Cambridge University Press
978-1-108-41870-6 — Foreclosed
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Introduction

There is an entire world behind how homeownership works in America, one completely hidden from view and governed by rules that hardly anyone knows and even fewer understand. At its center is an industry – a group of middlemen – that you've probably never heard of and the significance of which you most likely don't appreciate. But fear not – you aren't alone. Unbeknownst to the American public at large, the mortgage middlemen – known as *mortgage servicers* – are some of the most (if not *the* most) essential players in the story of modern homeownership. But, despite the immensely important role that servicers play in propping up the American housing finance structure, they have been given little attention by policy makers, the media, academics, or anyone else.[1] This book is about these mortgage middlemen and why it is time that we all start paying attention to them.

As of this book's date of publication, it will have been roughly a decade since the financial crisis of 2008 – the massive downturn in the global economy in which institutions failed, taxpayers bailed out banks and Wall Street firms, and several companies were taken over by the federal government. As the country faced the most significant financial challenge since the Great Depression, these enormous interventions in the private sector were heralded as the only way to save the U.S. economy.

The financial crisis revealed not only the complex and multifaceted architecture behind homeownership in America but also that this same complicated edifice was systemically defective and would easily crumble when just a little pressure was applied to it. As the walls started to fall, everyday-Americans began to get a glimpse of the massive machine behind their mortgage loan, previously hidden from view and seemingly inscrutable to most. While an individual who purchases a home typically does so through a loan procured from an area lender or broker, that transaction is only the beginning of a much more protracted process. Most loans are quickly sold, packaged, and repackaged several times before finally being turned into an investment product that is purchased by parties far removed from the homeowner. This process is known as *securitization*.

The securitization scaffolding, which holds together the entire American housing finance system, is administered by the mortgage servicers.[2] These entities – which I refer

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to in the preceding text and often throughout this book as the *mortgage middlemen* – have become important players in American homeownership. Despite not being chosen or even understood by the homeowner, servicers enjoy an outsized role in the housing economy. First, they are the sole point of contact between homeowners and their most important creditors – the ones that own their mortgage loans. Second, servicers are vested with extraordinary powers over the lives of homeowners, including not only the mechanics of making payments but also sometimes having physical authority over the home, even before a foreclosure takes place. When homeowners have questions or encounter problems, they go to the servicer to obtain a resolution. And importantly, servicers have been given or vested with the unilateral power to alter the obligations of the homeowner, all the while enjoying significant legal and practical power over the home. Servicers are the ferrymen of American homeownership. They can shepherd you across the waters of paying off your loan and ultimately becoming debt free. But, when those waters get rough, they can also throw you overboard.

Homeowners, for their part, are often completely unaware of the role played by the servicer. Most Americans believe they are paying their lender,[3] or at least some party that their original lender sold the loan to after it was made. This simplistic belief could not be further from the truth. In fact, the servicer generally owns no part of the loan.[4] Rather, the servicer acts on behalf of the owner of the loan and deals with the homeowner only in a representative capacity.

Yet, mortgage middlemen are far more than mere agents for the finance companies for which they work. Rather than servants that simply carry out the orders of their masters, servicers have enormous independent authority to deal with homeowners. More concerning, servicers have little to no direction to guide them in how best to deal with the homeowner or the mortgaged property in times of distress. Instead, the structural features that govern the relationship between the investors who own the loans and the middlemen who manage them leave remarkable discretion in the hands of servicers.

Servicers have often deployed this discretion in haphazard and abusive ways. Take, for example, the case of a Florida woman named Trish and her mother with a disability.[5] Prior to the financial crisis, Trish's mother bought a modest home with her husband and never missed a monthly payment. The elderly couple's mortgage payments were auto-debited from their bank account each month. But in August 2011, it was discovered that the installment amount suddenly included an extra $300. Trish helped her mother contact the servicer to find out what happened because the change was made without notifying or asking the permission of the homeowners. As it turns out, in 2011 the servicing of her mother's loan was transferred to a new company. The new servicer – using an obscure provision in the standard mortgage contract dealing with "force-placed insurance" – took out additional property insurance on the home and included the new premium amount in the August payment (without anyone's direct permission). Trish and her mother explained that the property had been insured continuously for years, but the new servicer declared

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that it had determined that the insurance was insufficient. And, unknown to Trish and her mother (and indeed, most homeowners), the servicer has the unilateral right to not only select additional insurance at will but also to tack on the resulting extra premiums to the monthly mortgage obligation. When Trish and her mother tried to dispute the additional insurance, the servicer advised them that they had better pay up or else a foreclosure was coming.

