Elizabeth A Duke: Foreclosure documentation issues

Testimony by Ms Elizabeth A Duke, Member of the Board of Governors of the Federal Reserve System, before the Financial Services Subcommittee on Housing and Community Opportunity, US House of Representatives, Washington DC, 18 November 2010.

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Chairwoman Waters, Ranking Member Capito and members of the Subcommittee, I am pleased to appear today to discuss issues related to mortgage loan servicing and the mishandling of documentation in foreclosure proceedings. The Federal Reserve is focused on a range of issues related to mortgage lending, such as loan underwriting and origination practices, loan servicing, loan modification, neighborhood stabilization and foreclosure. We take all of these matters seriously and are quite concerned about reported irregularities in foreclosure practices.

The Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve are conducting an in-depth review of practices at the largest mortgage servicing operations. The interagency examination and review focuses on foreclosure practices generally, but with an emphasis on the breakdowns that led to inaccurate affidavits and other questionable legal documents being used in the foreclosure process. The regulators expect the initial on-site portion of our work to be completed this year and currently plan to publish a summary overview of industry-wide practices in early 2011. At that time we will have more information about the extent and significance of these very troubling practices, as well as what must be done to prevent them from occurring in the future.

Losing a home is a tragic event for families and the communities in which they live. It is imperative that mortgage lenders and servicers provide borrowers every opportunity to modify the loan and retain their homes or, if that is not possible and foreclosure becomes necessary, that they give borrowers all the protection afforded by following due process as required by law. The issues raised as foreclosure improprieties came to light have cast a pall of uncertainty across the entire housing market. The Federal Reserve is actively working to accurately understand and size the threat to determine the appropriate response. Any response must ensure that actions taken with respect to borrowers and their homes are valid and in accordance with the law; at the same time, those actions should help remove uncertainty and restore smooth functioning to housing and financial markets. Although it is difficult to determine the incremental effect of further procedural delays in foreclosures, delays and uncertainty resulting from flaws in the foreclosure process have the potential to delay recovery in housing markets and to undermine confidence in our financial and legal systems.

In my testimony I will discuss the potential risks to consumers, financial institutions, housing markets, and the broader economy regarding failures to follow proper procedures. I will cover in more detail our interagency reviews of servicer performance and potential remedies if procedures are not being followed. And I will return to the important role of loan modifications in reducing the number of foreclosures to be processed.

Risks to consumers

Consumers and consumer counselors have been quite vocal in their frustration over unreturned phone calls, lost documents and changing decision criteria that have plagued the loan modification process. In light of such experiences, evidence of improper procedures in foreclosure cases causes consumers, at a minimum, to further mistrust the loan servicing process. At worst, it can result in improper loss of a home or premature eviction from that

home. For individual borrowers, uncertainty about the prospect or timing of foreclosure makes everyday decisions difficult. Borrowers who are uncertain about their ability to keep their homes have little incentive to invest in or maintain those homes, resulting in damage to neighborhoods and lowering the value of surrounding properties.

And, with wide-spread stories of foreclosure improprieties, families in the process of buying a home or considering the purchase of a home have become concerned about the validity of their titles. Others who have purchased homes in foreclosure have had their closings delayed while documents are reviewed. Consumers have already fallen victim to foreclosure rescue scams as charlatans posing as mortgage counselors claimed to be able to obtain mortgage modifications for a fee. In light of new stories of mortgage abuse, new incarnations of those scams are sure to proliferate.

Risks to financial institutions and the financial system

Financial institutions face a number of risks if inadequate controls result in faulty foreclosure documents or failure to follow legal procedures. Recent events have shown that even the possibility of problems can lead to costly delays and reviews. In cases where actual problems are found, regulators will require lenders and servicers to correct not only the faulty documents themselves but the faulty systems that allowed them to occur. Institutions with widespread problems may be subject to fines and fees in addition to the costs associated with correcting the errors.

Cost associated with foreclosure documentation problems, including "robo-signing" (discussed in more detail later), are not the only potential liabilities facing financial institutions. Investors in mortgage-backed securities and purchasers of unsecuritized "whole loans" have begun to explore and in some cases assert contractual and securities law claims against the parties that originated the loans, sold the loans, underwrote securities offerings, or had other roles in the process. The essence of these claims is that the mortgages in the securitization pools or that had been sold as unsecuritized whole loans did not conform to the representations made about their quality – specifically, that the loan applications contained misrepresentations or the underwriting was not in conformance with stated underwriting guidelines.

