Statement of
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Federal Deposit Insurance Corporation
On
Problems in Mortgage Servicing from
Modification to Foreclosure, Part II; Committee
on
Banking, Housing, and Urban Affairs
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Chairman Dodd, Ranking Member Shelby and members of the Committee, thank you for requesting the views of the Federal Deposit Insurance Corporation on deficiencies in mortgage servicing and their broader potential impact on the financial system. It is unfortunate that problems in mortgage servicing and foreclosure prevention continue to require the scrutiny of this Committee. While "robo-signing" is the latest issue, this problem is symptomatic of persistent shortcomings in the foreclosure prevention efforts of our nation's largest mortgage servicers. As such, I believe that major changes are required to stabilize our housing markets and prevent unnecessary foreclosures.

The FDIC continues to review the mortgage servicing operations at banks we supervise and also those institutions that have purchased failed-bank loans under loss-share agreements with the FDIC. To date, our review has revealed no evidence that FDIC-supervised state-chartered banks directly engage in robo-signing, and it also appears that they have limited indirect exposure through third-party relationships with servicers that have engaged in this practice. However, we remain concerned about the ramifications of deficiencies in foreclosure documentation among the largest servicers, most of which we insure. We will continue to work with the primary supervisors of these servicers through our backup examination authority. In addition, we are coordinating our work with the State Attorneys General (AG) and the Financial Fraud Enforcement Task Force – a broad coalition of federal, state, and local law enforcement, regulatory, and investigatory agencies led by the Department of Justice – to support efforts for broad-based and consistent resolution of servicing issues.

The robo-signing and foreclosure documentation issues are the natural result of the misaligned incentives that pervade the entire mortgage process. For instance, the traditional, fixed level of compensation for loan servicing has been wholly inadequate to cover the expenses required to implement high-touch and specialized servicing on the scale needed in recent years. Misaligned incentives have led to significant underinvestment in the systems, processes, training, and staffing necessary to effectively implement foreclosure prevention programs. Similarly, many servicers have failed to update their foreclosure process to reflect the increased demand and need for loan modifications. As a result, some homeowners have received conflicting messages from their servicers and have missed opportunities to avoid foreclosure. The failure to effectively implement loan modification programs can not only harm individual homeowners, but the resulting unnecessary foreclosures put downward pressure on home prices.

As serious as these issues are, a complete foreclosure moratorium is ill-advised, as it would unduly prolong those foreclosures that are necessary and justified, and would slow the recovery of housing markets. The regrettable truth is that many of the properties currently in the foreclosure process are either vacant or occupied by borrowers who simply cannot make even a significantly reduced payment and have been in arrears for an extended time.

My hope is that the newly established Financial Stability Oversight Council (FSOC) will take the lead in addressing the latest issues of foreclosure documentation deficiencies and proposing a sensible and broad-based approach to reforming mortgage servicer processes, promoting sustainable loan modifications and restoring legal certainty to the foreclosure process where it is appropriate and necessary.

In my testimony, I will begin with some background on the robo-signing and related foreclosure documentation problems and connect theses issues to other deficiencies in the mortgage servicing process. Second, I will discuss the FDIC's efforts to address identified servicing problems within our limited jurisdiction. Finally, I will discuss the central role that I believe the FSOC can play in facilitating broad agreements among major stakeholder groups that can help resolve some of these issues.

I. Robo-Signing and Foreclosure Documentation Problems and Shortfalls in Mortgage Servicing

The FDIC is concerned about two related, but separate, problems relating to foreclosure documentation. The first is referred to as "robo-signing," or the use of highly-automated processes by some large servicers to generate affidavits in the foreclosure process without the affiant having reviewed facts contained in the affidavit or having the affiant's signature witnessed in accordance with State laws. Recent depositions of individuals involved in robo-signing have led to allegations of fraud based on contentions that these individuals signed thousands of documents without knowledge or verification of the information contained in the filed affidavits.