A servicer's power, however, is not merely limited to matters involving property insurance. Servicers can also physically enter a person's home, even prior to a foreclosure and even when the owner is not present. Barry Tatum learned this the hard way.[6] Barry had fallen behind on his mortgage payments to his loan servicer, Bank of America. One day in December 2012, Barry returned home to find that the front and back doors to his house had been ripped from the hinges, leaving the contents exposed to the cold Chicago winter. But, this was not a street crime. Rather, a letter revealed that his servicer had hired a property management company, Safeguard Properties, to go out to the home and, further, that this contractor had determined that the home was abandoned. Despite calling Bank of America and Safeguard Properties multiple times over a series of months to tell them that he was still living in (and indeed, still owned) the property, Barry received twelve more abandonment notices pinned to his door.

The constant transferring of loan servicing rights can cause significant problems for homeowners. In 2003, Ceith and Louise Sinclair purchased their home in Altadena, California with a mortgage loan.[7] The couple, who lived in the house with their four children, never missed a payment. In 2012, when so many homeowners fell on hard times and after home values had plummeted, the Sinclairs applied for and received a loan modification from their servicer. Then, in June 2013, the Sinclairs's monthly mortgage payment was unexpectedly returned. Evidently, the servicing rights to Ceith and Louise's loan were transferred to a new company, Nationstar, that refused to honor the prior loan modification, claiming that one page of the application had not been notarized. The servicer then foreclosed on their property and sold the home to an investment firm. The Sinclairs, however, stated that they only found out about the sale when a representative of the buyer came to their door one day and told the couple that they had two weeks to get out. Calls to Nationstar, according to Louise, were met with runarounds and frequent requests to "call back in two days." The family would have been kicked out on the street but for a local news station picking up the story – and all despite the fact that they had never missed a single mortgage payment.[8] In the end, the Sinclairs retained a lawyer and were able to remain in their home. As it turned out, the page in the loan application had been notarized.

Mortgage servicers are the curators of the securitization system. Leading up to the crisis, they were the firms that managed the flow of funds from vulnerable, subprime borrowers to Wall Street investors, all the while taking a cut of the mortgage payments

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for themselves.[9] Many servicers were subsidiaries or affiliates of the very lenders that targeted and made risky loans to unsuspecting borrowers in the first place.[10]

What was (and what remains) one of the most interesting features about mortgage middlemen and the financial crisis is that although they occupied positions of colossal power and discretion when it came to the mortgage finance system, servicers were completely ill-equipped for the job assigned to them. They were frequently under-resourced and under-staffed, with little training on how to deal with homeowners in such dire straits or how best to handle distressed loans. In the aftermath of the crisis, servicing companies sent homeowners mixed signals, often by moving forward with foreclosures despite having promised that a workout was possible and then suddenly transferring the servicing rights to a different company on the eve of completing a workout with the homeowner.[11]

Even when the federal government attempted to implement programs to give homeowners relief from foreclosure,[12] servicers often failed to qualify individuals or act on applications for assistance. Jeremy Fletcher of Northridge, California owned a successful swimming-pool construction business before the financial crisis, but, like so many others, he saw his business tank in 2008 as his sales dropped significantly.[13] Facing a monthly home mortgage payment that he could no longer afford, he applied for assistance from an Obama administration program. This program was aimed at incentivizing servicers to help troubled Americans stay in their homes and avoid foreclosure by furnishing them a loan modification. Jeremy called his servicer, CitiMortgage, and tried to apply but was told that because he had not yet missed a loan payment he was not eligible. A few months later, when Jeremy was getting ready to try to sell his home, he got a call out of the blue from CitiMortgage telling him that his modification was approved for a trial run. Jeremy was told that his monthly payment would be dramatically cut for a period of five years. He readily agreed and immediately made a payment over the phone in the new amount. The CitiMortgage employee said that if Jeremy made all his payments on time for a period of ninety days and filled out additional paperwork, then his modification would become permanent. Everything sounded great.

