991).

Forces against opportunism

Opportunism in commercial enterprises is normally hemmed in by a variety of forces, including legal and nonlegal sanctions. The most significant nonlegal force restraining opportunism is the concern market participants have for their reputation and the fear that opportunistic behavior will damage their good name and so deny them future profit from new customers or business partners (Macaulay 2000). For many consumer goods, a rich and active system of checks and monitors exists to oversee businesses and affect their reputations should they misbehave. A business that engages in abusive behavior can lose customers as word of its actions spreads through newspaper articles, television reporting, or consumer advocates.

A second nonlegal sanction that constrains opportunistic behavior is the

ability of a transactor to withdraw or withhold a relationship-specific prospective advantage, such as a credit line (Charny 1990). For example, businesses that rely on repeat customers are constrained from engaging in abusive behavior by their desire to retain the loyalty of these customers.

A third type of nonlegal sanction is the loss of psychic or social well-being by individuals, such as those who work for or operate a business entity. As Charny notes, “The breaching promisor may suffer loss of opportunities for important or pleasurable associations with others, loss of self-esteem, feelings of guilt, or an unfulfilled desire to think of himself as trustworthy and competent” (1990, 393–94). Norms created by social groups, as well as individual ethics and a sense of responsibility, play a large role in regulating contracting parties (Scott 1987). One of the most important of these social norms is reciprocity, which is especially powerful where not only business but also personal relations exist between persons and organizations (MacNeil 1985; Scott 1987). Peer disapproval is surprisingly effective in sanctioning and so preventing overreaching (Scott 2000).

In addition to these nonlegal sanctions, legal sanctions against specific misbehavior are provided by contract or by public law, such as consumer protection laws enforced by consumers themselves or by various public entities. Contracts or laws can explicitly forbid a specific behavior that would cause harm and can also provide a remedy should the harm occur. Consumers can rely on such contractual tools as warranties to inhibit businesses’ taking advantage by producing shoddy goods. However, consumers rarely read the long contracts that constitute loan agreements and have little power to alter those that are drafted by lending company lawyers (Macaulay 2000). Unless contracts are drafted or influenced by third parties protecting consumer interests, the primary legal sanctions consumers have to rely on are consumer protection laws.

Even where laws bar specific abuses by servicers, borrowers may have trouble enforcing those laws. Private litigation can be more expensive than the value of borrowers’ claims. If a borrower has been charged several hundred dollars in improper late fees, retaining an attorney to litigate this dispute might take a far greater sum (Kripke 1968). Individual actions over late fees and force-placed insurance seem to occur most commonly in the context of bankruptcies, where borrowers often already have attorneys.

Ways securitization can facilitate opportunism

Securitization presents a servicer with several possibilities for opportunism against both borrowers and investors. Servicers can take advantage of

borrowers through the abusive tactics described earlier, such as undeserved late fees, unjustified foreclosures, or force-placed insurance. Abusive servicing practices, such as charging late fees even when payments have been made on time, have been observed in other servicing arrangements, for example, the servicing of credit card debt (Mierzwinski 2001). Servicers can take advantage of investors by procuring this extra income from late fees, foreclosures, and insurance even to the detriment of investors. By comparison, borrowers can drive up the costs of servicing loans by failing to make their payments on time or at all, but they then risk losing their homes. Borrowers have one notable information advantage in that they are far more likely to know whether they will make their payments on time or ever and whether they will fulfill any agreements they make as part of the servicer's loss mitigation efforts.

Servicers can also harm borrowers by reducing the level of service that they provide. Because the servicer's share of mortgage payments is set by the servicing agreement, a servicer can increase the profitability of that set pool of loans either by increasing the fees it charges customers or by reducing its expenses. One way to reduce expenses is to minimize the amount of time a borrower talks to any servicer's agent (Kropper 2002). If a servicer significantly curtails its customer service expenditures, it may be able to kill two birds with one stone. First, a servicer that slashes its check processing budget may start posting customer payments late and then use that late posting to claim undeserved late fees from the borrowers. Second, cutting the number of customer service representatives may make it harder for borrowers to resolve any disputes they may have with the servicer about whether and when they made their payments. In this way, a servicer's own poor performance may actually increase its profitable collection of late fees.