The second problem involves demonstrating the chain of title required to foreclose. Some servicers have not been able to establish their legal standing to foreclose because, under current industry practices, they may not be in possession of the necessary documentation required under state law. In many cases, a servicer is acting on behalf of a trustee of a pool of mortgages that have been securitized and sold to investors in a mortgage-backed securities (MBS) transaction. In MBS transactions, the promissory note and mortgage signed by the borrowers are held by a custodian on behalf of the securitization investors.

In many cases today, however, the mortgage held by the custodian indicates that legal title to the mortgage has been assigned from the original lender to the Mortgage Electronic Registration System (MERS), a system encompassing some 31 million active mortgage loans that was designed to facilitate the transfer of mortgage claims in the securitization process. Securitization often led to multiple transfers of the mortgage through MERS. Many of the issues raised about the authority of servicers to foreclose are a product of potential defects in these transfers and the requirements for proof of the servicer's authority. Where MERS is involved, foreclosures have been initiated either by MERS, as the legal holder of the lien, or by the servicer. In both cases, the foreclosing party must show that it has possession of the note and that its right to foreclose on the mortgage complies with state law.

Robo-signing and chain of title issues may create contingent liabilities for mortgage servicers. Investors who contend that servicers have not fulfilled their servicing responsibilities under the pooling and servicing agreements (PSAs) argue that they have grounds to reassign servicing rights. In addition, concerns have been raised by investors as to whether the transfer of loan documentation in some private MBS securitization trusts fully conform to the requirements established under applicable trust law and the PSAs governing these transactions. While the legal challenges under the representations and warranties trust requirements remain in their early stages, they could, if successful, result in the "putback" of large volumes of defaulted mortgages from securitization trusts to the originating institutions. The FDIC has been working with the FRB and the Comptroller of the Currency (OCC), in our backup capacity, to gather information from the large servicers to evaluate the potential financial impact of these adverse outcomes.

Long-Standing Weaknesses in Third-Party Mortgage Servicing

The weaknesses that have been identified in mortgage servicing practices during the mortgage crisis are a byproduct of both rapid growth in the number of problem loans and a compensation structure that is not well designed to deal with these loans. As recently as 2005, when average U.S. homes prices were still rising rapidly, fewer than 800,000 mortgage loans entered foreclosure on an annual basis.1 By 2009, the annual total had more than tripled to over 2.8 million, and foreclosures through the first three quarters of 2010 are running at an annualized pace of more than 2.5 million. Moreover, the proportion of foreclosure proceedings actually resulting in the repossession and sale of collateral appears to have increased even more rapidly over this period in some of the hardest-hit markets. Data published by the Federal Housing Finance Agency show that the percent of total homes sales in California resulting from foreclosure-related distressed sales increased more than eight-fold, to over 40 percent of all sales, between 2006 and 2008.2

The share of U.S. mortgage loans held or securitized by the government-sponsored enterprises (GSEs) and private issuers of asset-backed securities has doubled over the past 25 years to represent fully two-thirds of the value of all mortgages currently outstanding.3 One effect of this growth in securitization has been parallel growth in third-party mortgage servicing under PSA agreements. By definition, a large proportion of the mortgages sold or securitized end up serviced under PSAs.

The traditional structure of third-party mortgage servicing fees, put in place well before this crisis, has created perverse incentives to automate critical servicing activities and cut costs at the expense of the accuracy, reliability and currency of loan documents and information. Prior to the 1980s, the typical GSE mortgage pool paid a servicing fee of 37.5 basis points annually, or .375 percent of the outstanding principal balance of the mortgage pool. Since the 1980s, the typical servicing fee for prime loans has been 25 basis points. When Alt-A and subprime mortgages began to be securitized by private issuers in the late 1990s, the standard servicing fees for those loans were set higher, typically at 37.5 basis points for Alt-A loans and 50 basis points for subprime loans.

While this fee structure provided a steady profit stream for servicers when the number of defaulted loans remained low, costs rose dramatically with the rise in mortgage defaults in the latter half of the last decade. As a result, some mortgage servicers began running operating losses on their servicing portfolios. One result of a compensation structure that did not account for the rise in problem loans was a built-in financial incentive to minimize the investment in back office processes necessary to support both foreclosure and modification. The other result was consolidation in the servicing industry. The market share of the top 5 mortgage servicers has nearly doubled since 2000, from 32 percent to almost 60 percent.4 The purpose and effect of consolidation is to cut costs and achieve economies of scale, but also to increase automation.

