



NCBANKERS

NORTH CAROLINA BANKERS ASSOCIATION

P. O. BOX 19999, RALEIGH, NC 27619-9916 / 800-662-7044 / FAX: 919/881-9909

Legal Memorandum

February 4, 2015

Vol. 47, No. 1

TO: *Legal Memorandum Mailing List*

RE: The Consumer Financial Protection Bureau's New Mortgage Servicing Rules and the Flagstar Bank Enforcement Action

In the attached *Legal Memorandum*, Brooks Bossong of the Nexsen Pruet law firm provides a review of the CFPB's mortgage servicing rules. As Brooks illustrates with an example of a high profile enforcement action brought against a bank, the consequences of violating the rules can be both costly and have a far-ranging impact. We thank Brooks for his thorough review of this issue and encourage you to share this *Legal Memorandum* with appropriate members of your staff as it will improve their understanding of the rules and will show what pitfalls your bank will want to avoid.

Sincerely,

Nathan R. Batts
Senior Vice President & Counsel

NEXSEN PRUET

Brooks F. Bossong
Member
Admitted in NC

February 3, 2015

Nathan Batts, Esq.
E. Dawn Thompson, Esq.
North Carolina Bankers Association
P.O. Box 19999
Raleigh, NC 27619

Re: The Consumer Financial Protection Bureau's new mortgage servicing rules and the Flagstar Bank enforcement action

Dear Mr. Batts and Ms. Thompson:

The Consumer Financial Protection Bureau's new mortgage servicing rules have been in effect for just over a year now. The purpose of this letter is to provide a brief summary of these rules and examine the Consumer Financial Protection Bureau's September 29, 2014 enforcement action against Flagstar Bank as an example of the consequences a servicer can face when the servicer violates the rules.

Charleston

Charlotte

Columbia

Greensboro

Greenville

Hilton Head

Myrtle Beach

Raleigh

When the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 was enacted in July 2010, it transferred rulemaking authority under both the Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z) to the Consumer Financial Protection Bureau ("CFPB").¹ CFPB's new mortgage servicing rules, titled *2013 Real Estate Settlement Procedures Act (Regulation X) and Truth in Lending Act (Regulation Z) Mortgage Servicing Final Rules*, went into effect January 10, 2014. CFPB has since amended and will continue to amend these rules, and these amendments are published on CFPB's website.² While CFPB's website provides a comprehensive overview of the Rules and amendments, one must still look to the Federal Register for the final rules.

Broadly speaking, CFPB's new mortgage servicing rules (the "Rules") apply to residential mortgage loans and govern how servicers service these loans. More specifically, the Rules address and govern the content of the information that servicers

¹ 12 U.S.C. § 5511

² <http://www.consumerfinance.gov/regulations/2013-real-estate-settlement-procedures-act-regulation-x-and-truth-in-lending-act-regulation-z-mortgage-servicing-final-rules/#rule>

701 Green Valley Road
Suite 100 (27408)
P.O. Box 3463
Greensboro, NC 27402
www.nexsenpruet.com

T 336.387.5169
F 336.387.8905
E BBossong@nexsenpruet.com
Nexsen Pruet, PLLC
Attorneys and Counselors at Law

Nathan Batts, Esq.
E. Dawn Thompson, Esq.
February 3, 2015
Page 2

must include in periodic payment statements to borrowers, interest rate adjustment notices to borrowers, how payments are credited to the loans, how servicers deal with notices of errors or requests for information from borrowers, general servicing procedures, early intervention with delinquent borrowers, and loss mitigation procedures. There is a small servicer exemption, but, as will be discussed in greater detail below, such an exemption does not mean that exempt servicers are exempt from the application of the Rules in their entirety. For the sake of simplicity, references to “servicer” below will include a lender, assignee, and third party servicer (until we discuss the small servicer exemption below). The following is an overview of the main sections of the Rules, which by no means should be considered by servicers as a comprehensive summary of the provisions of the Rules:

Periodic Statements:³

The servicer must send a periodic statement each billing cycle;

Information to be included in each periodic statement includes the amount due, explanation of amount due, past payment breakdown, transaction activity, partial payment information (only if funds are held in suspense account), contact information, account information, and delinquency information (if applicable).