With respect to the contract claims, this potential liability is usually called "put back" risk, because many of the relevant agreements permit the buyer of the loans to put the loans back to the seller (or other party that makes representations). That is, the buyers can demand that the seller repurchase the loans at par if defects are found in the loan underwriting contrary to representations and warranties in the pooling and servicing agreement that created the securitization trust or the whole loan mortgage purchasing agreement. At the time of the put-back, the loan has usually gone into default, sparking a review of the original loan application file. The defaulted loan, given current market conditions, is typically worth substantially less than par, thus the put-back transfers any potential loss from the buyer back to the seller. Although the representations and warranties in the various agreements vary considerably, they frequently require that the defect materially and adversely affect the value of the loan before put-back rights can be exercised.

There are also pending claims by some that underwriters and sponsors of securitizations failed to comply with the Federal securities laws covering offering documents and registration statements. These suits specifically reference descriptions of the risks to investors, the quality of assets in the securitization, the order in which investors would be paid or other factors. Most of these lawsuits are in the early stages, and it is difficult to ascertain the probability that investors will be able to shift a substantial portion of the losses on defaulted mortgages, specifically, or mortgage-backed securities back to the parties that sold the loans or underwrote the offerings.

Nevertheless, the Federal Reserve has been conducting a detailed evaluation of put-back risk to financial institutions. Losses due to put-backs are not new; buyers, insurers of loans (private mortgage insurers), and guarantors of securitizations (GSEs) of defaulted mortgages have been seeking to put back defective loans since well before the mortgage crisis began. This practice has accelerated during the current mortgage crisis. Financial institutions have been resolving these claims throughout the crisis. However, just as holders and guarantors of mortgages and mortgage-backed securities are pressing their claims, financial institutions are vigorously defending against many of the claims that seek to impose substantial liability on them. We are gathering information to ensure that the institutions we supervise have adequately assessed these risks and have accounted for them properly.

Risk to mortgage market and housing

In addition to the potential harm to consumers, financial institutions and the financial system, the Federal Reserve is evaluating the potential macroeconomic effects of foreclosure documentation problems to the mortgage and housing markets. The number of foreclosures initiated on residential properties has soared from about 1 million in 2006, the year that house prices peaked, to 2.8 million last year. Over the first half of this year, we have seen a further 1.2 million foreclosure filings, and an additional 2.4 million homes were somewhere in the foreclosure pipeline at the end of June. All told, we expect about 2.25 million foreclosure filings this year and again next year, and about 2 million more in 2012. While our outlook is for filings to decline in coming years, they will remain extremely high by historical standards. Currently, almost 5 million mortgage loans are 90 days or more past due or in foreclosure.

The Federal Reserve believes that the best way to assist struggling borrowers is with a mortgage modification that allows borrowers to retain their homes with an affordable mortgage payment. Foreclosures are costly to all parties and, more broadly, to our economy. Lenders and investors incur financial losses arising from the litigation expenses associated with the foreclosure process and the loss on the defaulted mortgage when the foreclosed property sells at a “fire sale” price for substantially less than the loan balance. Local governments must contend with lower property tax revenue and the ramifications of neglected properties that may threaten public safety. Additionally, neighbors and neighborhoods suffer potential spillover effects from foreclosure sales because foreclosures may reduce the attractiveness of the neighborhood or may signal to potential buyers a forthcoming decline in neighborhood quality.

Problems with foreclosure documentation procedure could lead to further delays in an already lengthy foreclosure process. Recent estimates suggest that the average time to foreclosure in the United States has already increased from 251 days in January 2008 to more than 440 days in 2010. While a mortgage modification is always preferable to foreclosure, when a sustainable loan modification is not possible, long and uncertain delays in the foreclosure process can be harmful to neighborhoods and the housing market more generally. Vacant properties may fall into disrepair or be vandalized. Even when borrowers continue to live in their homes, those unable to make their mortgage payments may not have the resources or the incentive to adequately maintain their properties. In the end, an overhang of homes awaiting foreclosure is unhealthy for the housing market and can delay its recovery as well as that of the broader economy.

In addition, the lack of certainty and price discovery created by the glut of foreclosures has further weakened property values and has contributed to a slowing in the recovery of the housing market more generally. The most important action policymakers can take to address the rising foreclosures and the lack of mortgage activity is to craft policies that encourage market participants to act in a particular manner that will allow the economy to achieve a sustainable recovery. Over the course of the past two years, the Federal Reserve has taken forceful action in response to the financial crisis to help improve financial market conditions and to promote the flow of credit to households and businesses. More specifically, our

purchases of long-term mortgage-backed securities, government agency debt, and Treasury securities served to reduce mortgage rates which in turn allowed mortgage holders to refinance into lower payments and made home loans more affordable for new purchasers.

Foreclosure process

Before I turn to specific examination procedures underway, it might be helpful to review the foreclosure process and the role of investors and loan servicers. Foreclosure is a legal process initiated to terminate a borrower's interest in a property and is permitted only when the borrower has defaulted on the debt obligation for a specified period. To the extent a loan is secured by the property, the process allows the lender to sell the property and apply the proceeds in full or partial satisfaction of the borrower's unpaid debt. Foreclosure requirements are generally established by state law, and each state has its own statutes, rules, and court decisions pertaining to foreclosures. For this reason, a financial institution needs to understand the foreclosure procedures and documentation practices for each state in which it operates.