After Jeremy sent in all the required documentation and made timely payments for the full ninety days, his inquiries about making the modification permanent were met with statements by CitiMortgage that the servicer was "backed up but everything was fine" and that he should "continue to make trial payments." This holding pattern kept up for an entire year with different employees at CitiMortgage variously assuring Jeremy that everything was "fine" and that approval of his permanent modification was just a matter of time. Then, in June 2010, Jeremy got a call from CitiMortgage's collections department telling him that he was one year late on his loan and that he owed $12,000. After being transferred around on the phone from person to person, he was finally told that he had been dropped from the modification program. If he did not pay the necessary amount within the next month, CitiMortgage told Jeremy that he would lose his home. Jeremy struggled for weeks

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to get someone to help him and, only after he had retained a lawyer, was he able to get a mortgage specialist at CitiMortgage on the phone. The CitiMortgage specialist told him that it appeared his application had been dropped in error – it "got lost in the cracks."[14] Jeremy had to redocument the application but was otherwise told that everything would be fixed. Things seemed to come together until two days later when Jeremy received notification that CitiMortgage had just sold the rights to service his loan to a different company, Saxon Mortgage. After a year of painstaking good-faith efforts, Jeremy was back to square one.

The story was even worse for Alisa and her seventy-year-old parents living in Mississippi. Alisa's parents had always remained current on their mortgage payments and had a good deal of equity built up in their home.[15] One year after the crisis hit, her parents received a letter offering a loan modification from their servicer, Houston-based Litton Loan Servicing. Because Alisa's parents were retired, the drop in their monthly mortgage payments to $600 was extremely attractive. Although the arduous process involved the submission of numerous pieces of paper whereby Alisa's parents were often told by the servicer that the documents were either incomplete or never received, eventually Litton granted approval. Then, a year into the modification, Alisa reported that her parents received a letter stating that their modification was not approved and that they now owed more than $10,000 in late mortgage payments. Litton threatened foreclosure if payment was not made immediately.

The elderly couple living on retirement income did not have sufficient cash to make the overdue payment, and so they were forced into bankruptcy – something they never would have envisioned. In the end, the bankruptcy was not as successful as hoped, and the bank was said to have received $15,000. Now out of bankruptcy and still seeking a modification, the homeowners discovered that the servicing rights to their loan were suddenly transferred to a new company. Alisa's parents immediately received a default letter threatening foreclosure. The new servicer also issued a new demand that the couple start making monthly payments into an escrow account to cover end-of-the-year insurance and property tax expenses. About the same time, Alisa's mother was diagnosed with cancer. Despite her mother's illness, Alisa and her father were finally able to get a loan modification offer from the servicer, but not without having to pay a steep price. According to Alisa, the agreement required, among other things, that her parents sign away their right to dispute any past inaccuracies with how payments on their loan were processed or accounted for and that more than $19,000 would be added into the principal loan amount with little explanation.

Sharing these heartbreaking stories was not the only reason that inspired me to write this book. I also embarked on this journey because, as a law professor who writes and teaches in the areas of property law and finance with a particular interest in mortgage lending and consumer protection, it is my job to try and make the complex and arcane seem understandable and even interesting to everyday people. I

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have chosen this goal not merely because I think Americans should know something about the people who manage their loans and with whom they have to contend in the event the ups and downs of life threaten them with the loss of their home. Understanding mortgage servicing is also important because it helps us be better advocates for ourselves in the political process – the arena where the rules that govern the mortgage middlemen (and thus homeownership) are made and enforced.

But my goal is not only to put the spotlight on mortgage servicing. I also want to pull apart and explain how the industry operates. I endeavor in the pages that follow to show not only how it works, but also how it has changed over time and how it should be better regulated in the future. Mortgage servicing is necessary. We will never return to the *It's a Wonderful Life* version of banking, where George Bailey runs a small community bank that makes portfolio-held mortgage loans to the good folks of Bedford Falls.[16] Securitization and the secondary mortgage market are here to stay, and, truth be told, homeownership in the United States would likely look very different today (probably for the worse) without both. So, because mortgage securitization and mortgage servicing go hand in hand, the middlemen are here for the long haul as well.

