Statement of
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On Mortgage Servicing:
An Examination of the Role of Federal
Regulators In Settlement Negotiations
and the
Future of Mortgage Servicing Standards
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And
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Chairman Capito, Chairman Neugebauer, Ranking Members Maloney and Capuano, and members of the Subcommittees, thank you for the opportunity to testify on behalf of the Federal Deposit Insurance Corporation about the ongoing need to address and resolve challenges in mortgage servicing. The issues involved continue to impact our housing market, borrowers, and communities across the nation.

As you know, the FDIC is not the primary federal regulator for the largest financial institutions and loan servicers where major mortgage servicing and foreclosure deficiencies have been found. Nevertheless, we remain concerned about the potential ramifications of the deficiencies among the largest institutions, most of which we insure.

In April of this year, the primary federal regulators took an important first step in addressing servicer deficiencies by issuing enforcement orders related to foreclosure practices against 14 of the largest mortgage servicers. If implemented effectively, these orders will put servicers on a path to having the staffing, management, and operational controls necessary to work effectively with homeowners to fairly and efficiently resolve mortgage defaults.

However, the interagency review of foreclosure practices did not purport to examine loan modification practices or other potential errors in loan servicing. That is why the orders require a robust look-back review of prior foreclosures, and why the FDIC supports the state-federal collaboration between the State Attorneys General and the Department of Justice and several other federal agencies.

A comprehensive resolution for past servicing errors is essential to the recovery of the housing market and greater economy. Past servicer errors have given rise to a

multitude of actual and potential claims in litigation, placing a cloud over recent foreclosures and transfers of title. Market anxiety regarding the validity of prior actions dampens expectations regarding the housing market's recovery and discourages the return of private capital to the mortgage market. Furthermore, until servicers improve their practices and processes, some current homeowners will miss opportunities to avoid foreclosure, while others will remain able to game the system to delay the inevitable. Given the continuing fragility of the housing market, effective servicing is more important than ever.

In my testimony, I will begin with an overview of the FDIC's work and participation in addressing deficiencies and challenges in mortgage servicing and foreclosure practices. Second, I will discuss the impact of the continuing mortgage operation problems. Finally, I will highlight some key best practices and recommendations to address mortgage servicing.

The FDIC's Role in Addressing Mortgage Servicing

Poor mortgage servicing practices have both contributed to the creation of the housing crisis and acted as an impediment to its resolution. Resolution, however, will be challenging since the roots of today's mortgage servicing problems began before the financial crisis. For example, the traditional structure of third-party mortgage servicing fees created perverse incentives to automate critical servicing activities and cut costs at the expense of the accuracy and reliability of loan documents and information. When delinquencies began to rise, large servicers were ill-prepared to assist the millions of homeowners falling behind on their mortgages.

As early as 2007, the FDIC called for mortgage servicers to build programs and resources to restructure troubled mortgages on a broad scale. In 2008, the FDIC, as conservator for the failure of IndyMac, FSB, implemented a broad-based loan modification program.1 The lessons learned from this initial effort led us to propose a standardized loan modification program in 2009 for all loss-share partners.

In July 2010, the FDIC issued a securitization of $470 million of performing single-family mortgages. This transaction was the first single-family securitization in the history of the FDIC and the first time the FDIC sold assets in a securitization in the current financial crisis. The transaction included the alignment of the servicer's compensation with performance, independent third party oversight, and the ability to adapt servicing standards to changes in the performance of the underlying collateral and market conditions.

In the wake of news last fall of "robo-signing" at some of the largest mortgage servicers, the FDIC was invited by the primary regulators of 14 of the nation's largest servicers to participate in simultaneous or "horizontal" reviews of foreclosure practices. The findings of the interagency review clearly show that the largest mortgage servicers had significant deficiencies in numerous aspects of their foreclosure processing. These deficiencies included the filing of inaccurate affidavits and other documentation in

foreclosure proceedings, inadequate oversight of attorneys and other third parties involved in the foreclosure process, inadequate staffing and training of employees, and the failure to effectively coordinate the loan modification and foreclosure process to ensure effective communications to borrowers seeking to avoid foreclosures.

As a result, the primary federal regulators issued enforcement orders to all 14 of the reviewed institutions to improve foreclosure and servicing practices. The enforcement actions put these large servicers on a path to improving their management of the foreclosure and servicing processes, including the creation of a single point of contact for homeowners seeking assistance.