Some 23 states, known as judicial foreclosure states, require foreclosures to be reviewed and approved by a court in advance. Nonjudicial foreclosure states have varying waiting periods and documentation, filing, and notice requirements after a default occurs before a foreclosure sale may take place. In judicial foreclosure states, homeowners can challenge the foreclosure either by appearing in and defending the action already brought by the lender or by filing for bankruptcy. In nonjudicial foreclosure states, to challenge the foreclosure, the homeowner must take the initiative to file suit in state court to enjoin the foreclosure or file for bankruptcy. Almost half of all of the states have statutes that allow the borrower to cure a default by paying any amount already due, plus any allowable costs and fees, prior to the foreclosure sale without having to pay off the entire principal amount of the mortgage loan.

Mortgage servicers are a critical link between borrowers and mortgage holders as they maintain the official accounting of all amounts paid and owed by borrowers. In addition, servicers handle loan default management, including negotiating repayment of loss mitigation plans with borrowers. In the event that loan modification efforts are not successful, the servicer would initiate foreclosure, often as the agent for third parties, such as securitization trusts. In this regard, servicers have responsibilities to investors holding residential mortgage-backed securities. These securities are held by a broad range of investors including state pension funds and retirement systems. Servicers also have responsibilities to borrowers to maintain accurate and complete records of payments received, amounts advanced, notifications made to borrowers, and any mortgage modification discussions.

Foreclosure documentation typically requires an assertion that the agent bringing forth the action has the legal right to foreclose and that the loan is in default. The document filing would contain details of the transaction and the amounts owed. Problems associated with so-called robo-signing of documents include documents signed by individuals who do not have personal knowledge of the facts being asserted, documents signed by individuals who are not properly authorized to make such claims or assertions, notarized signatures on documents that were not executed in the presence of a notary or that have other violations of proper notary procedures, and documents that contain inaccurate amounts, dates, or other facts. Lenders and servicers are responsible for ensuring that the person who signs a document is duly authorized and has appropriate knowledge obtained from a review of the case. In addition, servicers and lenders are responsible for ensuring the accuracy of records and the facts recited in the documents.

State law and local real estate recording requirements govern recordation of real estate and mortgage title transfers. Given the multiple transfers of mortgage loans over time, concerns have been raised about investors' or servicers' right to foreclose. Although state-by-state practices vary considerably, generally the note holder has the right to initiate foreclosure if an

original note can be produced and the current holder's ownership is able to be verified in some fashion. If there is no controversy concerning ownership of the note, but rather an inability to locate original documents, processes usually exist that allow for a foreclosure to proceed, albeit at some cost and delay. If there is some question of ownership, the investor or servicer may be required to produce evidence of ownership before a foreclosure can proceed.

Matters regarding real estate titles and foreclosures are generally governed by state law, and the 50 state attorneys general have undertaken a joint review of lenders and servicers and the reported problems in foreclosures. In addition, numerous federal agencies have launched investigations, including examinations in process by the federal financial regulators.

Interagency examinations

The Federal Reserve has supervisory and regulatory authority for bank holding companies, approximately 800 state-chartered banks that are members of the Federal Reserve System (state member banks), and certain other financial institutions and activities. We work with other federal and state supervisory authorities to ensure the safety and soundness of the banking industry, foster the stability of the financial system, and provide for fair and equitable treatment of consumers in their financial transactions. As the consolidated supervisor of bank holding companies, including financial holding companies, the Federal Reserve conducts inspections of those institutions. The Federal Reserve is involved in both regulation, which involves establishing the rules within which banking organizations must operate, and supervision, which entails ensuring that banking organizations abide by those rules and remain, overall, in safe and sound condition.

As I indicated at the beginning of my statement, the OCC, the OTS, the FDIC, and the Federal Reserve are in the process of conducting interagency targeted examinations of the foreclosure policies and practices of the financial institutions that control a majority of outstanding mortgage loans. The agencies expect to conclude the on-site portion of our examination process by the end of this year and plan to review the findings immediately thereafter. We want to ensure that our analysis is comprehensive and provides a basis for development of remedial actions. Currently, the banking agencies plan to publicly release a summary report highlighting the industry-wide findings in early 2011.

In our examinations, the agencies are reviewing firms' policies, procedures, and internal controls related to foreclosure practices and are sampling loan files to test the effectiveness of those policies, procedures and internal controls. We are prepared to take supervisory action where necessary and appropriate to hold institutions accountable for poor practices.