Most PSAs allow for both foreclosure and modification as a remedy to default. But servicers have continuously been behind the curve in pursuing modification as an alternative to foreclosure. A survey of 13 mortgage servicers conducted by the State Foreclosure Prevention Working Group shows that the annual percent of all past due mortgages that are being modified has risen from just over 2 percent in late 2007 to a level just under 10 percent as of late 2009.5 At the same time, the percentage of past due loans entering foreclosure each year has also steadily risen over this same time period, from 21 percent to 32 percent.

One example of the lack of focus on loss mitigation strategies is the uncoordinated manner in which many servicers have pursued modification and foreclosure at the same time. Under such a "dual-track" process, borrowers may be attempting to file the documentation needed to establish their qualifications for modification and waiting for a favorable response from the servicer, even while that servicer is at the same time executing the paperwork necessary to foreclose on the property. While in some cases it may be reasonable to begin conducting preliminary filings for seriously past due loans in states with long foreclosure timelines, it is vitally important that the modification process be brought to conclusion before a foreclosure sale is scheduled. Failure to coordinate the foreclosure process with the modification process risks confusing and frustrating homeowners and could result in unnecessary foreclosures. As described in the concluding section, we recommend that servicers establish a single point of contact that can work with every distressed borrower and coordinate all activities taken by the servicer with regard to that particular case.

II. FDIC Efforts to Address Problems in Mortgage Servicing and Foreclosure Prevention

Since the early stages of the mortgage crisis, the FDIC has made a concerted effort to promote the early modification of problem mortgages as a first alternative that can spare investors the high losses associated with foreclosure, assist families experiencing acute financial distress, and help to stabilize housing markets where distressed sales have resulted in a lowering of home prices in a self-reinforcing cycle.

In 2007, when the dimensions of the subprime mortgage problem were just becoming widely known, I advocated in speeches, testimony and opinion articles that servicers not only had the right to carry out modifications that would protect subprime borrowers from unaffordable interest-rate resets, but that doing so would often benefit investors by enabling them to avoid foreclosure costs that could run as high as 40 percent or more of the value of the collateral. In addition, the FDIC, along with other federal regulators jointly hosted a series of roundtables on the issues surrounding subprime mortgage securitizations to facilitate a better understanding of problems and identify workable solutions for rising delinquencies and defaults, including alternatives to foreclosure.

More recently, the FDIC has been actively involved both in investigating and addressing robo-signing and documentation issues at insured depository institutions and their affiliates, ensuring that its own loss-share partners are employing best practices in their servicing operations, and implementing reforms that will better align the financial incentives of servicers in future securitization deals.

Supervisory Actions

The FDIC is exercising both its primary and backup authorities to actively address the issues that have emerged regarding banks' foreclosure and "robo-signing" practices. The FDIC is the primary federal supervisor for nearly 5,000 state-chartered insured institutions, where we monitor compliance with safety and soundness and consumer protection requirements and pursue enforcement actions to address violations of law. While the FDIC is not the primary federal regulator for the major loan servicers, our examiners are working on-site under our backup authority as part of an interagency horizontal review team at 12 of the 14 major mortgage servicers along with their primary federal regulators. This interagency review is also evaluating the roles played by MERS and Lender Processing Services, a large data processor used by many mortgage servicers.

