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North Carolina Announces a Loan Modification Protocol That Twists Servicers' ARMs

With virtually no statutory authority to support its actions, on November 14, 2008, the North Carolina Office of the Commissioner of Banks ("NCCOB" or the "Commissioner") announced a new loan modification protocol for "subprime loans" ("Protocol") pursuant to the recently created State Home Foreclosure Prevention Project ("Project"). Giving servicers little lead time, the Protocol took effect on December 1, 2008. The intent underlying the Protocol is to facilitate communication between mortgage lenders and servicers and the housing counselors working with homeowners to avoid foreclosure. Its effect is to pressure servicers to undertake streamlined modifications on terms proposed by the State of North Carolina. The more likely result is that the Protocol will further exacerbate the tension between and among mortgagors, loan servicers, mortgage investors, and government agencies regarding the extent to which a loan servicer should feel obligated to alter the terms of existing mortgage loan documents to achieve the laudable public policy goal of keeping delinquent borrowers in their homes.

The NCCOB promulgated the Protocol pursuant to the Emergency Program to Reduce Home Foreclosure Act, H. 2623 ("Foreclosure Act"). As we detail below, the most significant aspect of the Protocol is the apparent requirement imposed on a servicer either to agree to the state's specific recommendation regarding a proposed loan modification or to prove to the state why the servicer rejects this recommendation. This type of loan-level scrutiny by a government agency of a servicer's response to an individual borrower's default is unprecedented; in fact, the Foreclosure Act contains only scant traces of this concept. It raises two obvious questions. First, did the NCCOB overreach its statutory delegation of authority in designing the scope of the Protocol, particularly with respect to the various disguised or explicit mandates or directives imposed on the servicer? Second, what is the legal consequence of a servicer that chooses not to provide to the state what the Foreclosure Act euphemistically refers to as "optional" information?

The North Carolina legislature has been among the most active this year in introducing new mortgage lending and servicing laws. For instance, the state has enacted laws imposing new licensing obligations and servicing limitations (addressed in two recent K&L Gates' alerts).¹ Increasingly the provisions of North Carolina mortgage banking laws become templates for federal and state legislative initiatives. For instance, legislators in Michigan have introduced measures (2007 Mich. S. 1667 and Mich. H. 6615) with language nearly identical to that of the North Carolina statute on which the Protocol is based. In this client alert, we provide an overview of the Protocol and H. 2623, the statute that created the Project, and discuss an apparent disconnect between the two.

I. H. 2623: The Emergency Program to Reduce Home Foreclosure Act

The Foreclosure Act has a twofold purpose: to create an emergency program to reduce home foreclosures and to grant the NCCOB funds for home foreclosure prevention. As an emergency measure, the Foreclosure Act is effective from November 1, 2008 (except for an appropriation provision which took effect July 1, 2008) until October 31, 2010.² The Foreclosure Act attempts to reduce home foreclosures by authorizing the NCCOB to establish a statewide foreclosure prevention project – the Project – and imposes certain pre-foreclosure notice obligations.

Applicability of the Foreclosure Act

The Foreclosure Act applies to a “servicer,” a term defined generically that arguably does not include exemptions set forth in the licensing law. It also applies only to a “subprime loan,” which it defines as a loan originated between January 1, 2005 and December 31, 2007 that would meet the definition of “rate spread home loan” under North Carolina law had that provision been in effect when the loan was originated. A “rate spread home loan” is a “home loan” to which *both* provisions apply:

- (i) The difference between the APR for the loan and the yield on U.S. treasury securities having comparable periods of maturity is either equal to or greater than 3 percentage points if the loan is secured by a first lien or 5 percentage points if the loan is secured by a subordinate lien; and
- (ii) The difference between the APR for the loan and the conventional mortgage rate is either equal to or greater than 1.75 percentage points, if the loan is a first lien, or 3.75 percentage points if the loan is a subordinate-lien.³

Pre-Foreclosure Notice Requirements

The Foreclosure Act requires a servicer of a subprime loan to send a pre-foreclosure notice to a borrower at least 45 days prior to filing a foreclosure action on a primary residence. Among other information, the notice must inform the borrower of the resources available to help the borrower avoid foreclosure and must inform the borrower that he or she may discuss alternatives to foreclosure with the lender or servicer or with a HUD-approved counselor. The notice also must provide contact information for the lender, servicer, an approved counselor, and the consumer complaints section of the NCCOB. Loans that are not “home loans” (including those with a principal amount exceeding the conforming loan size limit for a single family dwelling established by Fannie Mae) or that do not meet the threshold for a rate spread home loan are not subject to this pre-foreclosure notice requirement. (However, a servicer may be subject to a similar notice requirement contained in the North Carolina Mortgage Lender Act).

