Skadden

CRA Charles River Associates

Fair Lending Testing for Mortgage Loan Modifications and Default Servicing

*By Anand S. Raman and Marsha J. Courchane**

Ensuring the fair and consistent treatment of mortgage loan borrowers who find themselves in default or are seeking loan modifications has become a significant fair lending priority for bank regulatory and enforcement agencies. As a consequence of the unprecedented downturn in the economy, millions of borrowers are now seriously delinquent on their mortgage loans.[1] Other borrowers who are current on their payments are nonetheless at risk of imminent default, or are "underwater" with homes worth less than the outstanding mortgage debt. In addition, recent institutional and legal developments have elevated the significance of default servicing. Most significantly, the Dodd-Frank Wall Street Reform and Consumer Protection Act creates a powerful new regulator – the Bureau of Consumer Financial Protection – which is charged with regular examination of mortgage loan servicers and is given broad fair lending enforcement tools.[2] The Dodd-Frank Act also expands the role of state laws and enforcement in fair lending oversight of servicers and other financial institutions. Additionally, the United States Department of Justice has commented on its own focus on loss mitigation, describing it as an area of "possible emerging abuse."[3] In light of these developments, servicers should strongly consider conducting internal fair lending testing of their default servicing and loan modification performance.

While the importance of conducting fair lending default servicing and loan modification (collectively "default servicing") testing is relatively clear, there is very little regulatory guidance on *how* this testing should be conducted.[4] Unfortunately, the need for default servicing arises in many cases due to changes in borrower circumstances. Because the necessary range of servicer options depends on the particular borrower circumstances, even some of the most basic concepts – such as defining "good" and "bad" outcomes – are difficult to clarify for default servicing. These issues specific to servicing remain unresolved, as do a number of issues that also arise in the fair lending testing of pricing and underwriting, such as whether to focus on discretionary decisions and whether and how to aggregate data from multiple geographies and originators. These issues, however, are equally or more difficult in the default servicing context.

The reporting of detailed loan-level data under the Obama Administration's Home Affordable Modification Program ("HAMP") goes a long way towards solving some of the data issues that previously impeded analysis in this area. The HAMP data and guidelines cannot, however, be used to resolve some of the more complicated issues in the default servicing context, for which there are no easy

---

* Anand S. Raman is co-leader of the Consumer Financial Services Enforcement and Litigation practice at Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates in Washington, D.C. His email address is anand.raman@skadden.com. Dr. Marsha J. Courchane is a Vice President at Charles River Associates and heads the firm's Financial Economics practice. Her email address is mcourchane@crai.com. The authors gratefully acknowledge the assistance of Darren Welch, counsel at Skadden Arps, in the preparation of this article.

analytical solutions. In default servicing, decisions and outcomes are inextricably tied to decisions – such as loan product selection and pricing – that occurred in the origination process. Moreover, servicers are often constrained by their contractual obligations to the owners of the loans, who may limit the choices that servicers can offer borrowers. Consequently, this area is fraught with complexity and short on easy answers. Our goal with this article is to shed light on the key problems and propose a number of practical solutions.

Outstanding Issues

Without doubt, the servicing industry – and those who advise it – would benefit from clarification of the guidelines for fair lending testing of default servicing. Lenders and servicers need to be able to develop systems for monitoring and control that reflect clear regulatory standards for fair lending testing of default servicing. We believe that if a consensus is to be developed, it will require grappling with a number of thorny issues, including those set forth below.

What decisions and outcomes are being tested?

In the default servicing context, there are a number of different decisions and outcomes that could conceivably be tested. These include the incidence of loan modification, the rate of converting temporary modifications to permanent ones, the magnitude of the modification of loan terms (for example, how much principal is forgiven), the effort applied by the servicer, processing times, foreclosure referral and completion rates, the range of workout options offered to the borrower, and the ultimate default servicing outcome (including non-modification outcomes such as short sales, etc.). While much of the dialog in this area suggests that *outcomes*, and in particular, how many modifications are provided, are one of the most important areas of inquiry, it is far from clear that they are the only relevant parameter. Moreover, it is not at all clear how to go about testing default servicing outcomes. For example, in testing loan modifications is the relevant denominator all applicants who requested a loan modification? Or is the appropriate denominator all applicants *eligible* for a loan modification? Or should it simply be all applicants who are in default?

