

Foreclosure Fiasco

Robo-signing: Just the start of bigger problems

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By Tami Luhby, senior writer October 22, 2010: 7:38 AM ET

NEW YORK (CNNMoney.com) -- Robo-signing is just the tip of the iceberg.

The revelation that loan servicers were rapidly signing foreclosure documents without even reading them has uncovered a morass of serious paperwork problems.

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These issues could potentially prevent some foreclosure cases from proceeding and allow delinquent borrowers to stay in their homes indefinitely or wrangle settlements from their servicers.

"The whole robo-signing scandal has caused many judges to mistrust what servicers are saying in foreclosure petitions," said Patricia McCoy, a law professor at the University of Connecticut, who co-authored "The Subprime Virus." "Many judges will scrutinize filings more closely."

Several major banks have halted their foreclosure proceedings while

they review their process and paperwork. However, several, including Bank of America (BAC, Fortune 500), are **ready to continue the cases**, saying they are confident that their methods are sound.

But servicers could still hit some big paperwork potholes in answering what seems like the simplest of questions: Who owns the loan and who has the right to foreclose?

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First, a quick primer.

The debt taken out to buy a house is called a note, which is similar to an IOU. The mortgage pledges the property as collateral to pay off that debt.

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When mortgages are bundled together into securities that are sold to investors, the notes are then transferred to a trust. The investors in that trust become the owners of the note and the holders of the mortgage.

Now for the problems.

The note: One of the most important documents in this foreclosure fiasco is the note, which gives investors the right to take action against delinquent borrowers.

The problem is that many servicers don't know where that piece of paper is. Or, they didn't transfer it properly to the trust that holds the securitized mortgages.

This could prove to be a possibly fatal problem for financial institutions.

Until now, many courts were lax about requiring servicers and investors to produce the actual note. Judges allowed the financial institutions to simply provide affidavits saying the investors owned the note.

Now that the robo-signing scandal has surfaced, more judges want to see the note.

In those cases, "the banks will have a big problem," McCoy said. "I don't see how the foreclosure can go forward."

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The American Securitization Forum, an industry group, said that the standard industry methods of transferring ownership of mortgage loans to securitization trusts are sufficient and appropriate.

"These concerns are without merit and our membership is confident that these methods of transfer are sound and based on a well-established body of law governing a multi-trillion dollar secondary mortgage market," said Tom Deutsch, the forum's executive director.

The mortgage: The mortgage industry is slamming into a digital wall.

State law requires that mortgages be recorded in county offices so homeowners and the general public can see that there is a debt on the property.

But as mortgage securitizations began to boom in the 1990s, servicers sought to digitize and centralize the paperwork surrounding the bundling and selling of the loans. So they created the Mortgage Electronic Registration System, known as MERS, to serve as a repository to show both the owner of the note and the home that serves as its collateral.

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About 60% of the nation's residential mortgages are now recorded in MERS' name, according to Christopher Peterson, a law professor at the University of Utah who wrote a recent paper on the issue.

When a homeowner falls behind on payments, the company often brings the foreclosure suit to court on behalf of the servicer and the investors who own the debt.

This has become a problem because some judges are questioning MERS' right to represent the owners of the note.

"An increasing number of courts have begun taking a dim view of MERS-recorded mortgages and deeds of trust," wrote Peterson in his recent paper.

If judges don't recognize MERS' right to bring the foreclosure suit, they could throw out the case.

But this problem can be rectified. The trustee can bring suit on behalf of the investors, McCoy said, though this involves more time, paperwork and filing fees.

MERS said it has prevailed in previous legal challenges to its authority.

"The MERS process of tracking mortgages and holding title provides clarity, transparency and efficiency to the housing finance system," said R.K. Arnold, the company's chief executive. ■

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