The typical nonlegal sanctions that normally constrain opportunistic behavior are strikingly ineffective against servicers. Borrowers do not choose servicers, which thus have little to fear in antagonizing borrowers. Servicers' true clientele consists of the securitizers and trustees that contract with them. Servicers need concern themselves about their reputation for abusive practices toward borrowers only to the extent that it affects the willingness of the entities that securitize loans to hire them and of ratings agencies to judge them qualified to serve. Servicers' reputation among borrowers does not, therefore, directly affect the ability to obtain new contracts or retain existing ones. The investors in loan pools do not need to worry about their reputation among borrowers, since most of them have no idea who owns the securitized loan and cannot direct how their loans are securitized anyway. Only originators have a real concern about their reputation among borrowers, and if a loan is

securitized and the servicing transferred, originators no longer control how borrowers are treated.

The second form of nonlegal sanction against opportunism, the ability of the other party to withhold or deny a relation-specific advantage, is also of little use to borrowers: Because they do not choose servicers, they also cannot refuse to become repeat customers. Even if they refinance their loans with a completely new lender, borrowers may find themselves saddled with the same servicer. Nor is there much they can do in the course of their relationship to make the servicer behave appropriately.

The securitization process and the business model most servicers follow also limit the effect of the third type of nonlegal sanction, the social norms, sense of shame, and individual ethics that would otherwise limit opportunism. Unlike the traditional banking system, in which lenders often lived in the same towns as borrowers, knew them socially, and shared a sense of community with them, servicers operate in a transactional milieu that has been almost completely depersonalized. A servicer could work with a borrower for 30 years without a single face-to-face interaction. If a borrower calls a servicer to complain, each new call might be handled by a call center in a different state or even on a different continent, since servicers outsource their call centers (O'Neill 2003). Individual agents who talk to borrowers follow a computerized script and have little discretion over the results of their conversation because a series of prompts directs them (Thinakal 2002). This depersonalization of the transaction robs social norms, shame, and ethics of their coercive power.

Ways securitization can help curb opportunism

Because borrowers have so little power, other influences are needed to induce servicers to behave ethically. In one scenario, loan pool investors would monitor the behavior of servicers and punish those engaging in opportunistic behavior. The interests of borrowers, however, are to a great extent antithetical to those of investors and other market participants in securitized loans. While borrowers would naturally prefer to reduce or eliminate the fee-based income of servicers, loan originators and investors have an interest in servicers' obtaining such income, since the more fee income servicers obtain, the smaller the share of the mortgage payment stream they need to be given. If servicers can use regular late fees, for example, to require a significant portion of borrowers in effect to increase their monthly mortgage payments, this ex post facto increase in the cost of the mortgage is a benefit that investors and originators can share through reducing the servicers' percentage of the mortgage payments.

Investors and borrowers also have very different interests in another aspect of the servicers' work, which is the timeline used to determine when to begin foreclosure proceedings and how quickly to foreclose once the process has begun. Naturally, borrowers would want this process to be lengthy to give them time to bring the loan current or, at worst, to live in the house for as long as possible before being evicted. Investors, of course, desire a shorter timeline. If foreclosure is delayed, lenders lose money if the borrower is making no payments. Even if there is enough equity in the property to protect the investor, the loan balance rises because payments are not being made, so the equity cushion declines, along with the excess equity investors can obtain if they buy the property at a foreclosure sale by bidding only the amount of the outstanding loan. Further, if there is enough equity in the house when the borrower first goes into default, the servicer, on behalf of the investors, may be tempted to refuse to work out a reasonable payment plan in order to declare default and sell the house in foreclosure (Scott 1986).

However, investors do have some interest in preventing abuse. If servicers charge too many inappropriate fees or attempt to foreclose unnecessarily, they may increase the default rate of the mortgage pool, which in turn will lower its value. While investors may benefit from some foreclosures if they can obtain a property for much less than its true value, in general, defaults and foreclosures harm investors because of the added legal costs, loss of interest payments, and property management and sales costs (Capone and Metz 2003). One study estimated that the savings from preventing one foreclosure are great enough to pay for any additional costs caused by four failed attempts at loss mitigation (Ambrose and Capone 1996a). Where the default rate of a loan pool is higher than expected, ratings agencies will normally react by downgrading the rating of the pool, thereby reducing the value of its outstanding securities.

HUD recently proposed a rule that would triple the civil penalty for servicers that failed to engage in loss mitigation techniques when appropriate for Federal Housing Administration (FHA) loans. In its comments to that proposal, HUD noted that such loss mitigation benefits both HUD and the mortgage holders, although it may impose additional costs on servicers and holders of notes (Office of the Federal Register 2004).