Interest Rate Adjustment Rate Notices:⁴

The servicer must make disclosures regarding the initial reset of an adjustable-rate mortgage and each time an interest rate adjustment results in a payment change;

Information to be included in the ARM disclosures includes the effective date of the adjustments and future adjustments, a table containing the current and new rates (along with the current and new payments), an explanation of how the rate is determined, limits on the rate or payment increases, an explanation of how the new payment is determined, and the phone number of the servicer.

Prompt Payment Crediting and Payoff Statements:⁵

Periodic payments must be credited the date of receipt;

³ 12 C.F.R. § 1026.41

⁴ 12 C.F.R. § 1026.20(c) and (d)

⁵ 12 C.F.R. § 1026.36(c)

Nathan Batts, Esq.
E. Dawn Thompson, Esq.
February 3, 2015
Page 3

If the servicer receives a payment that is less than the amount due for a periodic payment, the servicer may place the payment in a suspense account. Once the amount in the suspense account covers a periodic payment, then the servicer must treat the accumulated amount as a periodic payment and promptly credit it to the borrower's account;

Servicers must provide an accurate payoff balance to the borrower not more than 7 business days after receipt of a written request from the borrower for such information.

Force-Placed Insurance:⁶

The new rules place limits on the use of force-placed insurance;

The servicer must have a reasonable belief that the borrower has failed to maintain required hazard insurance before the servicer can implement and charge for force-placed insurance;

The servicer must send 2 notices to the borrower—and not have received a response from the borrower with evidence that coverage is in place—before the servicer can charge the borrower for force-placed insurance.

Error Resolution and Information Requests:⁷

This section of the rules deals with requirements for responding to borrowers' written information requests and complaints for errors. While this section has a number of exceptions and nuances, generally the following applies:

Within 5 days of receipt of a written request for information or notice of error, the servicer must acknowledge the borrower's request or notice;

Within 30 to 45 days, the servicer must either correct the error and provide notice to the borrower of the correction or conduct an investigation and provide notice to the borrower that no error occurred;

Within 30 to 45 days, the servicer must provide the information requested or conduct a reasonable search for the requested information and provide the borrower with notice explaining why the information isn't available.

⁶ 12 C.F.R. § 1024.37

⁷ 12 C.F.R. § 1024.35(d) and (e)

General Servicing Policies, Procedures, and Requirements:⁸

This section requires that servicers establish general servicing policies and procedures, covering such areas as the following:

- (i) Accessing and providing timely and accurate information, such as providing accurate disclosures to borrowers within the required timeframes, investigating and responding to borrowers' complaints, responding to borrowers' request for information, providing owners or assignees of loans with accurate information, submitting the appropriate documents for the foreclosure process, and dealing with a successor in interest upon notice of a borrower's death;
- (ii) Properly evaluating loss mitigation applications, including providing accurate information to borrowers regarding loss mitigation options;
- (iii) Facilitating oversight of, and compliance by servicer providers (to clarify, this means that lenders should facilitate oversight of, and compliance by, their own servicing personnel and those working for the lenders' third party servicers);
- (iv) Document retention requirements.

Early Intervention with Delinquent Borrowers:⁹

This section requires that servicers make good faith efforts to establish live contact with borrowers by the 36th day of delinquency and promptly inform them of loss mitigation options; live contact includes telephoning or conducting an in-person meeting with the borrower;

Additionally, servicers must provide borrowers with written notice about any available loss mitigation options by the 45th day of delinquency; the requirements for such written notice are provided in the Rules (§ 1024.39(b)). Note that while some of the required language for such written notice is similar to that in the notice required by N.C.G.S. § 45-102, the requirements are not identical. This means that satisfying the written notice requirements under the

⁸ 12 C.F.R. § 1024.38

⁹ 12 C.F.R. § 1024.39(a) and (b)

Nathan Batts, Esq.
E. Dawn Thompson, Esq.
February 3, 2015
Page 5

Rules is no substitute for satisfying the “45 day letter” and filing requirements under G.S. § 45-102 and G.S. § 45-103, and vice-versa (N.C. Housing Finance Agency has been clear on this point).