As noted above, there is little regulatory guidance to help servicers select default servicing testing metrics. The most specific regulatory guidance – which is applicable only to entities regulated by the Office of the Comptroller of the Currency ("OCC") – identifies several "[i]ndicators of potential disparate treatment" in "loan servicing and loss mitigation" and "HELOC modification," although most of these "indicators" are not readily ascertainable through statistical monitoring. [5] According to the OCC's guidance, areas that may be subject to inquiry include:

- "Substantial disparities among loss mitigation servicing options by prohibited basis group characteristic" including, but not limited to:
    - Reduction in rates
    - Lengthened terms
    - Reduction in principal balances
- "Substantial disparities in decision processing times by prohibited basis group characteristic";
- "Significant disparities in the completion of foreclosure actions once legal process

initiated by prohibited basis group characteristic"; and

- "High volume of policy exceptions or fee waivers by prohibited basis group characteristic."

It should also be noted that in testing servicing outcomes, it may be necessary to differentiate between decisions that are *discretionary* and those that are not. This issue arises frequently in the pricing context, where there is no uniform regulatory practice as to whether to test overall pricing to the borrower, typically expressed as an Annual Percentage Rate, or the discretionary "overage" on the loan. This analytical problem also arises in the default servicing context, where some decisions are based on objective considerations and automated decisioning processes, such as net present valuation ("NPV") models, and may therefore not be subject to significant servicer discretion, while other servicer decisions may involve the exercise of significant discretion. A good first step in deciding what decisions to test is to identify which aspects of the decision-making process involve discretion, so that informed decisions can be reached as to whether testing should focus on discretionary decisions and/or the impact of automated processes.

What are "good" and "bad" outcomes?

As noted above, in the default servicing context, there are not necessarily clear-cut "good" and "bad" outcomes. This distinguishes servicing from pricing (where the lowest-priced loan usually can be presumed to be in the borrower's best interest) or underwriting (where the consumer can generally be assumed to have wanted the loan that he or she applied for).

In servicing, however, what is "good" or "bad" may depend on each individual borrower's circumstances. For some, remaining in the home for as long as possible may be the "good" option. For others, moving out of the home and resolving the mortgage debt at least cost might be a "good" option. In fact, for some borrowers, it may not be a good outcome to grant a loan modification, particularly if the borrower does not have a realistic opportunity of paying the loan even as modified. In such cases, other outcomes – including some that do not result in retained home ownership – may be more favorable for the borrower. And even if a loan modification is deemed to be the best outcome for a borrower, some modifications may be better than others. For example, is an extended term good or bad? Is it enough if the monthly payment is lowered? The lack of any normative standard here greatly complicates fair lending testing.

Borrower-specific considerations

Not only are there no clearly defined good and bad outcomes, but fair lending testing of default servicing must also account for the fact that the availability and desirability of options and outcomes will generally depend on borrower circumstances. For example, if borrowers cannot be contacted or do not cooperate with information and document requests, servicers may have few options. Moreover, to the extent that borrowers are offered multiple workout options, borrower choice can play a significant factor in determining outcomes.

Another factor that complicates the question of whether borrowers are similarly situated is the *reason* for the borrower's inability to pay the loan. In some cases, this information may be readily discerned. For example, the HAMP Hardship Affidavit requires the borrower and co-borrower to identify separately the reasons why they are having difficulty paying their loan, including loss or reduction of income, household financial circumstances changing, increased expenses, insufficient cash reserves, excessive monthly debt payments, and a catch-all for "other reasons."[6] The particular reason (and the extent to which it is temporary or permanent) may affect the range of options provided to the borrowers. Any fair lending analysis should likewise take this variation into account.

