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Iowa's unlikely duo behind the national mortgage settlement

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It's difficult to pick a single moment that launched Iowa's attorney general into the middle of negotiations between the U.S. government and the mortgage servicing industry, but here's a start: Early 2007, Des Moines.

The phones at the attorney general's office started ringing, and homeowners were on the line.

They owed more than their home was worth, sometimes by a wide margin. Refinancing — their only saving grace for the better part of a decade — was no longer possible.

Patrick Madigan, an assistant Iowa attorney general who had helped secure a $325 million settlement with subprime lender Ameriquest a year earlier, started calling banks that service mortgages to find out what was happening. He would eventually suggest loan modifications — a change in terms to lower the borrowers' monthly payments, arguing that a $240,000 loan on a $160,000 house would almost certainly default. Maybe, he said to servicers, you should work something out.

Now, the banks and attorneys general are close to working something out. A deal to wrestle as much as $25 billion from major banks could be announced as early as today.

No one's making guarantees, but the New York Times reported Wednesday night that an agreement had been reached. Final details were being negotiated, including how many states would participate and when the formal announcement would be made, according to the Times. The two biggest holdouts, California and New York, now plan to sign on, the Times said, citing officials familiar with the negotiations.

The deal has been criticized from left and right, and it has lacked the support of some of the largest states.

Back in 2007, when Madigan suggested loan modifications to some servicers, the idea went nowhere.

"It was like I was from Mars," Madigan told the Register. He thought servicers would want to modify, if only so they could avoid foreclosing and losing the entire loan, which didn't help anyone.

"I'm sitting there scratching my head, saying 'Why wouldn't you?' " Madigan said. "I'm just talking about math here. It's just math. It's not politics, it's not social engineering, this is just math. It became clear to me that we had a real problem here."

The problem, as it turned out, was a home lending bubble that sank the U.S. into its deepest recession since the Great Depression.

Since the fall of 2010, Iowa Attorney General Tom Miller has been the face of mortgage settlement talks followed closely by banks, investors and economists who realize the key to recovery is improvement in the housing market. The talks are a complex negotiation among attorneys general in all 50 states, the Justice Department and the largest banks that service mortgages — including Ally Financial, Bank of America, Citigroup, JPMorgan Chase and Wells Fargo, whose mortgage operations are based in West Des Moines.

Miller's office has been tracking the mortgage business for more than a decade, and no one in his office has been closer to the action than Madigan, a bespectacled 40-year-old Spirit Lake native who got his bachelor's and law degrees at the University of Iowa and left private law practice in Denver, Colo., in 2004 to come back home.

For legal leverage against the banks, the attorneys general have only the charge of robo-signing, a little-understood violation of civil procedure that would be a slam dunk in court.

In Missouri, another attorney general announced on Tuesday he will prosecute charges of forgery against a company accused of having employees sign foreclosures without a witness present.

But as Madigan's experience shows, robo-signing was a symptom of the mortgage industry's larger dysfunction. The industry was a runaway train that Miller, Madigan and their colleagues were unable to stop.

THE PROBLEM

Madigan identifies two persistent misconceptions about subprime lending. First, that the people borrowing money were buying homes they couldn't afford, and second, that the people making the loans worked for banks. Neither was true for the most part, Madigan said.

Example? Ameriquest, the largest subprime lender in America in 2004. The firm was not a bank. It would get a line of credit from an investment bank, make mortgage loans, then package the loans into mortgage-backed bonds to sell to investors. It didn't matter whether the loan was a good one, because the company never kept loans on its books.

Ameriquest and other subprime lenders persuaded existing homeowners with credit card debt, past medical bills or car loans to consolidate their debt into a new, larger mortgage, which would require higher monthly payments. Many of these borrowers didn't have the home equity to qualify for a mortgage with a larger principal, so Ameriquest would falsify financial statements or get appraisers to inflate the value of their home, Madigan said.

In January 2006, the attorneys general announced a $325 million deal with Ameriquest to settle charges its employees inflated appraisals and encouraged buyers to lie on loan applications. To Madigan, the settlement should have opened the world's eyes to the subprime lending problem. It did not.

The deal hobbled Ameriquest, but a slew of other nonbank mortgage companies kept doing the same thing. They didn't stop until the markets crashed in 2008 and the world realized that billions in U.S. mortgage debt would never be repaid.

"It was worse than we even thought," Madigan said.

MISSED CHANCES

In July 2007, Miller's office rented a conference hall near O'Hare airport in Chicago and sent letters to all 50 state attorneys general saying a foreclosure

crisis was coming, Madigan said.

A month later, Miller and attorneys general from 11 other states — notably Washington, Illinois, North Carolina, California, Texas and Arizona — formed what they called the State Foreclosure Prevention Working Group. They aimed to influence policy on foreclosures, not necessarily sue anyone.