Continuity of Contact with Delinquent Borrowers:¹⁰

Generally, servicers must maintain policies and procedures designed to provide delinquent borrowers with access to personnel who can assist them with loss mitigation options;

Servicers’ policies and procedures must be designed to ensure that servicers assign personnel to delinquent borrowers by the time servicers send the written notice under the early intervention requirements described above (by the 45th day of the borrower’s delinquency);

Servicers’ procedures must be designed to ensure that the personnel assigned to delinquent borrowers provide the borrowers with accurate information about the specific loss mitigation options available to them, how to submit a complete loss mitigation application, get it evaluated and, if necessary, appeal a denied application, and the status of a borrower’s loss mitigation application.

Loss Mitigation Procedures:¹¹

This broad section of the Rules requires servicers to work with borrowers to complete timely applications for loss mitigation options, evaluate applications within 30 days for all loss mitigation options available to particular borrowers, inform borrowers of whether the servicers will offer a loss mitigation options (and, if a borrower is denied a loan modification option, the reason for said denial), evaluate timely appeals, and refrain from beginning foreclosure in certain circumstances when borrowers are being evaluated for loss mitigation options;

When a servicer receives a timely submitted loss mitigation application, the servicer must acknowledge receipt of the application and inform the borrower whether the application is complete or incomplete; the servicer must also exercise reasonable diligence to make an incomplete application complete;

This section also governs the handling of short-term payment forbearances, what a servicer must do if it denies a loss mitigation application, how much

¹⁰ 12 CFR § 1024.40(a) and (b)

¹¹ 12 C.F.R. § 1024.41

Nathan Batts, Esq.
E. Dawn Thompson, Esq.
February 3, 2015
Page 6

time a servicer must give a borrower to respond to loss mitigation offers, and the appeal process in connection with denial of loan modifications;

A servicer cannot make the first notice or filing for a foreclosure until the borrower is more than 120 days delinquent.

Small servicer exemption:¹²

Servicers that qualify as small services are exempt from certain parts of the Rules;

A servicer that, with its affiliates, services 5,000 or fewer mortgage loans, and the servicer is also the creditor or assignee of all of the loans, would qualify as a small servicer;

As servicer that services any mortgage loans that the servicer did not originate or does not own does not qualify as a small servicer, even if it services fewer than 5,000 loans;

Generally, small servicers are exempt from the following provisions of the Rules: The periodic statement provisions, the prohibition of purchasing force-placed insurance in some circumstances, the general servicing policies, procedures, and requirement provisions, the early intervention provisions, the continuity of contact provision, and some of the loss mitigation provisions;

Generally, small servicers must comply with the provisions of the Rules relating to the ARMs disclosure provisions, the prompt crediting and payoff statement provisions, the force-placed insurance provisions, the error resolution and information request provisions, and some of the loss mitigation provisions.

Before turning our attention to the CFPB's enforcement case against Flagstar Bank, I should touch on the Rules' relationship to North Carolina's statutes pertaining to mortgage debt collection and servicing¹³ and North Carolina's Emergency Program to Reduce Home Foreclosures.¹⁴ 12 U.S.C. § 5551, pertaining to the "Preservation of State Law," provides that the Rules do not annul, affect or exempt anyone subject to the Rules from "complying with, the statutes, regulations, orders, or interpretations in effect in any State, except to the extent that any such provision of law is inconsistent with the provisions of this title, and then only to the extent of the inconsistency...For purposes of this subsection, a statute, regulation, order, or interpretation in effect in any

¹² 12 C.F.R. § 1026.41(e)(4)

¹³ N.C.G.S. 45-90 et seq.