Admittedly, not all servicers are bad. Many servicers were simply ill-equipped to deal with the flood of defaults and foreclosures that overwhelmed the housing market after the 2008 crash. But there certainly were some bad actors who, in coordination with fraudulent originators, were guilty of some of the worst abuses. Later chapters will share some of these harrowing stories with you. Because of this, some generalizations will be made throughout the book, recognizing that the mortgage middleman industry is not without its bright lights.

Yet, it is not enough merely to understand mortgage servicing and the very important position it occupies in the lives of American homeowners. We also need to understand how it should be properly regulated, particularly as this important function moves more aggressively into the so-called shadow banking sector. We need to ensure that the foreclosure and servicing abuses of the past ten years – like those experienced by Barry, the Sinclairs, Jeremy, Alisa's parents, and countless others – do not occur again. We also need to guard against future breakdowns in the mortgage servicing system similar to those we saw during and after 2008.

In truth, meaningful mortgage servicing regulation has been lacking for a long time. That is not to say that that this industry has been unregulated – at least not in theory. The mortgage middlemen have been subject to some regulation, but it has not always been very effective or well coordinated. Rather than having clear and deliberate rules and standards to govern its proper operation (particularly as it relates to protecting the interests of homeowners), the industry has both benefited from and been burdened by a complex patchwork of rules and oversight requirements that stretch from the offices of state-level banking regulators to the halls of regulatory agencies in Washington, D.C. Even for those servicing firms that have only the best

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intentions, complying with the crisscrossing array of rules and overlapping governmental authorities invites mistakes and inadvertent consumer harm.

In this book, I show not only how this byzantine regulatory structure left homeowners with little protection from abusive servicing practices but also how servicers would have benefited (and still can) from rules on how best to prepare for and handle the extreme stresses of the foreclosure process and borrower delinquencies. I also suggest how a better regulatory system – one that draws on federalism principles to create a state/federal partnership for the licensing and prudential regulation of mortgage servicing – should be designed.

Some progress has already been made in the servicing arena. In response to the financial crisis, Congress passed comprehensive legislation in 2010 known as the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).[17] This act, among other things, amended a host of federal lending and banking statutes and established a new federal agency, the Consumer Financial Protection Bureau (CFPB), to protect consumers in all forms of financial transactions going forward. Part of this legislation involved creating new rules to govern many of the consumer-facing aspects of mortgage servicing. Also, in 2012 a number of the country's biggest servicers entered into a massive settlement with federal agencies and state attorneys general from across the United States regarding their shoddy foreclosure and lending practices.

While that may sound promising, there is yet work to be done. The mortgage servicing industry is still deeply troubled. Despite the fact that so many years have passed since the crisis occurred, enforcement actions by the CFPB and state-level regulators and attorneys general for foreclosure-related abuses continue against these firms.[18] Additionally, the market for the mortgage middlemen has gone through some significant changes (and challenges) since 2008. For instance, the value of mortgage servicing as a bank asset fell 33 percent at the end of 2008 – the period when the financial crisis was at its worst.[19] In the earlier part of 2008, bank-related mortgage servicing was valued at $78 billion. Between 2011 and 2012, that number dropped to somewhere between $30 and $40 billion.

What is the story behind these numbers? It is that banks – the ones that hold our money, issue our debit cards, and are insured by the federal government – are getting out of the mortgage servicing business in a big way. Into this gap have stepped nonbank servicing companies. Nonbanks are those financial institutions that, despite not being regulated like banks, are generally viewed as having many of the same attributes as banks. This corner of the financial sector is often known as "shadow banking."[20] As the name ominously suggests, shadow banks are those financial institutions that operate outside the general banking regulatory regime.[21] These firms do not take deposits or issue checks and debits cards like the banks around the corner, but they do play a significant role in the banking and broader financial economy. Shadow banks include hedge funds, payday lenders, private equity funds, investment banks, mortgage lenders, and insurance companies, and

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they often provide incredibly important services to the American economy and the world.

Shadow banks came into prominence in the aftermath of the crisis because they, in large part, contributed the disaster.[22] A prime example is the notorious fall of Lehman Brothers – a well-known shadow bank.[23] This firm, which played an enormous role in subprime mortgage lending and securitization, held as much as $600 billion in assets a year prior to its bankruptcy.[24] Other shadow banks that became central figures in the tale of the 2008 crisis include Goldman Sachs, Morgan Stanley, New Century Financial, Countrywide Financial, Ameriquest, and AIG – the list goes on.