The FDIC is committed to active participation in horizontal reviews and other interagency efforts so we are able to have a comprehensive picture of the underlying causes of these problems and the lessons to be learned. The onsite reviews are finding that mortgage servicers display varying degrees of performance and quality controls. Program and operational deficiencies may be correctable in the normal course of business for some, while others may need more rigorous system changes. The level and adequacy of documentation also varies widely among servicers. Where chain of title is not sufficiently documented, servicers are being required to make changes to their processes and procedures. In addition, some servicers need to strengthen audit, third-party arrangements, and loss mitigation programs to cure lapses in operations. However, we do not believe that servicers should wait for the conclusion of the interagency effort to begin addressing known weaknesses in internal controls and risk management. Corrective actions on problems identified during a servicer's own review or the examiners' review should be addressed as soon as possible. We expect each servicer to properly review loan documents prior to initiating or conducting any foreclosure proceedings, to adhere to applicable laws and regulations, and to maintain appropriate policies, procedures and documentation. If necessary, the FDIC will encourage the use of formal or informal corrective programs to ensure timely action is taken.

Actions Taken as Receiver for Failed Institutions

In addition to our supervisory efforts, the FDIC is looking at the servicing practices of institutions acquiring failed institutions under loss-share agreements. To date there are $159.8 billion in loans and securities involved in FDIC loss share agreements, of which $56.7 billion (36 percent) are single family loans. However, the proportion of mortgage loans held by acquiring institutions that are covered by loss share agreements is in some cases very small. For example, at One West Bank, the successor to Indy Mac, only 8 percent of mortgages serviced fall under the FDIC loss share agreement.

An institution that acquires a single-family loss-share portfolio is required to implement a loan modification program, and also is required to consider borrowers for a loan modification and other loss mitigation alternatives prior to foreclosure. These requirements minimize the FDIC's loss share costs. The FDIC monitors the loss-share agreements through monthly and quarterly reporting by the acquiring bank and semi-annual reviews of the acquiring bank. The FDIC has the right to deny or recover any loss share claim where the acquiring institution is unable to verify that a qualifying borrower was considered for loan modification and that the least costly loss mitigation alternative was pursued.

In connection with the recent foreclosure robo-signing revelations, the FDIC contacted all of its loss-share partners. All partners certified that they currently comply with all state and federal foreclosure requirements. We are in the process of conducting a Loan Servicing Oversight audit of all loss-share partners with high volumes of single-family residential mortgage loans and foreclosures. The FDIC will deny any loss-share payments or seek reimbursement for any foreclosures not compliant with state laws or not fully remediated, including noncompliance with the loss-share agreements and loan modification requirements.

Regulatory Actions to Reform Mortgage Securitization

We also are taking steps to restore market discipline to our mortgage finance system by doing what we can to reform the securitization process. In July of this year, the FDIC sponsored its own securitization of $471 million of single-family mortgages. In our transaction, we addressed many of the deficiencies in existing securitizations. First, we ensured that the servicer will make every effort to work with borrowers in default, or where default is reasonably foreseeable. Second, the servicing arrangements in these structured loan transactions have been designed to address shortcomings in the traditional flat-rate structures for mortgage servicing fees. Our securitization pays a base dollar amount per loan per year, regardless of changes in the outstanding balance of that loan. In addition, the servicing fee is increased in the event the loan becomes more complex to service by falling past due or entering modification or foreclosure. This fee structure is much less likely to create incentives to slash costs and rely excessively on automated or substandard processes to wring a profit out of a troubled servicing portfolio. Third, we provided for independent, third party oversight by a Master Servicer. The Master Servicer monitors the Servicer's overall performance and evaluates the effectiveness of the Servicer's modification and loss mitigation strategies. And, fourth, we provided for the ability of the FDIC, as transaction sponsor, the Servicer and the Master Servicer to agree on adapting the servicing guidelines and protocols to unanticipated and significant changes in future market conditions.

The FDIC has also recently taken the initiative to establish standards for risk retention and other securitization practices by updating its rules for safe harbor protection with regard to the sale treatment of securitized assets in failed bank receiverships. Our final rule, approved in September, establishes standards for disclosure, loan quality, loan documentation, and the oversight of servicers. It will create a comprehensive set of incentives to assure that loans are made and managed in a way that achieves sustainable lending and maximizes value for all investors. In addition, the rule is fully consistent with the mandate under the Dodd-Frank Act to apply a 5 percent risk-retention requirement on all but the most conservatively underwritten loans when they are securitized.