¹⁴ N.C.G.S. 45-101 et seq.

Nathan Batts, Esq.
E. Dawn Thompson, Esq.
February 3, 2015
Page 7

State is not inconsistent with the provisions of this title if the protection that such statute, regulation, order, or interpretation affords to consumers is greater than the protection provided under this title.”¹⁵ Without going into a comparison of the Rules with North Carolina’s laws relating to mortgage servicing and North Carolina’s requirements under our Emergency Program to Reduce Home Foreclosures, suffice it to say that servicers need to understand that, to the extent North Carolina’s laws provide more protections, North Carolina servicers will need to comply with both the Rules and North Carolina’s laws on these issues.

With the above overview of the Rules in hand, I will shift our focus to CFPB’s recent enforcement case against Flagstar Bank (“Flagstar”), which, as noted above, serves as an example of the consequences a servicer can face when a servicer does not comply with the Rules. Flagstar is also notable because it was CFPB’s first enforcement action under the Rules. In 2013, prior to the Rules going into effect, a number of mortgage servicers had started downsizing staff in part because of fewer delinquencies, higher interest rates, and a resulting drop in re-financings. As a result, prior to and when the Rules went into effect January 10, 2014, some servicers were still having to scramble to augment staff and ensure that systems were in place to comply with the Rules. For this reason, the Flagstar case is of particular relevance because one can assume that Flagstar was not the only servicer who was ill-prepared to comply with the Rules while attempting to deal with an existing backlog of delinquencies. Following is some brief background information on Flagstar, much of which was gleaned from Flagstar’s website:¹⁶

- Flagstar is the largest banking company headquartered in Michigan;
- According to Flagstar’s website, Flagstar is “one of the nation’s top 10 largest savings banks;”
- Flagstar is a full-service bank with over 100 branches;
- Flagstar has assets of over \$9 billion and over 3,000 employees;
- According to Flagstar’s website, Flagstar is a “top-tier mortgage originator” in the U.S.;
- In addition to originating mortgages, Flagstar is a mortgage servicer and administers foreclosure relief programs for other lenders;
- In January 2009, Flagstar was able to raise over \$500 million from a few sources, including \$266 million from the US. Treasury’s Trouble Asset Relief Program Capital Purchase Program;

¹⁵ 12 U.S.C. § 5551

¹⁶ <https://www.flagstar.com/>

Nathan Batts, Esq.
E. Dawn Thompson, Esq.
February 3, 2015
Page 8

Before we examine CFPB's enforcement case against Flagstar, a recent event in Flagstar's history provides additional background on Flagstar, an event which served to foreshadow CFPB's enforcement action. On February 24, 2012 the US Department of Justice filed a civil fraud lawsuit against Flagstar in the Southern District of New York.¹⁷ In its Complaint, the Department of Justice alleged, among other things, that over the past decade Flagstar "improperly approved thousands of residential home mortgage loans for government insurance using unauthorized staff employees to conduct key underwriting functions" and "submitted false certifications" to FHA and HUD leading to "thousands of loans being approved for government insurance that did not qualify for such insurance...When the loans ultimately defaulted, HUD – which had insured the loans against default – was left to cover the losses." In the Stipulation and Order of Settlement and Dismissal filed in this case, Flagstar admitted and accepted responsibility (to a certain extent) for the conduct alleged in the Complaint, agreed to comply with relevant HUD/FHA rules, and agreed to make a payment to the U.S. in the amount of \$15 million within 30 business days plus additional payments to the government of \$117,889,806 if certain events occurred and criteria met. Therefore, before the CFPB enforcement action against Flagstar was filed this past September, Flagstar already had this troubling, recent history in how it operated its home mortgage loan business.

