Sarah Bloom Raskin: Problems in the mortgage servicing industry

Remarks by Ms Sarah Bloom Raskin, Member of the Board of Governors of the Federal Reserve System, at the National Consumer Law Center's Consumer Rights Litigation conference, Boston, Massachusetts, 12 November 2010.

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Good afternoon. I would like to thank the National Consumer Law Center (NCLC) for inviting me to speak here at the Consumer Rights Litigation Conference. I'm particularly pleased to share my thoughts with you in my first public speech since joining the Federal Reserve Board of Governors last month.

These are challenging times for policymakers because they are *profoundly* challenging times for millions of Americans. Many families have suffered significant declines in their net worth over the past several years, especially as the value of their homes and other assets has plummeted. Many households have faced job losses or large reductions in the number of hours worked, events that have reduced family income and well-being. Retirees are feeling heightened anxiety as companies and local and state governments debate measures to restrict retiree pensions. The ability of households to borrow has also shrunk as underwriting standards have tightened, placing more weight on existing debt obligations of consumers. For households trying to navigate these difficulties, the work that many of you do to directly help consumers deal with the legal dimensions of their financial lives is of great importance. I commend you for your ongoing and persistent contributions to stabilizing family and community life in our country.

One aspect of the financial crisis that touches directly on your work is foreclosure. As you well know – and in fact you were among the first to predict the problem – millions of homeowners have gone through foreclosure in recent years; many more will go through it in the near future; and countless others are struggling to keep their payments current even as the housing market and the overall economy make it hard to do so.

The number of foreclosures initiated on residential properties has soared from about one million in 2006, the year that house prices peaked, to 2.8 million last year. There were 1.2 million foreclosure filings in just the first half of this year. In addition, right now nearly five million loans are somewhere in the foreclosure process, or are 90 days or more past due and hence at serious risk for a foreclosure filing.

Our projections remain very grim for the foreseeable future: All told, we expect about two and one-quarter million foreclosure filings this year and again next year, and about two million more in 2012. While these numbers are down from their peak in 2009, they remain extremely high by historical standards and represent a trauma in the lives of millions of people affected.

The most recent alarming development in the foreclosure process that has caught public attention involves improper activities by mortgage servicers. But let's remember that, for years, housing counselors and advocates nationwide have documented patterns of fraudulent and abusive mortgage servicing practices. Current attention is focused on so-called "robo-signers," individuals who appear to have attested to the validity of documents in a number of foreclosure filings so large as to suggest that something may be amiss in the recording process. This development is troubling on its own, but it also shines a harsh spotlight on other longstanding procedural flaws in mortgage servicing.

Many may view these procedural flaws as trivial, technical, or inconsequential, but I consider them to be part of a deeper, systemic problem and am gravely concerned. During my time as Commissioner of Financial Regulation for the State of Maryland, I encountered a Pandora's Box of predatory tactics that included:

- the padding of fees, such as late fees, broker-price opinions, inspection fees, attorney's fees, and other fees;
- the strategic misapplication of payments so that the homeowner's payments for principal and interest due on the loan were improperly applied to the servicer's fees, sometimes improperly causing the loan to be considered to be in default; and
- the inappropriate assessment of force-placed insurance, with premiums of two to four times the cost of standard homeowners' insurance, which in turn caused servicers to collect these premiums before applying the payments to principal and interest, precipitating foreclosure.

Theoretically, it is possible that the robo-signer controversy may turn out to be a short-term technical problem that can be addressed through additional verifications and, when necessary, re-processing of critical documents. Nevertheless, I believe that serious and sustained reform is needed to address the larger problems in mortgage servicing.

The mortgage servicing industry as we know it is a relatively recent invention, and, undoubtedly, it has never before been tested in a national housing crisis of this magnitude. As the continuing surge in foreclosures suggests, mortgage servicers simply are not doing enough to provide sustainable alternatives to foreclosure. This may be due to the fact that the vast bulk of loan servicing today is done by large servicers, which are either subsidiaries of depository institutions, affiliates of depository institutions, or independent companies focused primarily or exclusively on loan servicing.