In September and November 2007, the group held its first meetings with executives and lawyers from about nine mortgage servicers in Chicago to discuss processes and ways a foreclosure crisis might be forestalled.

"They were like, 'Everything's under control, we got it,' and it was the first of many missed opportunities by the mortgage servicing industry," Madigan said. The foreclosure group recommended, for instance, that servicers reduce the interest rates for borrowers to save loans.

The servicers had a different idea, Madigan said. Their standard procedure was to take all of a delinquent borrower's back payments, fees and interest, tack them onto the principal of the loan, and adjust the monthly payment on the mortgage — upward. A borrower who couldn't afford a $1,000 payment was now asked to pay $1,200 a month.

"Didn't work very well," Madigan said. "It sounds crazy, but this is where we started from."

Not all servicers were the same, though. Wells Fargo didn't resist modifying loans by reducing interest rates, said Theresa Schrettenbrunner, a spokeswoman for the company.

Wells was modifying loans before 2009, and has refinanced 3.3 million of them since the beginning of 2009, when the company started tracking the numbers closely. The company reduced principal on 50,000 mortgages in 2009, and from the beginning of 2009 to the end of 2011, the bank forgave principal worth $4.1 billion, Schrettenbrunner said.

ROBO-SIGNING

When defaults started rolling in, some servicers weren't ready. The industry had been built to create mortgages, not to handle a flood of delinquency.

Borrowers needed to be walked through their options, given a loan modification or foreclosed upon. These jobs all require work — hour-long phone conversations, boatloads of paperwork and packets going back and forth in the mail.

"Almost overnight you go from this situation of low defaults to a crushing amount of defaults, and the industry was completely unprepared," Madigan said.

Paperwork was lost, homeowners hung up on, calls not returned. The system wasn't designed for this, Madigan said. Servicers had to hire thousands to work in newly expanded "loss mitigation" departments.

Schrettenbrunner agrees with Madigan's analysis of the mortgage industry, that it was designed to create mortgages, not to handle a large number of defaults.

"No one was prepared for the volume of what was going to come in, and it was exacerbated by the fact that everyone was anticipating that the economy would turn around faster than it did," Schrettenbrunner said.

Wells Fargo Home Mortgage hired 10,000 people, more than doubling the number of employees in home preservation, the division's president, Mike Heid, told Congress in April 2010.

Despite all these problems, the attorneys general had no smoking gun to force a legal settlement with servicers. The banks had been overwhelmed by the sheer volume of loans defaulting, but that wasn't illegal, Madigan said. The attorneys general considered building a case against servicers under regulations prohibiting Unfair and Deceptive Acts or Practices, but a lawsuit would have been a stretch, Madigan said.

Then robo-signing came to light. Because foreclosed borrowers don't often show up for court proceedings, one of the keys to the foreclosure process is an affidavit that outlines basic facts of the foreclosure. The affidavit must be signed by a person at the mortgage servicing company who verifies its truth.

Many mortgage servicers took a short cut on this rule. Matigan said they would set a foot-high stack of affidavits in front of one employee, and that person would sign hundreds or even thousands of the documents. "Their hand would cramp because they were signing so many," he said.

For the attorneys general, it was a clear example of lawbreaking, and gave state prosecutors a chance to build a case.

"It got our foot in the door," Madigan said.

Wells Fargo didn't suspend foreclosures like other banks, but in October 2010 the bank said it had reviewed its foreclosure process and identified some instances where affidavit and notary processes "were not strictly adhered to."

RIGHTING THE SHIP

In October 2010, Miller announced he would lead an investigation into how companies were servicing mortgages and foreclosing on homeowners. Up to 40 states would participate, and they would seek a settlement with the banks.

As the investigation and negotiations dragged on, critics emerged. On the right, critics dismissed robo-signing as a procedural matter, a technicality, and said the investigation was a publicity stunt by the attorneys general.

On the left, critics said the attorneys general weren't doing enough to hold banks accountable. Locally, Hugh Espey, executive director of Iowa Citizens for Community Improvement, demanded criminal prosecutions and jail time for big bank executives who broke the law, mandatory principal reductions for millions of underwater borrowers, and tough fines and penalties of hundreds of billions of dollars.

The deal would release the five major servicers from liability on past home loan servicing and foreclosures.

In return, the banks would agree to pay for what Miller calls "substantial principal reductions" for homeowners who owe more money than their homes are worth and cash payments to some homeowners who have already gone through foreclosure, among other measures.

The deal doesn't prohibit prosecutors from suing banks over issues related to the packaging of home loans into mortgage-backed securities, which Madigan sees as the next step for state attorneys general.

"If there's a belief out there that this will be it for the state attorneys general,

that's a lie," Madigan said.