We are currently working on an interagency basis to develop the Dodd-Frank Act standards for risk retention across several asset classes, including requirements for low-risk "Qualifying Residential Mortgages," or QRMs, that will be exempt from risk retention. These rules allow us to establish a gold standard for securitization to encourage high-quality mortgages that are sustainable for the long term. This rulemaking process also provides a unique opportunity to better align the incentives of servicers with those of mortgage pool investors.

We believe that the QRM rules should authorize servicers to use best practices in mitigating losses through modification, require compensation structures that promote modifications, and direct servicers to act for the benefit of all investors. We also believe that the QRM rules should require servicers to disclose any ownership interest in other whole loans secured by the same real property, and to have in place processes to deal with any potential conflicts. Some conflicts arise from so-called "tranche warfare" that reflects the differing financial interests among the holders of various mortgage bond tranches. For example, an investor holding the residual tranche typically stands to benefit from a loan modification that prevents default. Conversely, the higher rated tranches might be better off if a servicer foreclosed on the property forcing losses to be realized at the expense of the residual tranche. A second type of conflict potentially arises when a single company services a first mortgage for an investor pool and the second mortgage for a different party, or for itself. Serious conflicts such as this must be addressed if we are to achieve meaningful long-term reform of the securitization process.

Therefore, the FDIC believes it would be extremely helpful if the definition of a QRM include servicing requirements that, among other things:

- grant servicers the authority and provide servicers compensation incentives to mitigate losses on residential mortgages by taking appropriate action to maximize the net present value of the mortgages for the benefit of all investors rather than the benefit of any particular class of investors;

- establish a pre-defined process to address any subordinate lien owned by the servicer or any affiliate of the servicers; and

- require disclosure by the servicer of 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.

Risk retention rules under the Dodd-Frank Act should also create financial incentives that promote effective loan servicing. The best way to accomplish this is to require issuers – particularly those who also are servicers – to retain an interest in the mortgage pool that is directly proportional to the value of the pool as a whole. Frequently referred to as a "vertical slice," this form of risk retention would take the form of a small, proportional share of every senior and subordinate tranche in the securitization, creating a combined financial interest that is not unduly tilted toward either senior or subordinate bondholders.

III. The FSOC Should Play a Central Role in Developing Solutions

What started a few months ago as technical documentation issues in the foreclosure process has grown into something more serious and potentially damaging to the nation's housing recovery and to some of our largest institutions. First, a transparent, functioning foreclosure process is unfortunately necessary to the recovery of our housing market and our economy. Second, the mortgage documentation problems cast a cloud of uncertainty over the ownership rights and obligations of mortgage borrowers and investors. Further, there are numerous private parties and government entities that may have significant claims against firms central to the mortgage markets.

While we do not see immediate systemic risk, the clear potential is there. The FSOC was established under the Dodd-Frank Act to deal with just this type of emerging risk.

Its mandate includes identifying risks to financial stability and potential gaps in regulation and making recommendations for primary regulators and other policymakers to take action to mitigate those risks. As such, these issues represent just the type of problem the FSOC was designed to address. In addition, the difficulties that have been experienced to date in coordinating a government policy response speak to the need for central role by the FSOC in negotiating workable solutions with the major parties that have a stake in the outcome.

The FSOC is in a unique position to provide needed clarity to the market by coordinating consistent interpretations of what standards should be applied to establishing the chain of title for mortgage loans and recognizing the true sale of mortgage loans in establishing private securitization trusts. The constituent agencies that make up the FSOC also have their own authorities that can be used to provide clarity of this type. Examples include rulings on standards that determine the tax-exempt status of mortgage trusts and standards for the recognition of true sale in a failed bank receivership, which the FDIC recently updated in its safe harbor regulation.

We need broad agreements between representatives of the major stakeholders affected by this issue so that the uncertainties associated with this issue can be resolved as quickly as possible. Outlined below are some of the principles I believe should be part of any broad agreement among the stakeholders to this issue.

