Opening Address by
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Today's summit takes place at a critical time for the mortgage industry. The housing bust and the financial crisis, the effects of which remain very much in evidence, arose from a historic breakdown in U.S. mortgage markets. Emergency policies enacted at the height of the crisis have helped to stabilize the financial system and plant the seeds of recovery. FDIC-insured institutions have recognized more than half a trillion dollars in losses thus far, and they're not finished yet.

We are 18 months into an economic recovery that has picked up momentum in recent months and is beginning to create private-sector jobs. Hundreds of thousands of mortgage modifications have been completed, reducing foreclosures enough at the margin to help stabilize our housing markets. Yet mortgage markets remain deeply mired in a cycle of credit distress, securitization markets remain frozen, and now chaos in mortgage servicing and foreclosure is introducing a dangerous new uncertainty into this fragile market.

Throughout the mortgage crisis, from the earliest days of the subprime credit problem to the current robo-signing controversy, the most persistent adversary has been inertia in the servicing and foreclosure practices applied to problem loans. Prompt action to modify unaffordable subprime loans in 2007 could have helped to limit the crisis in its early stages. Instead, we saw one and a half million foreclosures that year, contributing to a decline in average home prices that eventually totaled about one-third. Mortgage servicers have remained behind the curve as the problem has evolved to include underwater mortgages and, now, foreclosure practices that sow confusion and fear on the part of homeowners and fail to fully conform to state and local legal requirements.

I would like to talk with you this morning about the serious nature of the mortgage servicing problem, the factors that created it, and the urgent need to act in concert now to address the current crisis and prevent such a problem from recurring in the future.

The Economics of Mortgage Servicing

As you well understand, the development of our mortgage market over the past few decades has been marked by the unbundling of the mortgage-lending process. Traditionally, the originator, lender, and servicer of a mortgage were one in the same.

With the advent of mortgage securitization, these responsibilities were divided among different parties and gave rise to specialist entities. When it works well, there are great benefits and efficiencies to be gained in this arrangement. Capital from around the world finds its way to homebuyers, reducing interest rates throughout the mortgage market. Specialization, scale, and automation in originating and servicing mortgages have dramatically cut expenses.

But the mortgage crisis also has revealed a fatal flaw in this unbundling of the mortgage-lending process: the misalignment of incentives between the various parties and specialists involved. We have dramatically underappreciated the potential for what economists call "principal-agent" problems arising from misaligned incentives. Mortgage brokers and lenders had little or no incentive to worry about whether borrowers could repay their mortgages. Neither did the investment banks putting together securitizations and CDOs.

Just as misaligned incentives drove the origination of trillions of dollars of unaffordable subprime and Alt-A mortgages that triggered the crisis, the process deficiencies we now see in mortgage servicing show that its basic business model and compensation structure are also fundamentally flawed and in urgent need of reform. Paying servicers a low fixed-fee structure based on volume may be sufficient to ensure that payments are processed and accounts are settled during good times, when most mortgages are performing. But it does not provide sufficient incentives to effectively manage large volumes of problem loans during a period of market distress.

This compensation structure drove automation, cost cutting and consolidation in the servicing industry in the years leading up to the crisis, which further complicated the ability to responsibly manage distressed loans. The market share of the top five mortgage servicers has nearly doubled since 2000, from 32 percent to almost 60 percent. When mortgage defaults began to mount in 2007 and 2008, third-party servicers were left without the expertise, the contractual flexibility, the financial incentives, or the resources they needed to engage in effective loss-mitigation programs.

While the public and investors have increasingly come to understand that loss mitigation is an essential tool for stabilizing the housing market and minimizing losses, many servicers have refused to commit the resources necessary to pursue it in a coordinated and efficient manner. Among the paradoxes of this problem is that research consistently shows that servicing practices are critically important to mortgage performance and risk.