However, these consent orders do not fully identify and remedy past errors in mortgage-servicing operations of large institutions; in fact, the scope of the interagency review did not include a review of loan modification efforts of these servicers or the fees charged in the servicing process.[2] Much work remains to identify and correct past errors and to ensure that the servicing process functions effectively, efficiently, and fairly going forward.

As a consequence of the limited scope of the reviews, the consent orders require these servicers to retain independent, third party consultants to review past foreclosure actions and report the results of those reviews back to the regulators. It is essential that these reviews be credible. Therefore, these reviews must be independent and comprehensive in order to identify errors and to provide meaningful remedies to borrowers harmed in the process. In particular, it is critical for the period covered by the consent orders that the consultants review all foreclosures where the homeowner had applied for a loan modification, filed a complaint against the servicer, or was a member of the military.[3] In addition, given the importance of these reviews, an interagency team must conduct quality control samples of the consultants to ensure that the consultants are identifying issues consistently.

Finally, in addition to the work of the federal banking regulators, the FDIC continues to support the separate federal and state collaboration between the State Attorneys General and federal regulators led by the U.S. Department of Justice. The enforcement orders issued by the federal banking regulators complement, rather than preempt or impede, this ongoing collaboration.

Impact of Failure to Resolve Claims and Improve Servicing Operations

As mentioned earlier in my testimony, these servicing problems continue to present significant operational and litigation risk to servicers and originating banks. Servicers continue to encounter challenges to their legal standing to foreclose on individual mortgages as borrowers in approximately 90,000 foreclosure actions have taken steps to forestall foreclosure.

To put this in context, we are tracking the following foreclosure and mortgage-related cases: (1) borrower class actions – 67 pending class-action suits in 23 states

challenging foreclosures based upon robo-signing, defective assignments, reliance upon the Mortgage Electronic Registration Systems (MERS), or the misapplication of payments; (2) class action cases related to the Home Affordable Modification Program (HAMP) – 57 class actions in 25 states alleging impropriety in processing loan modifications regarding HAMP, as well as another 24 class actions in 18 states alleging misconduct under non-HAMP modification programs; (3) investor actions – 21 investor suits in 12 states alleging foreclosure and securitization misconduct that seek to "put back" defaulted loans to the loan originator and damages based upon failure to properly form the securitization trusts, misrepresentation regarding underwriting and other misrepresentations, robo-signing, or the use of MERS; and (4) Attorney General initiated suits – three suits brought by the Attorney General of Ohio against GMAC, and the Attorneys General of Nevada and Arizona against Countrywide and Bank of America. Additional investigations have just recently been undertaken. Absent a settlement with the state Attorneys General, more suits by state Attorneys General are likely to be filed.

Although no major judgments have been rendered to date, most of these cases are in the initial phase of litigation. If judgments are rendered for plaintiffs in these cases they could materially forestall the foreclosure process and create considerable uncertainty. Absent resolution to the mortgage servicing practices, claims and investigations regarding past practices will continue to proliferate, likely deferring the recovery of housing and mortgage markets.

In regards to mortgage servicing operation performance, evidence to-date demonstrates that servicers continue to struggle to effectively manage loss mitigation programs. The most recent evaluation of some of the largest servicers participating in HAMP underscores this point. Four of the ten largest servicers were found to need "substantial improvement" with the remainder found to need "moderate improvement."[4] Among the reasons for the poor grades is a high rate of error in calculating borrower income. For example, the Treasury Department found that, in nearly one-third (31 percent) of its files, JPMorgan Chase miscalculated borrower income by more than five percent.[5] An accurate calculation of income is crucial in determining eligibility for a modification and for calculating the new payment.

The housing market cannot heal and recover until mortgage servicing and foreclosure problems are resolved and systems are adequate to the task at hand going forward. Recent data clearly indicates that the housing market and homeowners continue to face major challenges. Loans in foreclosure are increasing in length of time to process – as of December 2010, the time spent in foreclosure was 8.8 months compared with 3.9 months as of year end 2007.[6] While servicers completed almost 1.8 million mortgage modifications in 2010, including 512,000 HAMP modifications and 1.24 million proprietary modifications,[7] the pace of modifications has declined.[8] Coupled with the impact of the market uncertainty regarding the impact of allegations of past errors, this current shadow inventory of non-performing loans in the foreclosure process hinders the clearing of the housing market.