Within three business days of mailing the notice, the servicer must make an electronic filing with the Administrative Office of the Courts stating the date on which the notice was filed, as well as the borrower’s name and address.⁴ Using that data, the Administrative Office of the Courts is required to establish a database to track foreclosure activities within the state. Information included in the database is not public record, but a mortgage lender or servicer may access information it has submitted with respect to its own loans.⁵

Establishment of the Project

The statute also authorizes the NCCOB to establish the Project for the stated purpose of seeking solutions to avoid foreclosure of certain subprime loans in the state. In turn, the statute permits the Commissioner to request “optional” information from a mortgage servicer to facilitate review of its servicing activities by the Project, subject to the limits of applicable state and federal law. The nature of the optional information that the Commissioner may request from a servicer is not specified. Perhaps more importantly, the Foreclosure Act does not explicitly mandate a servicer to provide the optional information. According to the Foreclosure Act, the Project should use the optional information “to prioritize efforts to reach borrowers most likely to avoid foreclosure and ... prevent delay for defaults where foreclosure is unavoidable.” The Foreclosure Act also provides that the “nature of the optional information requested shall be determined in connection with the design of the database,” which suggests that optional information must go into the database.

Authority of the NCCOB to Delay Foreclosure

If the NCCOB, based upon information received from a borrower and/or servicer about a particular loan, determines that the Project’s efforts could prevent foreclosure on a property, the statute authorizes the Commissioner to extend the filing date for a foreclosure proceeding on the property for up to 30 days.⁶ Thus, while it is not clear that the servicer must provide the optional information, a failure to provide this information may influence the Commissioner’s decision to extend the filing date for the foreclosure. Other than this one-time right to postpone a filing for 30 days, the Foreclosure Act provides no explicit

statutory authority to the Commissioner to impose on a servicer the Commissioner's subjective judgment regarding the terms of a loan modification.

II. The Protocol

One of the Project's primary initiatives is the establishment of the Protocol that both facilitates outreach to homeowners who have been unresponsive to servicers' collection efforts and streamlines work-out opportunities. According to the Protocol, once the NCCOB receives a pre-foreclosure notice, it refers the homeowner to a certified housing counselor.⁷ The referral to the counselor and the NCCOB's review of the pre-foreclosure notice run on parallel tracks.

Assuming the homeowner is willing, the counselor will interview the homeowner to determine her current financial status and to develop a proposal for modification of her loan. Under the Project, modified loan payments – including principal, interest, taxes, and insurance – should not exceed 34 percent of the borrower's total income. If the counselor believes that the proposed modification would decrease the financial burden on the homeowner and would be reasonably likely to succeed, the counselor will transmit a request for modification to the homeowner's loan servicer.⁸ The Protocol is silent on what happens if the mortgagor disregards the notice and does not meet with a certified housing counselor; presumably, the servicer is free to pursue whatever loss mitigation strategy it believes is appropriate and subject to other laws that may apply.

However, as noted above, there is another track the loan is traveling down. When the NCCOB receives the servicer's pre-foreclosure notice, the NCCOB will evaluate the subprime loan to ensure that there have been no material violations of law. If the NCCOB finds violations, it will make referrals for "appropriate action." Obviously, this exposes the originating lenders, and potentially the servicers, to additional scrutiny and the possibility of administrative action.

Standard Protocol

Effective December 1, 2008, the Protocol prescribes the process through which the NCCOB receives and acts on information regarding the foreclosure of a residential property in North Carolina. According to the NCCOB, the Protocol is intended to serve a twofold purpose of (a) allowing housing counselors to present consistent loan modification proposals, and (b) providing loan

servicers with "a streamlined and systematic set of proposals for proposed modifications."⁹

The Protocol provides standard formats for the housing counselor to submit a modification proposal ("Loan Modification Request") and for the servicer to respond to the proposal. Once the counselor believes it has structured a sustainable payment for the borrower's loan, the counselor will send a Loan Modification Request to the servicer requesting a response within five business days. The servicer is supposed to determine whether the proposed payment is likely to lead to a greater benefit to the investor of the mortgage loan than recovery in foreclosure. In making that determination, the servicer can consider a number of factors enumerated by the Protocol. The servicer can reach the payment structure proposed in the Loan Modification Request through a combination of reductions in interest rate, extensions of the loan amortization period, or deferrals of or reductions in principal. Additionally, the NCCOB encourages a servicer evaluating a proposed loan modification to consider waiving late fees, modification fees, loan arrearages, and/or its own expenses to reach the proposed payment level.¹⁰