Researchers at the Federal Reserve Bank of New York have recognized that: "The servicer can have a significantly positive or negative effect on the losses realized from the mortgage pool."1 And Fitch Ratings has concluded that: "The effectiveness of a servicer's default management practices is a key determinant in the ultimate performance of any portfolio."2

Addressing Today's Foreclosure Crisis

If we are to successfully respond to today's foreclosure crisis, all parties involved must recognize some important principles. Loss mitigation is not just a socially desirable practice to preserve homeownership where possible. It is wholly consistent with safe and sound banking and has macroeconomic consequences. Fair dealing with borrowers and adherence to the law are not optional. They must be viewed as mandatory if our servicing and foreclosure process is to function in the interest of all parties concerned.

The bottom line is that we need more modifications and fewer foreclosures. When foreclosure is unavoidable, we need it to be done with all fairness to the borrower and in accordance with the law. Only by committing to these principles can we begin to move past the foreclosure crisis and rebuild confidence in our housing and mortgage markets.

First, in order to remedy failures endemic to the largest mortgage servicers, I hope to see enforceable requirements that will significantly improve opportunities for homeowners to avoid foreclosure. The first such requirement is that servicers must provide a single point of contact to assist troubled borrowers throughout the loss-mitigation and foreclosure process. In order to prevent costly miscommunication, this person - and it does need to be a real person - must be well trained and adequately compensated. This person must have access to all relevant information and be authorized to put a hold on any foreclosure proceeding while loss-mitigation efforts remain ongoing.

Second, servicers must commit to adequate staffing and training for effective loss mitigation. There is no question that the fee structure currently in place for most servicers provides insufficient resources for effective loss mitigation and has led servicers to cut corners in their legal and administrative processes. While we cannot fix these incentives after the fact, we should insist that servicers do the right thing now and devote a level of resources that is commensurate to the scale of the problem. We need to establish industry benchmarks - based on a maximum number of delinquent loans per representative - and insist on a minimum standard of training to ensure that staff are up-to-date on the latest loss-mitigation programs.

In addition, to expedite the loan modification process and help clear the market, we should look for opportunities to greatly simplify loan-modification offers in exchange for waivers of claims.

A broad agreement must also deal head-on with the second-lien problem. Throughout the mortgage crisis, the competing interests of first and second lien holders have been a source of conflict for servicers. Early in the crisis, many servicers were unwilling to modify first mortgages unless second-liens were written down or extinguished. More recently, investors in first mortgages have complained that they were accepting losses without meaningful participation of second lien holders. This complaint is especially pronounced when the servicer of the first mortgage is also the owner of the second.

While big banks and big investors can handle themselves, the uncertainty around the treatment of second liens has reduced opportunities for effective foreclosure prevention. As part of any resolution of claims regarding large servicers, a fixed formula should be established to govern the treatment of first and second mortgages when the servicer or its affiliate owns the second lien.

At a minimum, this formula should require that the subordinate lien be reduced pro-rata to any change in the first mortgage. Any credible settlement should provide for independent monitoring of servicer compliance to supplement oversight by federal and state regulators.

We also need independent review of loss-mitigation denials. Borrowers should have the right to appeal any adverse denial of a loan modification request to an independent party who has the proper information to conduct an immediate review and the power to correct erroneous determinations. Weak practices associated with title documentation must also cease. This means that banks and other servicers must: foreclose in their own names instead of allowing MERS to foreclose; and provide complete chain of title and note transfer history in the notice of default.

And while the financial incentives that govern servicers are, in many cases, embedded in contracts that cannot be altered, some practices and incentives in the process can be addressed now. For example, a broad settlement could eliminate incentive payments to law firms for speedy foreclosures, as well as the use of lost-note affidavits, except where the servicer has made good faith efforts to obtain the note. Most importantly, such a settlement should prohibit foreclosure sales when a loan is in loss mitigation, except in specific situations where delay would disadvantage the investor, violate existing contracts, or reward a borrower acting in bad faith.

Finally, we need to provide remedies for borrowers harmed by past practices. A foreclosure claims commission, modeled on the BP or 9/11 claims commissions, could be set up and funded by servicers to address complaints of homeowners who have wrongly suffered foreclosure through servicer errors.