Population parameters – what is the denominator?

There are several different ways to define the relevant population for fair lending testing. A key threshold question with respect to loan modification analysis, for example, is whether the relevant population for analysis includes all borrowers who requested modifications; borrowers who requested loan modifications and were in fact eligible for a loan modification; or all loans in the default servicing process.

If the denominator in an analysis includes only borrowers who were *eligible* for modification – which we believe to be a reasonable approach – ascertaining modification eligibility in an objective manner is an essential, but not easy, step in this process. Any fair lending analysis, however, is much easier and probative to the extent that servicers keep accurate records and good data regarding the reasons why loans are deemed not eligible for modification. In this regard, the HAMP fallout codes are a good starting point, but may not be sufficient in all cases to identify non-eligible modification requests and similarly-situated borrowers.

In addition, if a borrower is not eligible for a modification, forbearance, or other option, the more detail accompanying the reasons for the ineligibility decision, the better. Such detail, particularly if it is standardized, greatly facilitates fair lending testing.

The degree of servicer assistance to applicants must also be assessed. For instance, if a servicer actively encourages borrowers to contact the servicer to seek a loan modification, it is possible that a higher percentage of borrowers who are not eligible will request loan modifications than might otherwise be the case if the servicer had made no outreach effort. If the denominator is not appropriately identified, servicers may be inhibited from aggressive outreach, out of fear of having unfavorable approval ratios.

Aggregation issues

In order to compare similarly-situated borrowers and obtain meaningful results, careful thought must be given to the issue of data aggregation. For servicing, even more so than for underwriting and pricing, recognizing the appropriate geographic level at which to analyze the data is critical. For example, threshold decisions must be made as to whether data should be analyzed at the Metropolitan Statistical Area ("MSA") or state level. In making this decision, one must in turn account for local home price declines and different state laws regarding foreclosure procedures and timelines.

In pricing and underwriting analyses, where geographic issues are also important, examiners have taken varying approaches on this issue. Some have focused on national data, while others have examined states, regions, MSAs, or various arbitrary geographic units.

In the absence of regulatory guidance on this point, servicers would be well advised to consider their geographic portfolio concentrations, degree of decentralized decision making, and other factors in determining the appropriate geographic scope of the analysis. They may also wish to evaluate the extent to which NPV calculations implicitly include geographic considerations such as MSA or state-based predications of home price paths. In any event, if a servicer conducts a national analysis only, the results may provide reason to conduct more granular analysis to identify higher-risk areas for more targeted review or remediation.

Recognition of contractual considerations

Fair lending analysis of default servicing should also take into account the impact of different investor requirements. Indeed, as the Federal Financial Institutions Examination Council has acknowledged, "[s]ervicers have an obligation to act in the best interests of the owners/investors of serviced residential mortgage loans and in accordance with the terms of the governing contracts."[7] Thus, insofar as different contractual obligations compel different outcomes or processes, it will likely be appropriate to segment or control by investor, rather than aggregating loans from all investors into one analysis. Further complicating the matter is the fact that contractual servicing obligations may vary even for the same investor depending or the tranche that a loan falls under.

Other statistical issues – classifying borrower groups and sample sizes

Even though the HAMP data will include some demographic information – thus reducing one of the previous obstacles to fair lending analysis of default servicing – a still unresolved issue is how to define the race, ethnicity, sex, or other class characteristics of a loan. Different "waterfalls" have been implemented for fair lending testing for underwriting and pricing, to deal with situations where borrowers identify multiple races or where the race and/or ethnicity of the primary applicant and the co-applicant differ. Several different conventions likewise exist for dealing with missing race and/or ethnicity data.