Servicers that increase profit by reducing the amount they spend on customer services can harm investors and borrowers alike. Borrowers may no longer have their telephone calls answered, their payments posted in a timely fashion, or their disputes resolved informally. As a result, borrowers may be forced either to litigate their disputes or to default, both of which may increase costs to investors. Investors simultaneously want servicers to provide a high

level of service to borrowers but to be paid as little as possible out of the payment stream to finance that service. Servicers can save money at investors' expense by failing to engage in the loss mitigation steps that could prevent a foreclosure with its attendant costs to investors but that also cause the servicer to expend time and effort to work with borrowers.

Ratings agencies and other securitization participants have another significant interest in restraining excessive abuse by servicers—their interest in the integrity and robustness of the securitization process in general. Participants, such as ratings agencies, profit through fees and therefore would naturally desire that many residential loans be securitized. If servicer abuse is too widespread and well documented, it could undermine the confidence in and support of the process by government bodies and regulators, as well as by the general public. If servicers give securitization in general a public black eye, this disrepute may cause securitization to lose legal or political protection, become less common, and so decrease the earnings of securitizers. Some servicers are developing their own set of best practices, which may be a more attractive option for originators who also service their own loans and hope to generate repeat customers through good service (Bergquist 2003c).

Servicer abuse: Reevaluating the causes of default and foreclosure

A striking aspect of documented servicer abuses is that some borrowers are driven into default and even foreclosure not through their own decisions, financial distress, or risk characteristics, but rather as a result of an abusive servicer. The traditional literature on mortgage default treated it as a conscious decision by a borrower who defaulted, as this thinking went, when it was to his or her financial advantage to do so. This theory ignored involuntary defaults, those that occurred not because they were chosen by borrowers but because of financial stress.

More recent scholars distinguish between the so-called “ruthless defaulters,” who default when the value of the collateral securing the loan falls below the remaining balance of the loan by an amount equal to the default’s transaction costs to the borrower (Crawford and Rosenblatt 1995, 543), and “trigger-event defaulters,” who default because of some financial hardship, such as divorce or unemployment (Ambrose and Capone 1996b, 393). There is significant disagreement over the importance of either transaction costs or trigger events in the incidence of mortgage default (Capozza, Kazarian, and Thomson 1997).

Newer research is questioning the extent to which mortgage default is altered not only by the borrower's decisions, distress, or characteristics, but also by the characteristics of other market participants. For example, recent research (Alexander et al. 2002) indicates that even among borrowers with equal ability to pay, options incentives, and loan terms, those who obtained their loans through third-party originators such as mortgage brokers are significantly more likely to default than those who got their loans directly from a lender. Alexander and colleagues conclude that third-party originators have an incentive to "game the system" either by actively enhancing the purported credit of the borrowers or by passively failing to engage in rigorous underwriting (2002, 672). Also, investors are often protected from assignee liability through the holder in due course doctrine, which may make them more willing to purchase loans from unscrupulous originators (Eggert 2002a, 2002b).

Just as the opportunism of third-party originators may leave borrowers more likely to default, so too may a similar opportunism by servicers, which may be too tempted to increase their income by claiming that borrowers are in default or paid late, so that they can charge late fees. Or servicers may fail to engage in effective loss mitigation and thus increase foreclosure rates. A 1998 study found that, at least since 1980, increases in foreclosures had closely tracked the increase in the third-party servicing of mortgages (Elmer and Seelig 1998).¹³

Conversely, servicers that engage in effective loss mitigation techniques can substantially reduce the number of defaults that go to foreclosure. A study of the loss mitigation program at FHA, for example, found that its decision to encourage servicers to reach forbearance agreements with borrowers in default dramatically increased the percentage of 90-day default loans that were insured by a specific fund and resolved through a forbearance agreement (from 17 percent in 1998 to 74.1 percent in 2002). At the same time, defaulted loans reaching foreclosure decreased from 77.5 percent in 1998 to 14.5 percent in 2002 (Capone and Metz 2003). Ratings agencies have also noted how much effect servicers have on the costs and risks of a pool of loans. According to one agency, investments in subprime loan pools are greatly affected by servicer performance and "loss severities can vary as by as much as 30% even for pools with similar loan and borrower characteristics" (Fitch Ratings 2003b).

¹³ Elmer and Seelig find some but, in their view, only limited evidence that loans serviced by third parties tend to be foreclosed more rapidly. However, they review conventional and FHA loans, not subprime loans, and so their research covers the servicers most closely regulated by outside entities and therefore least likely to commit abuses.