Many in the servicing industry will resist a settlement such as this because it would impose much of the immediate financial cost on the major servicers themselves. But this would be short-sighted. The fact is, every time servicers have delayed needed changes to minimize their short-term costs, they have seen a deepening of the crisis that has cost them - and the rest of us - even more.

It is time for government and industry to reach an agreement that will finally bring closure to the crisis and pave the way for a lasting recovery in our housing and mortgage markets.

Preventing Future Misalignment of Servicing Incentives

In addition to holding servicers accountable for past behavior, we cannot restore long-term confidence in the securitization process unless we address the misalignment of servicing incentives that contributed to the present crisis. That is why regulators must use both their existing authorities and the new authorities granted under the Dodd-Frank Act to establish standards for future securitizations to help assure that as the private securitization market returns, incentives for loss mitigation in mortgage servicing are appropriately aligned.

The FDIC took a significant step in this regard when we updated our 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 includes incentives to assure that loans are made and managed in a way that achieves sustainable lending and maximizes value for all investors.

We know they will work. Incentive structures to promote timely and effective loss mitigation and loan modification were included in the FDIC's own securitization of residential mortgages in 2010.

We are now working on an interagency basis to develop the Dodd-Frank 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. for instance, the definition of a QRM could require servicing agreements that, among other things: Provide for the legal authority and require financial incentives for servicers to take actions that maximize the value of the entire mortgage pool rather than the claims of any one class of investors, including modifying loans where default is reasonably foreseeable; Require disclosure in cases where the servicer manages both the first and second mortgages, and establish a pre-defined process to address conflicts between these positions; Restrict the commingling of mortgagors' payments with its own assets; Require an independent master servicer to provide oversight and resolve disputes regarding the servicers' actions; And cap servicer principal and interest advances and provide for a means other than foreclosure for servicers to be repaid.

Because effective servicing of problem loans is so important to preserving value for investors and preventing systemic instability, it is imperative that the Dodd-Frank risk-retention rules also create financial incentives that promote effective loan servicing. The FSOC agencies writing the risk-retention rule have been charged with establishing securitization standards that will align incentives in the securitization process. This task cannot be considered complete unless they have addressed the misaligned incentives in servicing that created the present foreclosure crisis.

And by better aligning economic incentives in securitization standards, we will not only address key safety and soundness and investor concerns. We also will provide a stronger foundation for the new Consumer Financial Protection Bureau to improve consumer protections for troubled borrowers in all products and by all servicers, when they obtain authority to write rules later this year.

Conclusion

As I mentioned at the outset, we stand today at a critical phase in the mortgage crisis. Through the effort and determination of so many in the private sector and the public sector, we have sown the seeds of recovery in our economy, our financial markets and our housing markets. But we are not out of the woods yet.

If we fail to act decisively now to deal with the foreclosure crisis, we risk triggering a double-dip in U.S. housing markets that could roll back the progress that has been made to date. The problem is serious, and the need for action is urgent. We cannot afford to wait for Congress to take action on this issue.

Instead, the parties most directly involved in the crisis - namely the major servicers, federal regulatory agencies of the FSOC, and the state Attorneys General - need to work together now to provide much-needed clarity and fairness to the loss mitigation and foreclosure process. And to prevent the misaligned incentives responsible for the crisis we are currently facing, we need to use our full-range of existing regulatory authorities, now, to create strong servicing standards for the future.

Unless we follow through and address servicing incentives and standards in our implementation of the Dodd-Frank reforms, we will have missed an historic opportunity to restore investor confidence, restart a constructive securitization market, and create long-term stability in our mortgage markets. I urge your active support of these initiatives. Thank you.

1 Ashcraft, Adam B. and Schuermann, Til, "Understanding the Securitization of Subprime Mortgage Credit," Staff Report No. 318, Federal Reserve Bank of New York, March 2008, p. 8. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1071189

2 "Global Rating Criteria for Structured Finance Servicers," Fitch Ratings / Structured Finance, August 16, 2010, p. 7.

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