Specifically, we are examining the firms' internal governance processes related to: (1) foreclosure policies and procedures; (2) organizational structure, approval process, and staffing levels; (3) vendor management of outside law firms; (4) quality control processes and internal audit; and (5) foreclosure workflow process and loan documentation procedures. We have also solicited information from consumer organizations to help us better direct our actions to detect problems at specific servicers and to determine whether systematic weaknesses are leading to improper foreclosures.

For additional insights into foreclosure processes, we have sent a self-assessment questionnaire to other Federal Reserve-regulated institutions that have mortgage servicing activity but were not part of the interagency horizontal examination effort. The staff will analyze the responses from the firms and determine what follow-up work is required to validate the information they provide.

The Federal Reserve requires supervised institutions to have sufficient corporate governance and maintain adequate risk-management programs to ensure the institution's safety and soundness, as well to comply with consumer protection laws and regulations. Institutions with identified weaknesses will be directed to take remedial actions. Any remedial action

mandated by the Federal Reserve will be consistent with the goals and objectives of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 to promote best practices and financial stability.

Supporting loan modifications

Notwithstanding the right of lenders to pursue foreclosure, the Federal Reserve encourages mortgage servicers to first pursue a sustainable loan modification for the borrower. To ensure that modification requests are handled appropriately, we have leveraged the information from our consumer complaint investigation process. As a result of complaints received from consumers and members of the Congress on behalf of their constituents, in October 2009 the Federal Reserve began a review of the loan modification practices of loan servicers for which we have supervisory responsibility. These reviews include on-site examinations that began in the second quarter of this year and are still underway.

The Federal Reserve has emphasized the importance of using loan modifications as a means to avoid unnecessary foreclosures and continues to encourage effective loan modifications. Prudent modifications that are consistent with safe and sound lending practices are generally in the long-term best interest of both financial institutions and borrowers. We have sponsored numerous modification fairs and events to bring lenders and borrowers face-to-face to explore alternatives to foreclosure. In addition to promoting loan modifications, the Federal Reserve has actively supported efforts to help communities that have been hard hit by vacancies and foreclosures. Federal Reserve staff members in our research, community development, and supervision and regulation divisions are collaborating to encourage foreclosure prevention at the local level and promote neighborhood stabilization initiatives. Further, Federal Reserve staff members are conducting empirical research on mortgage- and foreclosure-related topics, and they are reaching out to industry and consumer experts as well.

A key initiative developed under the leadership of the Federal Reserve Bank of Chicago has been the Mortgage Outreach and Research Effort (MORE). MORE involves all 12 Federal Reserve Banks and the Board of Governors in a collaboration that pools resources and combines expertise to inform and engage policymakers, community organizations, financial institutions, and the public at large. In September 2010, MORE sponsored a discussion among experts and policymakers on effective strategies for stabilizing neighborhoods weakened by real estate owned by financial institutions and vacant properties. This meeting also included a publication developed by the Board and the Boston and Cleveland Federal Reserve banks that featured analysis and promising practices from leading practitioners and applied researchers.[1] Another important resource published this year by MORE summarizes key actions that the Federal Reserve has taken to address the foreclosure crisis.[2]

In addition to encouraging loan modifications by other holders of mortgage loans, the Federal Reserve has worked with servicers of mortgages it acquired in actions taken to stabilize the financial system. On January 30, 2009, the Board of Governors adopted a policy requiring the pursuit of mortgage modifications prior to initiating foreclosure on loans held in the Federal Reserve System.

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1 Federal Reserve Bank of Boston, Federal Reserve Bank of Cleveland, Board of Governors of the Federal Reserve System, and others (2010), *REO Vacant Properties: Strategies for Neighborhood Stabilization*.

2 Federal Reserve System, Mortgage Outreach and Research Efforts (MORE) Initiative (2010), *Addressing the Impact of the Foreclosure Crisis: Federal Reserve Mortgage Outreach and Research Efforts* (Chicago: Federal Reserve Bank of Chicago).

Conclusion

In summary, the Federal Reserve has been actively working to mitigate the harm to consumers and markets caused by problems in mortgage loan origination, securitization, and loan foreclosures. We are participating in interagency examinations of the foreclosure processes and controls in the financial institutions that control the majority of the nation's mortgages. We are conducting examinations of lenders' and servicers' loan modification efforts. In response to the fallout from the financial crisis, the Federal Reserve has helped stabilize the mortgage market and improve financial conditions more broadly, thus promoting economic recovery. As the foreclosure crisis has intensified, Federal Reserve staff in our research, community development, and supervision and regulation divisions have actively collaborated to support foreclosure prevention at the local level and promote neighborhood stabilization initiatives. These efforts reflect a continuation of actions undertaken by the Federal Reserve System since the start of the financial crisis. We remain committed to the goal of stabilized financial markets that promote economic recovery.

Thank you for holding this important hearing today, and I would be happy to answer any questions that you may have.