Before securitization became commonplace, it was much more likely for a mortgage to be serviced by the same entity that had originated the loan. This simple approach ensured that lenders knew immediately if a homeowner was having payment problems, and could take action to mitigate possible losses. A fair bit of this kind of "portfolio servicing" still takes place, but as the residential real estate market shifted from an originate-to-hold model to an originate-to-distribute model, an industry of independent third-party entities emerged to service the loans on behalf of the securitization trusts. These trusts, as a requirement for their tax-preferred status, were supposed to be passive, with the management of individual loans left to the servicer. These servicing arrangements are now commonplace in the industry: In fact, the system has matured rapidly and experienced considerable consolidation over the past twenty years.

The benefits to consolidation include significant economies of scale in the collection and disbursal of routine payments. But the kind of time-consuming, involved work that is now needed in the loss mitigation area was not contemplated at anything like this kind of scale, and the payment structures between the servicers and investors may not always be sufficient to support large-scale loan workout activity. Unfortunately, as we are seeing now, there are also dramatically significant drawbacks to this model. Third-party servicers earn money through annual servicing fees, a myriad of other fees, and on float interest, and they maximize profits by keeping their costs down, streamlining processes wherever possible, and by buying servicing rights on pools of loans that they hope will require little hands-on work. Again, for routine payment processing this all leads to economies of scale, and the industry has consolidated significantly in recent years as a result.

But the services needed in the current housing crisis are not one-size-fits-all. Loan servicers likely never anticipated the drastic need for the kind of time-consuming, detailed work that is now required in the loss mitigation area, and the payment structures between the servicers and investors are not sufficient to support large-scale loan workout activity. As it turns out, the structural incentives that influence servicer actions, especially when they are servicing loans for a third party, now run counter to the interests of homeowners and investors.

While an investor's financial interests are tied more or less directly to the performance of a loan, the interests of a third-party servicer are tied to it only indirectly, at best. The servicer makes money, to oversimplify a bit, by maximizing fees earned and minimizing expenses while performing the actions spelled out in its contract with the investor.

In the case, for instance, of a homeowner struggling to make payments, a foreclosure almost always costs the investor money, but may actually earn money for the servicer in the form of fees. Proactive measures to avoid foreclosure and minimize cost to the investor, on the other hand, may be good for the homeowner, but involve costs that could very well lead to a net loss to the servicer. In the case of a temporary forbearance for a homeowner, for example, the investor and homeowner both could win – if the forbearance allows the homeowner to get back on their feet and avoid foreclosure – but the servicer could well lose money. In the case of a permanent modification, the investor and homeowner could both be considerably better off relative to foreclosure, but the servicer could again lose money.

Why might a servicer lose money in an instance that could be win-win for the borrower and investor? It’s because of the amount of work needed, the structure for reimbursing costs to the servicer, and other costs incurred by the servicer on delinquent, but not yet foreclosed upon, borrowers. Loss mitigation options, such as forbearance and loan modification, require individualized case work. Thus, the servicer needs to invest in additional resources, including trained personnel who can deal with often complex one-off transactions. In the case of a private-label security, many of the costs of this work may not be reimbursed by the trust. Other costs result from even temporary forbearance, such as the servicer’s requirement, in most cases, to advance principal and interest to the investor every month, even though it has not received payment from the borrower. Even in the case of a servicer who has every best intention of doing “the right thing,” the bottom-line incentives are largely misaligned with everyone else involved in the transaction, and most certainly the homeowners themselves.

We don’t know yet what the end results will be for homeowners. But the best third-party servicers would have to be diligent and willing to absorb relative losses when the standard business model for the industry would seem to put a thumb on the scale in favor of foreclosure. The most urgent needs of the servicing world today require a sufficient number of personnel with the adequate mix of training, tools, and judgment to deal with problem loans on a large scale – in other words, activities with few economies of scale. The skill set of personnel hired and trained for routine work – efficiency and accuracy in following rules, and little discretion in decisionmaking – is likely a poor match for loss mitigation activities that require constant creativity and case-by-case judgment. Therefore, simply transferring work from one part of a company to another does not achieve much without significant investments in training and retraining. Servicers have been publicly pledging for several years to increase their servicing capacity, and many have. Unfortunately, there is plenty of evidence to suggest that many servicers’ workforces lack the knowledge and capacity to deal with the immensity of the mortgage crisis.