Laws regulating servicers

Given the great effect that servicers can have on borrowers, one might think that servicers would be bound tightly by laws designed to protect consumers. The primary federal law that regulates servicers, the Real Estate Settlement Procedures Act (RESPA), is not designed to cure many of the servicer abuses described here. RESPA has several primary aims:

1. To force lenders to disclose settlement costs to borrowers during the origination process and to tell them whether servicing may be transferred (12 U.S.C. § 2605(a)), as well as the percentage of a lender's loans that have been transferred (24 C.F.R. § 3500.21(b)(3))
2. To force servicers to notify borrowers about any impending transfers of the servicing of the loan (12 U.S.C. § 2605(b), 24 C.F.R. § 3500.21(d))
3. To require servicers to respond to certain requests for information by borrowers (24 C.F.R. § 3500.21(e))

RESPA also requires servicers to pay insurance premiums and taxes from escrow accounts “in a timely manner as such payments become due” (12 U.S.C. § 2605(g), 24 C.F.R. § 3500.21(g)). However, the act does too little to prohibit the primary servicing abuses—unjustified and trumped-up late fees, force-placed insurance, defaults, and foreclosures.

Some states have stepped into this breach, attempting to protect their citizens from abusive servicing practices.¹⁴ For example, some states require servicers to post payments, either the same day or the next day, unless there are mitigating circumstances.¹⁵ Some require servicers to maintain toll-free numbers or other ways for their borrowers to contact them.¹⁶ Many have rules governing the escrow accounts that servicers maintain, requiring them to give borrowers statements and to pay them interest on the accounts; limiting how much can be held in escrow accounts, how much can be charged each month, or how much can be charged in fees; and determining what the servicer should do when it holds excess or insufficient funds. Some states also require servicers

¹⁴ An extensive list of state mortgage servicing laws can be found in Carter et al. 2002.

¹⁵ See, for example, Utah Code Ann. § 70D-1-7(4), requiring a servicer to credit a borrower's payment on the date it was received unless the payment is insufficient, the loan has already been referred to an attorney due to default, or the payment was sent to the wrong address.

¹⁶ See, for example, Maryland Code, Commercial Law, § 13-316(f), requiring servicers to maintain a toll-free number accessible during regular business hours.

to make prompt insurance or tax payments.¹⁷

Perhaps more important, some state laws provide real remedies for borrowers. Such remedies include specific amounts for minimum damages, forcing the servicer to be liable for late fees for any late payments of taxes or insurance, liability for any loss caused by allowing insurance to lapse, liquidated damages, and even criminal charges. However, these state laws may be eviscerated through federal preemption.¹⁸ Some have even predicted that servicers will cease business in some states that regulate servicers (“New ‘Predatory’ Laws Take Aim” 2003).

Proposals for reform

If these market forces and new or proposed government regulation fail to constrain servicer opportunism, other solutions could be designed. One proposal is to provide a system of consumer servicers, so that consumers have their own representative in the servicing phase of the mortgage, much like they can have a buyer’s agent when they purchase a house (Guttentag 2003). The consumer servicer would collect the payments from the borrower and forward them directly to the investors’ servicer. It could also monitor the payment history to ensure that the lender’s servicer has properly credited all payments and reduced the outstanding balance accordingly, as well as calculated the correct rate of any adjustable rate mortgages (Guttentag 2003). Further, consumer servicers could monitor borrowers’ insurance coverage to make certain that it is not inadvertently dropped. By using easy-to-track direct bank transfers and maintaining proof of insurance, consumer servicers could reduce the ability of investors’ servicers to charge improper late fees or needlessly force-place insurance. Also, these consumer servicers could track the market rate for loans and advise borrowers when they should refinance.

Unfortunately, this system of borrower servicers would transfer some of the cost of servicing from the investors or servicers to the borrowers, unless the system became so widespread that borrowers could insist on a reduced interest rate because of the decreasing costs of servicing. Some of this cost is from the collection of numerous individual checks and coupons. Much of this work would be reduced for the note holder’s servicer, saving that servicer some direct

¹⁷ For example, Connecticut Gen. Stat. § 36a–717 provides that a servicer that fails to make tax or insurance payments in violation of statute shall be liable to the borrower for any charges, including penalties and interest, as well as any damages resulting from that failure, including the amount the borrower would have received on a claim against an insurer, along with reasonable attorney’s fees.

¹⁸ Federal preemption, a topic too complex to be treated here, has become one of the battlegrounds in the fight over how to address predatory lending (Schiltz 2004).

costs. However, borrowers would also have to compensate their consumer servicer, and without a price reduction by the investors' servicer, those who use a consumer servicer would essentially be double-billed.