If the benefit analysis favors modification, the NCCOB will "urge" the servicer to accept the proposal and expedite the modification. If the servicer declines the request, the NCCOB will request that the servicer explain its rationale, identifying the factors it considered and stating whether the proposed loan modification would have created a net present benefit to the mortgage holder that would exceed that available in the case of foreclosure of the loan. If the servicer determines that the financial recovery under foreclosure would produce a greater net benefit for investors than the proposed modification, the NCCOB will "request" that the servicer "provide information on the estimated loss due to foreclosure (including the assumptions used to make that calculation, such as the market value of the property upon disposition), and the estimated loss due to" the proposed modification. Similarly, if the servicer declines the proposal request because of a limitation imposed by an investor – for instance, because the investment instrument prohibits reductions in principal – the NCCOB will ask the servicer to identify the limitation and provide contact information for the investor who can modify it. How forcefully the NCCOB will be "urging" and "requesting" servicers is yet to be seen.

Finally, if the servicer declines a request, it may make a counterproposal to the homeowner through the housing counselor. According to the Protocol, the NCCOB will review all alternative offers to determine whether they will facilitate sustainable homeownership.¹¹

Alternative Protocol

The NCCOB may permit a servicer that maintains its own loan modification protocol to qualify that protocol as an alternative to the one described above. To qualify, the servicer's alternative should meet standards set by the NCCOB, although those standards are not specifically articulated in the Protocol. Rather, the NCCOB has indicated that "[s]ervicers interested in qualifying their protocol in this program should contact NCCOB for further information." While the specifics are not clear, the NCCOB will consider whether the servicer's protocol includes two items. First, the NCCOB will look to whether the servicer has "a proactive approach to make pre-qualified modification offers to homeowners at risk prior to contact with the homeowner." Such an approach would encourage the servicer to monitor each homeowner's likelihood of default before the borrower becomes delinquent on his or her mortgage. Second, the NCCOB will evaluate whether the alternative protocol includes "a streamlined loan modification program focused on sustained housing affordability for homeowners in contact with the servicer." Such a program may eliminate the need for excessive or "burdensome" paperwork for a homeowner requesting a loan modification, provide transparency to the homeowner, and ensure that the modified loan payments meet the suggested debt-to-income ratio provided by the standard protocol (as discussed above, ideally no more than 34 percent).¹²

III. Unanswered Questions About the Interaction of the Law and the Protocol

Although the Protocol clearly emerged from the underlying purpose of the Foreclosure Act and the Project, a closer comparison of the Protocol and its statutory authority raises an important issue: Does the Foreclosure Act actually grant the NCCOB the authority to request all of the information described above – including that which the NCCOB may "request" if a servicer declines a Loan Modification Request? For instance, if a servicer declines a proposed loan modification because it does not comply with investor limitations, the servicer is "requested" to provide specifics about the limitation and contact information

for the investor to the NCCOB. A servicer also may be requested to provide information to substantiate its decision not to accept a proposed modification, including information about the borrower and the particular loan, as well as its own method for determining the relative benefit of modification or foreclosure of the loan to investors.

As indicated above, the Foreclosure Act permits optional information to be collected from a mortgage servicer "to be determined in connection with the design of the database." This optional information may be collected "as permitted by applicable State and federal law."¹³ It is unclear from the statutory context whether there must be express or implied state or federal authority to request such information, or whether the Commissioner's ability to request information is subject only to any express limitations or prohibitions that state or federal privacy laws impose. It also is unclear whether the Protocol requires servicers to provide information that is not collected via the Project database, thereby raising the question of whether the NCCOB's issuance of the Protocol exceeds the already tenuous authority in the Foreclosure Act. For instance, according to FAQ's issued by the NCCOB, among the types of optional information that a servicer may provide to the database are whether the servicer believes a property is vacant, or whether the servicer has knowledge that the homeowner has recently lost his or her job.¹⁴ Arguably, the Foreclosure Act gives the NCCOB authority to collect information from pre-foreclosure filings to include in the database and to use that information to assist troubled borrowers. However, it is not clear whether the optional information the NCCOB requests will be included in the database. Assuming it is, and further assuming that the Foreclosure Act grants the NCCOB authority to obtain additional information, the question remains whether the NCCOB can require a servicer to submit that information under the Protocol. Can the NCCOB do so without following the state's Administrative Procedures Act, which would likely require a lengthy formal notice and comment period? Absent such protections, what is to suggest that the NCCOB won't request further, more proprietary information from loan servicers?