Best Practices for Mortgage Servicing

Improving mortgage servicing will take both market reforms and regulatory reforms. It is essential that the marketplace alter the incentive structure of the mortgage securitizations to promote effective servicing of both performing and non-performing loans. The Federal Housing Finance Agency and the U.S. Department of Housing and Urban Development have begun a process to rethink compensation structures for mortgage servicing. As they do so, it will be important to consider the implication of these compensation structures on small or community bank servicers, who have not demonstrated shortcomings associated with the large bank servicers.

In addition, the FDIC's own experience suggests the following common-sense servicing practices should be incorporated in mortgage securitizations and other servicing operations:

- Grant servicers the authority, and provide compensation incentives, to mitigate losses on residential mortgages to address reasonably foreseeable defaults and to take other appropriate action to maximize the net present value of the mortgages for the benefit of all investors rather than the benefit of a particular class of investors.

- Require the servicer to disclose any ownership interest of the servicer or any affiliate of the servicer in other whole loans secured by the same real property that secures a loan included in the pool, and establish a pre-defined process to address any subordinate lien owned by the servicer or any affiliate of the servicer, if the first mortgage is seriously delinquent in order to eliminate any potential conflicts of interest.

- Establish a single point of contact to coordinate borrower communications, both oral and written, relating to collection, loss mitigation and foreclosure activities in a manner that ensures that communications are timely, effective and efficient and do not confuse a borrower or otherwise impair or impede loss mitigation activities.

- Provide sufficient staffing resources in the areas of loss mitigation, collateral management, collections, and foreclosure activity to ensure compliance with state and federal laws, regulations, policies, and servicing guidelines. Front-line employees working with borrowers, especially those who are candidates for modification, should receive sufficient training to ensure communications with borrowers are accurate and consistent.

- Maintain proper documentation. For example, a foreclosing entity should have possession of the original note and either a recorded mortgage or a recorded valid assignment of the mortgage before initiating the foreclosure process. The attestations in a foreclosure affidavit should comply with applicable local substantive, evidentiary, and procedural law and should contain: (a) facts

explaining the basis for the personal knowledge of the affiant (e.g., job title, job position, job duties, how an affiant became familiar with the facts in the affidavit, etc.); and (b) assurances the affiant has reviewed supporting documents and records to ensure all necessary and proper documents for foreclosure in that jurisdiction are included.

Through the collective efforts of state and federal regulators, servicers will be expected to implement these and other practices. It is important that these efforts be aligned and coordinated to the extent possible in order to avoid inconsistency. This will require extensive consultation and cooperation among state and federal regulators and law enforcement agencies.

Conclusion

The mortgage servicing system over the past few years has ill-served all parties involved – borrowers, lenders, neighborhoods, and investors – and has impaired the health and recovery of the housing and mortgage markets. Accordingly, the FDIC has encouraged the Financial Stability Oversight Council to continue its efforts in examining the potential financial systemic risks surrounding mortgage servicing and foreclosures. Addressing the problems that have been uncovered is critical to reducing the risk of a wider disruption to the foreclosure process, a larger cloud of uncertainty over the ownership rights and obligations of mortgage borrowers and investors, and further significant claims against firms central to the mortgage markets.

Looking forward, we continue to work with our colleagues to develop a set of national servicing standards that will apply the lessons learned from the current crisis in order to better align interests and, we expect, produce better outcomes in the future.

Thank you for the opportunity to testify on these issues before you today. I would be happy to respond to your questions.

1 http://www.fdic.gov/consumers/loans/loanmod/loanmodguide.html

2 As reported in the Interagency Review of Foreclosure Policies and Practices; (http://www.federalreserve.gov/BoardDocs/RptCongress/interagency_review_foreclosures_20110413.pdf at 2 (last visited July 5, 2011)), "Examiners may not have uncovered cases of misapplied payments or unreasonable fees, inappropriate force-placing of insurance, failure to consider adequately a borrower for a modification, or requiring a borrower to be delinquent to qualify for a loan modification."

3 http://www.justice.gov/opa/pr/2011/May/11-crt-683.html

4 “Making Home Affordable” monthly report for April.

5 Ibid, page 25.

6 FDIC analysis of Lender Processing Services data.

7 Statement of Faith Schwartz, Executive Director, HOPE NOW Alliance Before the Financial Services Committee Hearing on “Government Barriers to the Housing Recovery” p. 3. (Feb. 16, 2011).

8 FDIC analysis of HOPE NOW and Treasury data.

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