

Loan Servicing: Mortgage Work-Outs and the Influence of Securitization

Loan servicing is an important factor in determining whether low- and moderate-income borrowers who fall behind in their mortgage payments will end up losing their homes. For example, through “smart servicing” and early intervention in 2004, Fannie Mae’s loan servicers helped nearly 34,000 financially strapped borrowers avoid foreclosure, 92 percent of whom received workouts that allowed them to stay in their homes.¹

Loan servicing not only prevents foreclosures in many situations, but also saves the lenders significant sums. Stegman’s research showed that in 2002 FHA paid out \$5.5 billion in claims on 64,000 foreclosures, while paying just \$98 million to keep 73,000 financial troubled borrowers in their homes with recast loans.

If mortgage work-outs are cost-effective for the lender, and clearly beneficial to the borrower, why is so little of it being done? Many point to the rise of the secondary mortgage market, which buys mortgages originated by banks and mortgage companies – a process that infuses cash to make more loans but adds layers of impediments for servicers to make loan modifications. The agreements that create securitized loan pools may limit the powers of servicers to modify loans, set a ceiling on the percent of loan modifications allowed, or require the involvement of the investor.²

In what Eggert calls “tranche warfare,” securitization takes the mortgage loan and “subdivides it by pooling it with other loans and dividing the interest in the overall loan pool into different classes of securities. These different classes of securities, called tranches, may own different aspects of the note – one the payment of principal, another the payment of interest, another the residual payments,” including prepayment penalties.

These different ownership interests may be affected very differently by loan repayments or modifications, making it difficult for a servicer to engage in meaningful loan modifications.

The conclusion for foreclosure prevention is bleak: “With the loan sliced and tranced into so many separate interests, the different claimants with their antagonistic rights may find it difficult to provide borrowers with the necessary loan modifications, whether they want to or not. In the tranche warfare of securitization, unnecessary foreclosures are the collateral damage.”³

¹ Michael A., Stegman et al, “Preventive Servicing Is Good for Business and Affordable Homeownership Policy,” Housing Policy Debate, Vol. 18, No. 2 (2007).

² Kurt Eggert, “What Prevents Loan Modifications?” (a commentary on Stegman’s research), Housing Policy Debate, Vol. 18, No. 2 (2007).

³ Ibid.

Predatory Practices within Subprime Mortgage Lending

Subprime lending historically refers to loans made to those with impaired credit. They may also include those with good credit but who represent additional risks because of high loan-to-value ratios, high debt-to-income ratios, or similar factors. These subprime loans carry higher interest rates and fees than prime loans, justified because of the higher risk assumed by the lender.

The majority of subprime loans over the last several years are hybrid adjustable rate mortgages (ARMs) that carry low initial rates that jump quickly to higher interest charges, creating the “payment shock” that presages defaults, particularly when the loans contain obstacles to refinancing or the market declines.

Predatory lending is a subset of subprime lending. It contains features not found in other subprime or prime loans. These predatory practices raise borrowing costs or increase default risks without providing any substantial countervailing benefit to the borrower.⁴ Such practices include:

- **Equity stripping** - Called “unjustifiably exorbitant fees financed into the loan amount,” these fees include credit insurance often calculated on the fully amortized loan rather than the amount borrowed. These fees, often ranging from 10 to 20 percent of the loan amount, are recouped by lenders from the homeowner’s equity when the property is refinanced.⁵
- **Flipping** – Serial refinancing, often including unsecured debt, generates additional points and fees for the lender. The practice is endemic for loans based on the value of collateral rather than on the borrower’s ability to repay the loan, leading a borrower to repeated refinancings.
- **Steering** – Steering includes broker or lender actions that result in a borrower’s taking a loan with higher costs than necessary. Steering is so widespread that up to 50 percent of subprime borrowers could have qualified for prime, low cost credit. Countrywide Financial, for example, ignored borrower assets in order to offer higher interest loans. Steering benefits brokers, who receive a higher premium for higher interest loans.⁶ Steering and other deceptive practices are targeted to low-income minority neighborhoods.

⁴ Roberto G. Quercia, Michael A. Stegman, and Walter R. Davis, “The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments, Housing Policy Debate, Vol. 18, No. 2.

⁵ This list of predatory practices is taken from the California Reinvestment Coalition, “Top Ten Predatory Practices,” and Wei Li and Keith S. Ernst, “Do State Predatory Lending Laws Work? Housing Policy Debate, Vol. 18, No. 2.

⁶ “Inside the Countrywide Lending Spree,” New York Times, August 26, 2007.

- Prepayment penalties – High penalties lock borrowers into expensive loans when they could have refinanced at more favorable terms, or cause them to lose substantial equity if they do refinance.
- Balloon payments – often exceeding the borrower’s ability to repay, they force another refinancing with more fees and charges.
- Mandatory arbitration - this feature requires borrowers to waive their rights to defend against foreclosure in a court of law, making it difficult to seek meaningful redress.
- Fraud – high pressure deceptive practices, including bait-and-switch and adding expensive provisions at loan closing, constitute fraud. Other harmful practices approaching fraud include failure to consider a borrower’s ability to repay and making loans based on grossly overstated collateral (sometimes involving fraudulent appraisals).⁷

Subprime loans riddled with predatory practices are concentrated in minority neighborhoods, even when they are middle class. A Federal Reserve study recently suggested that a big part of the reason is the lenders that minority borrowers do business with. “The biggest home lenders in minority neighborhoods are mortgage companies that provide only subprime loans, not full-service banks that do a range of lending.” But a bigger reason may be the tactics of the mortgage brokers and telemarketers, who aggressively target minority neighborhoods.⁸

Borrowers with predatory loans also face the impact of riskier loan products found in subprime lending overall. First among them is the hybrid adjustable rate mortgage (ARM) loan with low teaser rates that quickly reset after two or three years, often to above-market rates and unaffordable levels. These hybrid ARMs have made up a majority of subprime originations for the past several years. Combined with predatory practices in a declining real estate market, they create significant obstacles for borrowers to overcome.

⁷ “New York Sues Mortgage Appraiser,” Los Angeles Times, November 2, 2007. The New York attorney general sued First American’s EAppraisalIT unit for allowing Washington Mutual, its biggest customer, to choose the appraisers who gave the highest valuations, leading to inflated appraisals.

⁸ “What’s Behind the Race Gap?” New York Times, November 4, 2007. The Community Reinvestment Act “was intended to address redlining by forcing banks to make loans in lower-income areas. But the law’s provisions do not apply to banks in neighborhoods where they have no branches.”