After Flagstar's settlement with the Department of Justice in the government's fraud suit against Flagstar, we move forward two years to January 10, 2014 when the Rules--including the provisions for handling borrowers' loss mitigation applications--went into effect. At this point, as previously noted, servicers across the country had been in the process of putting staff, resources, and systems in place to comply with the Rules. In September, 2014 CFPB brought the enforcement action against Flagstar for, according to CFPB's website, "violating those rules by failing borrowers and illegally blocking them from trying to save their homes."¹⁸ CFPB's action against Flagstar also covered activities by Flagstar that predated the date the Rules went into effect (activities which CFPB included in its action pursuant to CFPB's powers to regulate unfair and deceptive acts and practices), the action did not simply cover Flagstar's activities post January 10, 2014.

The Consent Order filed in CFPB's action against Flagstar on September 29, 2014 opens by stating that CFPB has reviewed the default servicing practices of Flagstar and "has identified the following law violations. First, Respondent has committed unfair acts or practices by impeding borrowers' access to loss mitigation. Respondent failed to review loss mitigation applications in a reasonable amount of time; withheld

¹⁷ United States of America v. Flagstar Bank, FSB, Case No. 12-cv-01392 (U.S. District Court for the Southern District of New York).

¹⁸ C.F.P.B. Administrative Proceeding File No. 2014-CFPB-0014 (2014 WL 4953486)

Nathan Batts, Esq.
E. Dawn Thompson, Esq.
February 3, 2015
Page 9

information that borrowers needed to complete their loss mitigation applications; improperly denied borrower requests for loan modifications...violated the loss mitigation provisions of...RESPA..." and "committed deceptive acts or practices by misrepresenting borrowers' right to appeal the denial of a loan modification." In the "Overview" portion of the Consent Order, CFPB notes that Flagstar is a mortgage servicer responsible for administering loss mitigation programs to delinquent borrows on behalf of the owners or guarantors of the owners' loans" and that between 2011 and 2013, Flagstar "serviced loans for over 40,000 delinquent borrowers."

CFPB's Findings and Conclusions in the Consent Order include the following background:

- Flagstar has operated a mortgage servicing business since at least 2011;
- Flagstar "performs these functions primarily for loans it does not own;"
- The "vast majority" of the loans in Flagstar's "first lien servicing portfolio are owned or guaranteed by 'investors,' (someone besides Flagstar);
- These "investors" play a critical role in Flagstar's mortgage servicing operations; the investor is the default risk holder and, as such, the investor establishes the terms and conditions by which Flagstar "is required to service the loans the investor owns or guarantees. These guidelines include comprehensive rules for the servicing of loans that become delinquent;"
- As a result of the collapse in the housing market starting in 2007, the investors responded by developing "loss mitigation programs," the goal of which was to "minimize the losses to both borrowers and investors by providing borrowers alternatives to foreclosure;"
- Flagstar "is responsible for administering loss mitigation programs on its investors' behalf in accordance with rules established by the investor;"
- Pursuant to these loss mitigation programs, Flagstar's duties include "soliciting borrowers for loss mitigation programs; collecting loss mitigation applications; decisioning (i.e., underwriting) complete loss mitigation applications to determine if a borrower is qualified for a loss mitigation program; and executing the loss mitigation program for qualified borrowers."

Up to this point, we know what Flagstar was supposed to do but the following Findings and Conclusions in the Consent Order depict a bleak turn of events:

- Flagstar, "like many servicers, experienced a dramatic increase in the volume of loss mitigation applications in connection with the foreclosure crisis;"
- Flagstar "was not equipped to handle the influx;"
- Flagstar "had insufficient staff, no written policies...and inadequate servicing systems;:"