Since the crisis, shadow banking firms have been purchasing sizable amounts of mortgage servicing rights from banks.[25] For instance, in early 2017 Citigroup – the subsidiaries of which have been fined up to $29 million by the CFPB for foreclosure-related abuses[26] – announced that it was selling off billions worth of mortgage servicing rights to the nonbank firm New Residential Mortgage LLC.[27] In 2012, Bank of America sold $10.4 billion worth of its mortgage servicing assets to nonbank Nationstar Mortgage.[28] All this buying has added up. Whereas in 2012 the percentage of mortgage loans serviced by shadow banks was only 6.8 percent, that number rose to at least 24.2 percent in 2015, with some estimates being as high as 31 percent.[29]

So, why does it matter that shadow banking institutions have taken such an interest in mortgage servicing? First, shadow banks operate outside the traditional banking regulatory system, which reduces oversight of their activities. Also, as a general matter shadow banks tend to be very active in minority communities and with at-risk borrowers.[30] They also originate and service a huge portion of Federal Housing Administration (FHA) loans and a sizable portion of loans sold to Fannie Mae and Freddie Mac.[31] Between 2013 and 2016, the servicing of FHA-backed mortgage loans by nonbanks increased from 35 percent to more than 70 percent. This market share growth is important because the FHA loan program and Fannie and Freddie are major drivers of homeownership for families of modest means.[32] The result is that the mortgage servicing activities of shadow banks have a great deal to say about how low- to moderate-income Americans and homeowners of color manage their mortgage debt (and thus keep their homes during financial downturns). From this perspective, mortgage servicing is changing in fundamental ways and is becoming dominated by firms that, although subject to some federal and state laws, are not regulated in the same way as banks and traditional financial institutions. And for an industry that is already relatively hidden from view and little understood even by those who have glimpsed at the structure of America's mortgage finance system, the ascendancy of shadow banks in the area of mortgage servicing carries much importance and significant potential danger.[33]

Americans, for the most part, do not have sufficient understanding of the servicing industry to form their own views about how best to regulate it or to look with a critical eye at what other people – such as industry advocates or politicians – have to say

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about it. Though most homeowners remain in the dark, mortgage firms (including mortgage servicers) and their lobbyists pour long strings of acronyms, economics catchphrases, and generally confusing financial services jargon over the heads of members of Congress, regulators, state legislators, and the media. Because most people lack the basic background knowledge of the architecture of mortgage finance, they do not challenge the industry. A central goal of this book is to change that when it comes to mortgage servicing.

Many who work in or lobby on behalf of the financial services and banking industry argue that any kind of serious financial reform effort would have an adverse impact on the ability of individuals to access credit[34] and that it would hobble a financial firm's ability to grow the economy.[35] This argument is frequently made through the lens of mortgage lending specifically: regulation of mortgage markets – including servicing – will drive up the cost of credit and thereby shut out many homeowners from the American dream. They argue that if we want credit to flow and homeownership to flourish, we need to tread lightly and keep regulation at a minimum. Wall Street executives declare that lessons have been learned, that points of breakdown have been identified, and that controls have been put into place to make sure a disaster does not happen again. Trust us, they say, this stuff is complex: We understand it better than anyone else. For example, in April 2017 Jamie Dimon (the CEO of JPMorgan Chase, which has a substantial mortgage servicing business,[36] and the de facto voice of Wall Street) attacked postcrisis mortgage regulatory efforts, stating that they hurt "lower income buyers, first-time homebuyers, the self-employed[,] and individuals with prior defaults who deserve another chance."[37] He argued that the post–Dodd-Frank regulation of mortgage lending is too complex and creates too much risk for lenders to operate effectively.

