

Penn State law professor sheds light on foreclosure crisis (w/ Video)

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(PhysOrg.com) -- Penn State Law Professor Marie Reilly, a bankruptcy and banking law expert, worries that the backlash over the current foreclosure crisis may be the "medicine that kills the patient." Laws and regulations developed more than a century ago that require paper documentation continue to govern a process which is now electronic and involves a complex system of lenders and servicers. She discusses the origins of the current problem and what effect they may have on the economy.

Can you step us through some of the pitfalls in the current mortgage process?

Let me explain a little bit about what happens when somebody borrows money to purchase a house. The borrower will enter into a contract with the lender and we think of the lender as the [mortgage](#) originator. The borrower promises to make a series of payments in a promissory note. The second aspect of that transaction is that the borrower agrees that in the event he breaks his promise to pay, the lender has a conditional property interest. So upon default the lender can become the owner of the property. The lender takes the mortgage and records it in the land records of the county and the note is taken and in the old days they used to put it in a bank vault.

In order to draw capital to finance home mortgages, it became necessary to attract investors who weren't interested in undertaking the business of originating mortgages, they just wanted to buy interest in promises to

pay. The problem was the original mortgage system assumed a personal relationship between the borrower and the lender where the paper would be signed and recorded, all taking place locally. When we moved to a more complicated market for mortgages we have investors all over the world who buy a piece of this stream of payments that are going to arise out of these promissory notes.

Around 2002, a private company solved the problem of getting reliable interest in the hands of these remote investors called the mortgage electronic recordation service. When the mortgage is recorded the mortgage holder's name is filled in as MERS (Mortgage Electronic Registration Service). It operates as a stand in mortgagee who can assign interests in the mortgage to third party investors who are far away. This is all done electronically. If those investors had to physically change the name of the mortgagee on the paper copy of the recorded mortgage it would make it way too complicated and too error prone to make mortgages a viable opportunity for remote investment.

All of that worked pretty well until we saw a drastic spike in the number of mortgages going into default. At that point the foreclosure process begins. In 23 states there is a judicial foreclosure process, which begins with the filing of a complaint and includes the production of documents like the original promissory note. And if the mortgage holder can't produce the original note, which they mostly can't, they have to submit an affidavit explaining why they can't produce the original note -- that's where you heard about the "robo-signing" of these documents. In the remaining states the foreclosure process is government by the terms of the mortgage itself. There are a lot of safeguards built in to both. In October, I think the average foreclosure process was reported at 500 days. People aren't dumped out of their houses overnight. The foreclosure process has been around since the Middle Ages. Both the borrower and the lender have a powerful interest in trying to work it out.

What three things lead to the current crisis?

One is a significant spike in mortgages processed concentrated in the areas that are now experiencing the highest rates of foreclosure. What caused that spike is really a chicken and an egg thing. Was it the demand for mortgages or the supply of mortgages because it was cheap and easy to obtain mortgage financing for acquisition of property? And so, people did it which drove the building market in those areas and now we have a glut of housing, a decline in the value of those properties, and as values decline people look at their situations and say, “I’ve borrowed money on a property that isn’t worth what I thought it would be worth. I’m walking away from it.” And many of those properties weren’t occupied in the first place.

The second thing is joblessness. Between 2005 and 2010, we’ve seen a marked increase in the rate of unemployment. As people lose their jobs or they become insecure about their jobs, they may decide to downsize. We see a lot of people walking away from homes where the value of the property has declined and they either lost their job or found a better paying opportunity somewhere else. But they can’t sell their property because they are going to have a huge payoff. They owe more than the property is worth and they are sort of stuck and they may walk away from the property in order to start a new life somewhere else.

The third contributing factor is the conception on the part of borrowers of a paper-based, very personal mortgage relationship and the reality that we actually experience where you’re not going to know where your payments are ultimately landing when you make your mortgage payment. You’re not going to be able to go down to the bank and talk to a loan officer across the desk about working out a dislocation in the ability to make your mortgage payments. You’re going to have to deal with a 1-800 number and a servicer who doesn’t know you and doesn’t know anything about you. And it’s a very stressful situation for a lot of people.

A surprising number of people who probably could work out their short-term financial problems just don't want to do it. It's just too hard. And that's prompted the government and others to come up with programs to simplify the mortgage process and those programs have not been terribly successful.