Establish a single point of contact for struggling homeowners. Servicers should identify a single person to work with homeowners once it becomes evident the homeowner is in distress. This single point of contact must be appropriately authorized to provide current, accurate information about the status of the borrower's loan or loan modification application, as well as provide a sign-off that all loan modification efforts have failed before a foreclosure sale. This will go a long way towards eliminating the conflicts and miscommunications between loan modifications and foreclosures in today's dual-track system and will provide borrowers assurance that their application for modification is being considered in good faith.
Expand and streamline private loan modification efforts to increase the number of successful modifications. To accomplish this end, servicers should be required to intervene with troubled borrowers from the earliest stages of delinquency to increase the likelihood of success in foreclosure mitigation. Modifications under such programs should significantly reduce the monthly payment through reductions in the interest rate and principal balance, as needed, to make the mortgage affordable over the long term. Analysis of modifications undertaken in the FDIC program at Indy Mac Federal Bank has shown that modifying loans when they are in the early stages of delinquency and significantly reducing the monthly payment are both factors that promote sustainable modifications that perform well over time. In exchange for the creation of highly-simplified modification programs, mortgage servicers should have a "safe harbor" that would give them assurance that their claims will be recognized if foreclosure becomes unavoidable. In addition, streamlined modification programs should be recognized as a best practice in adjudicating disputes with mortgage investors.

Invest appropriate resources to maintain adequate numbers of well-trained staff. Broad agreements should require servicers to hire and train sufficient numbers of staff to professionally process applications for loan modifications. Further, servicers should be required to improve information systems to help manage and support the workload associated with loan modifications.
Strengthen quality control processes related to foreclosure and loan servicing activities. Some servicers need to make fundamental changes to their practices and programs to fulfill their responsibilities and satisfy their legal obligations. Lax standards of care and failure to follow longstanding legal requirements cannot be tolerated. Regulators must vigorously exercise their supervisory tools to ensure that mortgage servicers operate to high standards. Servicers need to institute strong controls to address defective practices and enhance programs to regain integrity of their operations. Where severe deficiencies are found, the servicers should be required to have independent third-party monitors evaluate their activities to ensure that process changes are fully implemented and effective. Servicers must also fully evaluate and account for their risks relating to their servicing activities, including any costs stemming from weaknesses in their operations.
Resolve the challenges created by second liens. Since the early stages of the mortgage crisis, second liens have been an obstacle to effective alternatives to foreclosure, including loan modification and short sales. We must tackle the second lien issue head on. One option is to require servicers to take a meaningful write-down of any second lien if a first mortgage loan is modified or approved for a short sale. All of the stakeholders must be willing to compromise if we are to find solutions to the foreclosure problem and lay the foundation for a recovery in our housing markets.
Conclusion

We must restore integrity to the mortgage servicing system. We need a mandate for dramatically simplified loan modifications so that unnecessary foreclosures can be avoided. Servicers need to establish a single point of contact to coordinate their communication with distressed borrowers. They also need to invest appropriate resources and strengthen quality control processes related to loan modification and foreclosure. We must finally tackle the second liens head on, by requiring servicers to impose meaningful write-downs on second lien holders when a first mortgage is modified or approved for a short sale.

This is the time for all parties to come together and arrive at broad agreements that will reduce uncertainty and lay the foundation for long-term stability in our mortgage and housing markets. The FSOC has a unique role to play in addressing the situation and can provide needed clarity on issues such as standards for recognizing true sale in securitization trusts.

Again, thank you for the opportunity to testify on this important issue. I look forward to your questions.

1 FDIC estimate based on data from the Mortgage Bankers Association data and the American Housing Survey.

2 "The Impact of Distressed Sales on Repeat-Transactions House Price Indexes," FHFA, May 27, 2009, http://www.fhfa.gov/webfiles/2916/researchpaper_distress%5B1%5D.pdf

3 Source: Federal Reserve Board, Flow of Funds, Table L.218.

4 Source: Inside Mortgage Finance.

5 Analysis of Mortgage Servicing Performance," Data Report No. 4, January 2010, State Foreclosure Prevention Working Group, http://www.ohioattorneygeneral.gov/ForeclosureReportJan2010.

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