An additional problem would be that an unscrupulous servicer might still charge a late fee or force-place insurance even in the face of protests by a consumer servicer. Certainly, having a consumer servicer with unimpeachable records would aid the borrower in any subsequent litigation with the servicer, but this potential advantage may not be worth the cost of making monthly payments to a consumer servicer. This problem could be solved in part by legislation that would forbid an investors' servicer from charging a late fee or force-placing insurance without the consent of a consumer servicer, where one is in place, unless some neutral third party finds that the investors' servicer is correct in doing so.

Jack Guttentag, Professor Emeritus at the Wharton School, has proposed another system, one that would allow borrowers to opt out of their relationship with their primary servicer completely after some initial period (2004). The borrower would pick another primary servicer to collect the mortgage payments and then, after deducting a fee, transfer them to the trustee or some master servicer supervising the entire pool. While this proposal has some definite advantages, several difficulties need to be worked out for it to function.

The greatest difficulty, at first glance, is how to determine the amount of the fees the consumer servicer would receive. Normally, fees are determined by negotiations and set by contract, either as a subservicer with a master servicer or in the pooling and servicing agreement with the trustee. This agreement bundles together the trust agreement between the trustee and the investors, and the servicing agreement, which would otherwise be between the trustee and the servicer.¹⁹ However, if borrowers are free to select their servicer, there must be some process to fix prices. One possibility is to allow the new servicer to sign on for some fraction of the original servicer's set fee (only a fraction because the new servicer is not likely to be fully able to perform all of the tasks of the original servicer, a limitation discussed next).

Another difficulty is that the servicer selected by the borrower may well be unsuitable for some of the original servicer's tasks, and so those tasks would likely need to be divided, with the servicer fee divided as well. While borrowers would rationally want to have greater control over their servicers' loss mitigation strategies—control they could gain to at least a small extent by being

¹⁹ For a description of servicing agreements and the duties owed by servicers to investors, see Frankel 1991.

able to choose—a trustee would have a hard time supervising a pool of mortgages if it could not also control the loss mitigation strategies used. A trustee would have difficulty if it had to supervise a hundred different servicers in each mortgage pool, each one either using a different loss mitigation strategy or interpreting the trustee's set strategy differently. Ratings agencies would also face great challenges in rating pools of mortgages, since part of the ratings they assign depends on the identity of the servicer (S&P 2004).

Another market-based solution could be provided by ratings agencies, which are taking increased interest in the loss mitigation strategies of servicers and now monitor those strategies and how well they are implemented (Fitch Ratings 2003c). To standardize loss mitigation techniques across the lending industry, ratings agencies could require even subprime servicers with no loans connected to government-sponsored enterprises (GSEs) such as Fannie Mae and Freddie Mac to adopt the loan mitigation policies promulgated by these GSEs. Such standardization might reduce monitoring costs by the ratings agencies as well as compliance costs by servicers that handle both GSE and non-GSE loans. Ratings agencies could argue, however, that subprime, non-GSE loans differ so greatly from GSE prime or near-prime loans that different loss mitigation techniques and timetables are in order.

In addition to their own monitoring efforts, ratings agencies could also impose conditions much like the rights and remedies provided by the strictest state servicer laws: that is, require servicers to explicitly designate borrowers as third-party beneficiaries in their contracts with trusts and mandate that those contracts provide borrowers with specific rights and remedies if their third-party beneficiary rights under the contracts are violated. For example, the contract could require a servicer to post mortgage payments the day they are received, to maintain a toll-free number for borrowers to call with complaints or questions, and to send two notices and wait a set period before force-placing insurance. Similarly, the contract could forbid the servicer to pyramid late fees or to misrepresent the amount owed or the fees that are allowed. Borrowers could be given discrete remedies sufficient to encourage them to sue the servicer, perhaps in small claims court, but not so severe as to make servicing costs prohibitive. For example, these contracts could make servicers liable to borrowers for any failure to post payments on a timely basis or to make escrow tax and insurance payments, and give borrowers a minimum recovery of \$500 for each failure.

Clearly, both states and the federal government could play a greater role in limiting servicer opportunism. To a great extent, the FTC informal best practices standards laid out in the settlement with Fairbanks could be

codified at either the state or federal level and so provide at least minimum protections for borrowers.

Conclusion

Servicers have had too great an opportunity to take advantage of their captive borrowers. With a recent best practices suggestion by FTC, greater scrutiny by ratings agencies, increased private litigation, and new state laws regulating servicers, this opportunity appears to be diminishing. However, the inherent structure of securitization, with borrowers unable to choose their servicers or avoid bad servicers, may overwhelm even these encouraging trends and necessitate new laws or market strategies to rein in servicer abuse.

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