The three factors really are kind of like the perfect storm. I think what we're seeing in the papers today is kind of common after an economic downturn. It's very human for people to want to lay blame somewhere; the nation is hurting. Who is to blame? Foreclosure has a literary content. You think of Snidley Whiplash and an evil heartless beast throwing people out on the street who are suffering from joblessness or illness. And because your servicer is not your friendly banker, the day you need somebody to help you the most, you don't find a human being but is a 1-800 number. It's very human to want to turn what's a dry, boring, unemotional process into the bad actor that's caused the situation.

Foreclosure has a somewhat upbeat outcome in which a title that was murky becomes clear and ready to sell the piece of property to someone else who is going to move into that house and light up the windows. The downside though is this impersonal machine feeling that has left a lot of people really bitter.

Can you describe the types of actions being taken on the part of consumers to stem foreclosure?

A lot of litigation is about to hit the courts in which borrowers who are admittedly not making their payments at all are attempting to halt the foreclosure process by challenging the documentation that the lender's agent produces as part of the process. And they may be successful in making those claims because of the disconnect between the kinds of electronic documentation that is out there and the paper-based

documentation that the legal regime envisions is supporting the mortgage foreclosure process.

What is the impact on the economy of all this?

The one thing I'm worried about is that the emotional backlash at what may turn out to be some deviations in the mortgage foreclosure system will really turn out to be the medicine that kills the patient. If we really end up with a total lockdown of our ability to process mortgage foreclosure, we'll have a lot of people who just aren't paying their mortgages either walking away or continuing to live in their homes without paying. So, the guy down the street who's making his payments is going to say 'What kind of fool am I? If this guy isn't making his payments and is still living there, I don't think I'm going to make my payments either.' This could have a tremendous effect on the rehabilitation of the construction market putting more people out of work. The problems with drawing capital to residential real property finance could become worse as investors are less and less sure about whether the mortgages we originate today are going to be enforceable on the day that they need them. Tax implications also are this dark cloud that sits over all that's happening. A lot of lawyers are going to make some money and their clients are going to be loveable and popular, but on the other hand you have to think about the amount of expense that the mortgage originators and servicers are going to have to incur in order to defend what may turn out to be largely meritless or overblown claims. That's capital that could have been invested in job-producing enterprises.

What would you like to see as an outcome of this crisis?

The Internet can be a great source of information. In thinking about this problem, I've looked at what kind of information might be available to

consumers who might be worried about whether they're going to be able to keep making payments on their mortgage or who to call if they want to take a couple of months off. What are my rights? And I'm happily surprised at the number of resources, some of which are hosted by the government and some of which are hosted by the major banks -- the Mortgage Banker's Association. It's relatively easy to get very good information if you are a consumer.

Another positive effect will be a much more intelligent and educated population. I seriously doubt, at least within my lifetime, that we will see the kinds of mortgage products that were available and selling five years ago in which people were borrowing 100 percent to purchase property and making payments that were barely covering interest and not amortizing any principal. They're highly speculative investments and they depend on a rising economy, and I think people are likely to be less interested in those products in the future. I think that people also are a little bit more careful about making the choice between home ownership and renting. As we move from a manufacturing-based economy to a knowledge-based economy, people are starting to think, 'I'm going to need some flexibility. I'm going to need to move where my job is going to be.' With crisis and suffering comes learning, and I hope that that's going to be the good outcome.

Will the laws change?

Probably not, and that's because mortgage [foreclosure](#) laws have not changed substantially since colonial times. The mortgage system changes that I've described have happened completely privately. MERS is a private company that offered a private service to accommodate a market that was interested in that. I think we're going to see some changes in the ways state and local governments are organized. We're going to see some changes in the way property tax liability is enforced as states and local government begin to grapple with their own debt problems. We may see

some changes in the way lawyers interact in the mortgage system.

With the robo-signing problem, my big concern with it is professional responsibility. There are lawyers who knew what they should have been doing and didn't do it and, in essence, lied to courts. I don't think there are damages to consumers; it's not a consumer problem in that it's a problem with the behavior of lawyers. Lawyers should have said, "I know our clients want us to do this, but we're just not going to do it."

Provided by Pennsylvania State University

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