Another open issue is the fact that the control group can be identified in different ways – a problem that is not unique to servicing. For example, loans with only female borrowers may be compared to loans with only male borrowers in some instances. In other cases, however, loans with female borrowers may be compared to loans with male borrowers and to joint male/female loans. Likewise, Hispanic borrowers may be compared against all non-Hispanic borrowers in some cases and only *White* non-Hispanic borrowers in others. There is far from a consensus on either of these issues. In addition, there continue to be debates and unresolved issues regarding issues such as minimum sample sizes and controls for statistical significance.[8] The effectiveness and reliability of fair lending testing – for servicing and pricing and underwriting as well – would be significantly increased if progress could be made developing clear and consistent guidelines with respect to these threshold issues.

Conclusion

Default servicing is an emerging priority for federal regulators and enforcement agencies. The significance of default servicing is likely to grow even more in the coming years as HAMP data is publicly released and evaluated by regulators and private litigants, and as the full effects of the economic slowdown, declining housing market, and high unemployment are fully realized. Although there is little official guidance on appropriate techniques for fair lending testing for default servicing, and numerous complicating factors, it is nonetheless advisable for servicers to adopt a prudent course of statistical testing. In addition, we encourage dialog among regulators, enforcement agencies, servicers, and their advisers on these issues.

---

1 *See* Office of the Comptroller of the Currency and Office of Thrift Supervision, "Mortgage Metrics Report: Disclosure of National Bank and Federal Thrift Mortgage Loan Data, First Quarter 2010" (June 2010), available at http://www.ots.treas.gov/_files/482142.pdf.

2 Pub. L. No. 111-203 (July 21, 2010).

3 U.S. Department of Justice Press Release, "Assistant Attorney General Thomas E. Perez Delivers Remarks on Fair Lending and Fair Housing at the Brookings Institution" (June 23, 2010), available at http://www.justice.gov/crt/opa/pr/speeches/2010/crt-speech-100623.html.

4 The fair lending examination procedures promulgated by the Federal Financial Institutions Examination Council ("FFIEC") – the body responsible for coordinating federal bank examination policy – state that "a lender may not, because of a prohibited factor . . . [t]reat a borrower differently in servicing a loan or invoking default remedies," but they provide no guidance for default servicing testing. *See* FFIEC, Interagency Fair Lending Examination Procedures, p. ii (Aug. 2009), available at http://www.ffiec.gov/pdf/fairlend.pdf. The appendix to the procedures contains a checklist that asks "is it specifically communicated to employees that they must not, on a prohibited basis . . . [o]ffer or authorize loan modifications" or "[i]nitiate collection or foreclosure?," but it, likewise, contains no guidance regarding testing of these issues. *See* FFIEC, Interagency Fair Lending Examination Procedures, Appendix, pp. 3-4 (Aug. 2009), available at http://www.ffiec.gov/pdf/fairappx.pdf. As described below in more detail, only one banking agency – the Office of the Comptroller of the Currency – has guidance on default servicing fair lending testing in its examination procedures/guidance.

5 Office of the Comptroller of the Currency, "Comptrollers Handbook, Consumer Compliance Examination, Fair Lending," pp. 31-32 (Jan. 2010), available at http://www.occ.treas.gov/handbook/fairlep.pdf.

6 *See* Home Affordable Modification Program Hardship Affidavit, available at http://makinghomeaffordable.gov/docs/hamphardshipaffidavit.pdf.

7 FFIEC Press Release, "FFIEC Support for Responsible Loss Mitigation Activities" (Aug. 6, 2009), available at http://www.ffiec.gov/press/pr080609.htm.

8 The Interagency Fair Lending Examination Procedures, amended in August 2009, state, with respect to loan origination analyses, that "if examiners learn of other indications of risks that favor analyzing a prohibited basis with fewer transactions than the minimum in the sample size tables, they should consult with their supervisory office on possible alternative methods of analysis." *See* FFIEC, Interagency Fair Lending Examination Procedures, Appendix, p. 5 (Aug. 2009), available at http://www.ffiec.gov/pdf/fairappx.pdf. Prior to this amendment, there was no below-threshold exception to the minimum sample size requirements.