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Understanding the Causes and Consequences of Residential Mortgage Foreclosure Problems

By Jody Martin

Beginning in late September 2010, almost all of the nation's largest residential mortgage servicers acknowledged problems with their mortgage foreclosure practices. The two most common problems identified involved (1) signed attestations of facts by people without direct knowledge of the facts (otherwise known as "robo-signing"), and (2) improper notarization of legal documents (signatures on documents were notarized without the notary actually witnessing the signature).

Recognition of these issues resulted in many firms halting foreclosures until internal practices could be reviewed and any identified issues remediated. Many of these reviews were focused on the 23 states with judicial foreclosure laws. Generally speaking, judicial foreclosures occur before a judge, in contrast to nonjudicial foreclosures, which are processed without court intervention. Within these two foreclosure categories, laws and practices vary from state to state. In response to the recognized issues, the Federal Reserve, along with the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS) and the Federal Deposit Insurance Corporation (FDIC), conducted an in-depth review of practices at the largest mortgage servicing operations. These interagency examinations focused on foreclosure practices in general, but placed emphasis on breakdowns that led to inaccurate affidavits and other questionable legal documents being used in the foreclosure process. The on-site portions of the exams were completed in 2010, and it is anticipated that a summary overview of industry-wide practices will be released in early 2011.

To gain additional knowledge about foreclosure practices, the Federal Reserve also sent a self-assessment questionnaire to other Federal Reserve-regulated institutions that have mortgage servicing activity but were not part of the inter-agency examination effort.

While the results of the examinations have not been released, two factors have been identified as potential drivers of the breakdown in foreclosure practices: the significant increase in the number of foreclosures as a result of the real estate downturn and the myriad state laws governing the foreclosure process.

In 2006, the number of foreclosures initiated on residential properties was approximately 1 million. By 2009, that number had risen to 2.8 million, with expectations of approximately 2.5 million each in 2010 and 2011. This dramatic rise in the number of foreclosures undoubtedly strained the resources of mortgage servicers, not only for those directly processing foreclosures but also for those responsible for the quality control of the foreclosure process.

In addition to the number of foreclosures, the variety of legal requirements from state to state may have contributed to the breakdown in practices. There was a time when mortgage servicing portfolios were focused in certain localities or regions, allowing servicers to build expertise in the legal requirements specific to their portfolios. Now most servicers operate on a national scale, significantly adding to the complexity of foreclosure operations.

There have been several consequences of the problems identified in foreclosure practices and the efforts to remediate them:

Firms have been delaying foreclosures to ensure compliance with legal requirements and to correct any deficiencies in practices. This has resulted in more time for borrowers to try to resolve financial difficulties, pursue mortgage modifications, and gain a better understanding of their rights and responsibilities in the foreclosure process. The delay has reduced the inventories of homes on the market, although this is viewed as temporary. There is concern that foreclosure delays will ultimately result in a glut of inventory coming to market all at once, and potentially causing a drop in housing prices in high-foreclosure areas.

Purchasers may shy away from buying foreclosed properties because of concerns over their ability to obtain proper title. Again, this may have negative consequences on inventory and further weaken house prices. Legal costs associated with foreclosures will rise, changing the economics of both mortgage servicing and mortgage securitization.

In addition to the reviews performed by the federal regulatory agencies, all 50 states, led by the attorneys general, are scrutinizing firms' compliance with foreclosure laws.

While the nature, causes and severity of shortcomings in foreclosure practices vary from firm to firm, improvements are needed in internal practices, internal quality control processes, and regulatory oversight of these functions if confidence and stability in the housing markets are to be restored. Additionally, many of the issues highlighted point to the need for structural changes in the foreclosure process; both those issues driven by requirements from investors and security holders, and those issues arising from the legal framework underpinning the foreclosure process.

It is now up to the mortgage servicers and regulators and legislators at both the federal and state levels to effectively address these challenges.

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