Dimon is not alone in his "industry knows best" attitude to the regulation of mortgage finance. Financial industry advocates, invoking appealing catchphrases rather than sound arguments, state that the government should end its "failed experiment with top-down government control of housing, and let markets once again do the job they do best."[38] If we fail to do so, they assert, then "we may soon face a housing-related financial crisis worse than the last one." Also, Dodd-Frank is "driving consolidation" and may result, most ominously, in making "lending markets less able to serve core economic demand."[39] The way banks are regulated is "anti-American"[40] and "the housing collapse . . . was largely the result of government interference in the mortgage market."[41] Rather than regulating the types of loans that are offered to borrowers and how those loans are managed, "[b]orrowers and lenders should be free to negotiate the terms of mortgage agreements."[42] Financial regulations, including mortgage regulations, "limit mortgage options and access to credit – and further erode Americans' freedoms."[43] And, Dodd-Frank and the regulations that flow from it should either be repealed[44] or greatly curtailed.[45]

The truth is that lobbyists and financial executives do not know what is best, and although mortgage lending and servicing are multifaceted, the basics are not that

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difficult to understand. They are at least not as complex as some would have us believe. True, the labyrinth of securitization takes some time to navigate, but a mastery of the topic is not necessary to gain the foundational knowledge necessary to see mortgage servicing and how it constitutes an integral part of the scaffolding of housing finance. Understanding a few terms and their definitions, accompanied by some explanation of process and a few concrete hypotheticals, is all that is needed to get up to speed. And with that process behind us, we can begin to see why servicers are so important and to also better appreciate how crucial they become when a homeowner hits rough waters.

Mortgage finance lobbyists have incentives to keep the curtains in place because the more people understand how the hidden financial architecture behind their home loan works, the less likely they will be to accept, unchallenged, assertions that any new rule or new requirement would overly burden the lending industry and create adverse consequences for consumers. And unfortunately, even in the aftermath of the financial crisis – when the hearts and minds of our elected leaders were as receptive as they ever would be to looking out for the rights of consumers and fighting back against Wall Street risk-taking – the flawed narratives and rickety arguments made by financial sector lobbyists often won the day in Congress and with federal regulators. Legislative proposals were steered in a particular direction and suggestions from consumer groups were frequently sidelined. It is no surprise that, considering the wealth and power of banking lobbyists and lending trade groups, most of the comments and critiques submitted to governmental agencies relative to financial regulatory rule-making efforts come from them.[46] Reports from 2013, a few short years after the Dodd-Frank Act was passed, revealed that numerous bills passed by the Republican-controlled House of Representatives and aimed at rolling back many of the act's provisions contained almost the exact same language (word-for-word) as proposals submitted by banking lobbyists.[47] In one bill, seventy of the eighty-five lines contained in the legislation were copied verbatim from a Citigroup document.[48]

Knowledge is power in all spaces, and mortgage finance is no different. Those who understand the system have the ability to shape and steer it. This means that lobbyists and the industry, armed with the best information and having created the perception of impenetrability, can ensure that regulations are weak and enforcement is ineffectual. Americans need to better understand the world of mortgage servicing and the reality that it exists around them rather than in some far-off glass building on Wall Street. Armed with that knowledge, homeowners will be better equipped to participate in the political process and make their voices heard by elected officials when housing finance reform finally does come up again in Congress (something that the Obama administration was not eager to undertake and that remains uncertain in the Trump era). And lastly, I hope that even just a little bit of knowledge about the servicing process will help homeowners better deal with their own middlemen.

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It's an interesting time to write about the mortgage lending industry because the pendulum is swinging back toward the interests of the financial sector. After the crisis there was such outcry – such outrage – regarding the greed and fraud that permeated the financial sector that Congress and consumer advocates were able to pass significant legislation in the form of the Dodd-Frank Act, which resulted in the creation of the CFPB. Without the crisis, these legislative and policy feats would not have been possible. But now, with the election of Donald Trump and the dominance of a deregulatory agenda in the U.S. Congress, the recent focus on consumer rights appears to be over – or at least on pause.[49]

But it does not have to be that way. Protecting American consumers (particularly homeowners) and providing for an effective and appropriate regulatory system to achieve that goal is not a partisan issue. A stable financial system that allows for competition, provides credit where appropriate, promotes safe innovation, and guards against fraud, information asymmetry, and predatory practices is in the interest of everyone. And an understanding of the hidden architecture behind homeownership in America can help everyday people become armed with the basic knowledge they need to challenge the conventional wisdom of Wall Street lobbyists and bank executives when the big policy questions related to consumers and mortgage finance come before our elected leaders. With this project, I hope to do my part in pulling back the curtain so that, eventually, we will not only be more collectively aware of the fragility of this architecture but also that we may strengthen it.

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