- It took Flagstar's "loss mitigation staff as long as nine months to review a single application during this time;"
- By 2011, Flagstar "had 13,000 active loss mitigation applications versus 25 full-time employees in the loss mitigation department" and Flagstar was using a third party vendor in India to help review applications;
- The "average call wait time in the loss mitigation call center was 25 minutes; the average call abandonment rate was almost 50 percent;"
- In response to notification from a government-sponsored entity that Flagstar's servicing rights on "loans owned or guaranteed by the GSE could be terminated," Flagstar restructured its loss mitigation department and "hired additional staff in late 2011;"
- However, despite Flagstar's changes to and restructuring of its loss mitigation department, Flagstar's loss mitigation department remained "under-resourced;"
- Flagstar "failed to make a decision on loss mitigation applications prior to referring borrowers to foreclosure. On average, borrowers were over 250 days delinquent by the time they knew if they qualified for loss mitigation;"
- To move the backlog, Flagstar "sometimes closed applications due to expired documents, even though the documents had expired due to [Flagstar's] delay;"
- Flagstar's "acts and practices" caused "borrowers to drop out from the loss mitigation process;"
- While borrowers waited "for a loss mitigation decision," the foreclosure process would continue;"
- "For at least a nine month period in 2012-2013, [Flagstar] withheld critical information that borrowers needed to complete their loss mitigation applications;"
- Flagstar "denied loan modifications to qualified borrowers by regularly and frequently miscalculating borrower income;"

The Findings and Conclusions in the Consent Order continue at length, and the picture painted in the Consent Order does not improve for Flagstar. The result is Flagstar was sanctioned by CFPB as follows:

1. Flagstar had to pay \$27.5 million to CFPB in order to compensate the affected consumers (in the range of 6,500) whose loans were being serviced by Flagstar, with \$20 million of this amount to go to victims of foreclosure;
2. Flagstar had to pay an additional \$10 million civil penalty to the CFPB's Civil Penalty Fund;
3. Flagstar must of course cease its mortgage servicing violations;
4. Flagstar is banned from acquiring new mortgage servicing rights until Flagstar can demonstrate it has the ability comply with the new rules.

Nathan Batts, Esq.
E. Dawn Thompson, Esq.
February 3, 2015
Page 11

This last point under the sanctions, # 4 above, is especially significant if Flagstar is insufficiently nimble in ramping up staff and resources to the point that it can demonstrate an ability to comply with the Rules. Generally speaking, mortgage servicers have to constantly purchase new servicing rights to refresh their portfolios in order to make a go of the mortgage servicing business. The downtime in Flagstar's ability to acquire new mortgage servicing rights can only have a negative impact on its servicing business model.

One may contend that Flagstar, and perhaps other mortgage servicers, simply got overwhelmed by the influx of loss mitigation applications. However, it is difficult to sympathize with Flagstar's situation in light of the relatively recent civil fraud lawsuit brought by the Department of Justice in 2012. Flagstar was purportedly a significant participant in the mortgage servicing business and held itself out as being capable of administering loss mitigation programs for its investors. Additionally, some of the activities and omissions on the part of Flagstar spelled out in the Consent Order are egregious, even if Flagstar was overwhelmed by delinquencies and a backlog of loss mitigation applications. Finally, the Rules – when they went into effect last January – did not appear out of nowhere. The initial version of the Rules had been available for public review since January, 2013, and servicing standards had been under consideration by CFPB (and open to comment) well before January, 2013. The servicing industry, including Flagstar, knew the Rules were coming, and mortgage servicers, including Flagstar, knew they would have to augment staff, invest resources, and implement systems in order to comply with the Rules.

Mortgage servicers need to be aware of the Flagstar case. In his prepared remarks on September 29, 2014, the date the Consent Order and Stipulation were entered in the Flagstar case, CFPB Director Rich Corday stated “[t]he Bureau has been clear that mortgage servicers must follow our new servicing rules and treat homeowners fairly. Today's action signals a new era of enforcement to protect consumers against the cost of servicer runarounds.”¹⁹

Very truly yours,

Brooks F. Bossong

¹⁹ <http://www.consumerfinance.gov/newsroom/prepared-remarks-of-cfpb-director-richard-corday-on-the-flagstar-enforcement-action-press-call/>