Additional issues arise as well. What are the repercussions if a servicer elects not to participate in the Protocol? For certain entities to which federal preemption applies, it may be argued that

the Commissioner lacks the authority to request information. In that case, it is unclear how the Protocol would impact a servicer's consideration of a proposal for loan modification. For state-regulated entities not entitled to federal preemption, the Foreclosure Act does not create penalties for a servicer's failure to provide "requested" information or follow a counselor's or the NCCOB's loan modification suggestions. The statute authorizes the Commissioner to seek solutions to avoid foreclosure, and provides that it may include input from other organizations and entities – including mortgage lenders and servicers – but does not give the NCCOB authority to mandate compliance.¹⁵ We cannot find an alternative basis in the statute for the NCCOB to ensure compliance. Nor is there an apparent statutory basis upon which the NCCOB could rely to impose additional obligations on servicers under the Project. Although the Commissioner may look to alternative statutory authority for a proper basis, that statutory authority does not appear to exist. And for federally chartered entities, the notion that a national bank or federally chartered thrift must submit to the visitorial powers of a state governmental authority before it may proceed to foreclosure raises serious federal preemption issues regarding at what point local real estate law becomes a backdoor way to restrict the servicing activities of federally chartered entities.

The NCCOB's request for particular information about a borrower also raises privacy concerns. The Foreclosure Act does not clarify whether any additional information that the NCCOB requests regarding a borrower or loan will be added to the Project database. As discussed above, North Carolina law now provides that information included in the database does not become public record (except for

limited access by mortgage lenders and servicers to information regarding their own loans).¹⁶ The Foreclosure Act assures that a lender or servicer who provides information to the Administrative Office of the Courts for use by the Project does not violate the state's privacy law regarding the disclosure of financial records.¹⁷ However, as discussed above, a servicer who receives a loan modification request from a homeowner may have to provide a substantial amount of information to the NCCOB. The Foreclosure Act provides that a servicer "shall be held harmless for any alleged breach of privacy rights of the borrower with respect to the information" the servicer is required to provide under the statute's provisions.¹⁸ What is unclear is how broadly that exemption from liability could reach, in the case that a borrower objected to the extensive disclosures required under the Protocol, especially if there is a security breach. (Breaches of data maintained by federal and state agencies have become a too-common occurrence.)

Because the Protocol became effective just a few weeks ago, it has not been in operation long enough to see how these issues will play out as a practical matter. The Protocol is intended to effectuate the goals of the Foreclosure Act, but it appears to reach beyond the authority delegated to the Commissioner under the statute. While the Commissioner may want to twist the arms of servicers to induce modifications of subprime ARM loans, it is not at all clear that the servicers must subject themselves to such measures. Although the Project's dual focus on the best interests of both homeowners and loan investors is admirable, it appears that additional revision may be needed to make the Protocol work.

Endnotes

- 1 See Nanci L. Weissgold and Morey E. Barnes, *Make My Day: States Dare Servicers to Foreclose*, K&L Gates Mortgage Banking Alert, Nov. 4, 2008; Kristie D. Kully and Kerri Smith, *Minding the Gap – Servicers Subject to Regulatory Scrutiny*, K&L Gates Mortgage Banking Alert, Aug. 26, 2008.
- 2 North Carolina House Bill 2623 (Session Law 2008-226) (effective July 1, 2008, and November 1, 2008).
- 3 See N.C. Gen. Stat. § 24-1.1F.
- 4 Id.
- 5 Id. The deadline for establishment of the database was October 1, 2008.
- 6 Id.
- 7 North Carolina Office of the Commissioner of Banks, *NCCOB Modification Protocol for State Home Foreclosure Prevention Project*, Nov. 14, 2008.
- 8 Id.
- 9 Id.
- 10 Id.
- 11 Id.
- 12 Id.
- 13 North Carolina House Bill 2623.
- 14 See FAQ's for Servicers, Updated Oct. 29, 2008, [http://www.ncforeclosurehelp.org/SFPPDocs/Frequently %20 Asked%20Questions%20for%20Servicers.pdf](http://www.ncforeclosurehelp.org/SFPPDocs/Frequently%20Asked%20Questions%20for%20Servicers.pdf).
- 15 N.C. Gen. Stat. § 45-104.
- 16 Id. § 45-106.
- 17 Id.
- 18 Id.

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