In order to do their jobs well servicers need strong internal procedures and controls. Recent events suggest that servicers may be lacking in this regard, to the detriment of consumers, and, quite possibly, to the detriment of the investors to whom they are contractually obligated to maximize revenue. I recognize that many servicers have stepped up and diligently tried to improve their work; I applaud and encourage them. However, lingering problems remain and I suspect that these may be due to deferred maintenance and investment on a significant scale. In boom times, servicers had the luxury of building out relatively lean systems that efficiently processed the more routine aspects of the business, but they do not appear to have planned for the infrastructure that would be needed during a serious down cycle. As you know, consumers hold the losing end of this stick.

More seriously, recurring issues that have dogged some elements of the servicing industry go beyond misaligned incentives to simple bad business practices. One recurring problem that has triggered litigation involves the servicer’s handling of fees. When a servicer does not properly carry out its primary duty of collecting and appropriately allocating mortgage payments, it can cost homeowners money and, in the most extreme cases, cause a homeowner to be pushed into premature default. Some servicers obtain unwarranted or unauthorized fees from borrowers after engaging in unfair collection practices, or through other conduct that causes borrower default, such as misapplied payments, padded costs, erroneous charges, late fees, and so on.

Too many accounts of shoddy operating procedures – lost paperwork, slow response times, and sloppy recordkeeping – cast a dark shadow on this part of the industry that links mortgage borrowers and lenders. The broad grant of delegated authority that servicers enjoy under pooling and servicing agreements (PSAs), combined with an effective lack of choice on the part of consumers, creates an environment ripe for abuse. Moreover, the inability of some servicers to maintain complete and accurate records, and to transfer servicing rights cleanly, causes additional uncertainties and vulnerabilities.

The impact of poor business practices can linger on even after the foreclosure sale. In managing foreclosed properties in lenders' inventories, servicers may be motivated by timeliness measures in PSAs to induce the former homeowner or bona fide tenant to vacate before they are legally required to do so, sometimes under the threat of eviction. Once the properties are vacant, servicers exercise great discretion in deciding whether or not to repair foreclosed property based on the likelihood that the servicer's advances are recoverable from the sale proceeds. With real estate owned (REO) inventories projected to reach one million by the end of 2010, servicer actions will heavily influence the effectiveness of neighborhood stabilization efforts at a time of persistent decline in home values and in fragile markets already weakened by a glut of vacant and abandoned properties, particularly in low-wealth communities.

Finally, we face a cluster of problems surrounding loan modification. Servicers' significant concerns about the U.S. Treasury's Home Affordable Modification Program (HAMP) are well-known. That said, we do not know enough about how well servicers are complying with the requirements of that program, or whether all of the HAMP modifications that should be made are indeed being made. Many servicers, in fact, currently report that the bulk of their loan modifications are being done outside of HAMP. Again, we do not know enough about what those modifications look like or how they are being structured.

Prior to HAMP, many servicers were creating modifications that themselves were problematic. For example, high percentages of the pre-HAMP modifications provided no payment relief to borrowers and, not surprisingly, then exhibited high re-default rates. Servicers may not be doing everything they can do to ensure that loss mitigation activities, including HAMP and non-HAMP modifications, are responsible and sustainable and subject to strong internal controls.

So the problems that have been grabbing headlines in recent weeks are neither new nor amenable to quick fixes. While there may be some specific practices – "robo-signing" among them – that are possible to isolate and eliminate, chronic, uncured problems continue to plague this industry. There is a long track record of actions and cases brought by attorneys general, which some of you in this room have no doubt litigated, demonstrating the harm done to consumers by sloppy or unscrupulous practices. Because consumers cannot choose to hire or fire their servicers (other than by paying off the loan), the industry lacks the level of market discipline imposed in other industries by the working of consumer choice. For this reason, if servicers do not actively maintain adequate and trained staff and do not establish and heed internal controls, if investors do not monitor their servicers' behavior, if regulators do not conduct meaningful examinations, if courts do not stand guard against unfair practices, both substantive and procedural, then it will be much less likely that a well-functioning housing market will reemerge from this crisis. Because the very structure of the loan servicing industry as it currently operates inevitably leads to misaligned incentives and a propensity to defer costly investments, a more significant re-thinking of the basic business model must also be undertaken if we are to avoid repeating prior mistakes.

I realize that I'm painting a rather gloomy picture. But be assured that I do believe that we can make real progress on the ground through coordinated public and private action. Let me conclude by talking a little bit about what the Federal Reserve and others are doing to address these issues.

Although foreclosure practices have traditionally been – and rightfully should remain – a domain of the states, the Federal Reserve has been expanding its expertise in working with the industry – first, in a review of non-bank subsidiaries in conjunction with other state and federal regulators, and, currently, with a review of loan modification practices by certain servicers. As the current servicing issues began to emerge more clearly, the Federal Reserve and other federal banking agencies initiated an in-depth review of practices at the largest mortgage servicing operations. The review focuses on foreclosure practices generally, but with a concentration on the breakdowns that seem to have led to inaccurate affidavits and other questionable legal documents being used in the foreclosure process. When the interagency review is completed, we will have more information about the extent and significance of these very troubling practices, as well as an understanding of what must be done to prevent them in the future. We have also solicited information and input from other knowledgeable sources, including NCLC, to help us better direct our actions to detect possible systematic problems at specific servicers or within the industry at large.

Preliminarily, we have directed certain firms to complete thorough self-assessments of the policies and procedures they use for determining whether to foreclose on a residential mortgage loan, and, in those cases where foreclosure is authorized, an examination of the processes they used to comply with relevant federal and state laws. We have directed these firms not just to address their stated policies and procedures, but to assess how they actually work in practice. At the same time, examiners from the banking agencies will be on-site to review individual loan files, evaluate controls over the selection and management of third-party service providers, and carefully test the assertions that the institutions make in their self-assessments. Institutions will be directed to correct any deficiencies that they discover in their self-assessments or that come to light in the on-site examination process.

As a general matter, the Federal Reserve reviews the compliance procedures of the banking organizations that we supervise as part of the examination process. However, federal examiners typically are not experts in the application of each state's laws, especially in an area as complex as mortgage foreclosure procedures. So, federal examiners need to coordinate with their state examiner counterparts who should have a stronger understanding of their state foreclosure laws. For federally chartered institutions, the Federal Reserve requires that the banks we supervise have adequate compliance risk management programs that are being followed.

Given the potential ramifications for consumers, the housing market, and the economy as a whole, I believe it's fair to say that every relevant arm of the federal government is taking the underlying dynamics of the mortgage foreclosure crisis very seriously. I also hold out hope that the multi-state work engaged in by the 50 state attorneys general will prove to be a vehicle for resolving the underlying problems. The coordination and expertise at the state level in these matters is an essential corrective. To the extent that legal settlements are structured in such a way as to generate a broader underlying reform of servicing processes, it will be more likely that we can assure consumers that they will not encounter other mortgage harms moving forward.

The complex challenges faced by the loan servicing industry right now are emblematic of the problems that emerge in any industry when incentives are fundamentally misaligned, and when the race for short-term profit overwhelms sustainable, long-term goals and practices. Responsible parties within the industry are no doubt already scrambling to fix some of the problems that have surfaced. However, because so much is riding on getting these systems right, and because consumers have such little measure of individual choice or recourse, reliance on pledges from market participants will not be enough. Many of you have been doing your part for years to point out problems in the industry and to give consumers some protection and redress when wronged. The public sector too is stepping up its efforts to monitor firms' actions and systems. Until a better business model is developed that eliminates the business incentives that can potentially harm consumers, there will be a need for close regulatory scrutiny of these issues and for appropriate enforcement action that addresses them.

Thank you.