Daniel K Tarullo: Problems in mortgage servicing

Testimony by Mr Daniel K Tarullo, Member of the Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, US Senate, Washington DC, 1 December 2010.

*   *   *

Mr. Chairman, Ranking Member Shelby, and other members of the Committee, thank you for your invitation to this morning's hearing on problems in mortgage servicing.

In the first portion of my testimony, I will explain our current understanding of the nature and extent of the deficiencies in mortgage documentation that have been so apparent in the robo-signing misconduct, as well as what the banking agencies are doing in support of a broader interagency effort to develop a full picture of these problems. I also want to address the issue of so-called put backs of mortgage-backed securities (MBS) to mortgage originators or securitization sponsors. Though only indirectly related to robo-signing and associated servicing flaws, financial exposure resulting from put backs could be more significant for some institutions than that from documentation flaws.

In the second portion of my testimony, I will turn to the question of appropriate policy responses – with respect to specific regulated financial institutions, to supervisory practices more generally, and to the structural problems we have observed in the mortgage servicing industry, including the discouragingly sluggish pace of mortgage modifications. This last point is a matter of concern not only because of its significance for the millions of American families who are unable to maintain their mortgage payments on homes that have lost considerable value in recent years, but also because of the importance from a macroeconomic perspective of realizing as quickly and efficiently as possible a clearing of housing prices, which would help create the conditions for a market recovery.

Mortgage documentation and other servicing issues

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. The process allows the lender to sell the property and use the proceeds to satisfy the borrower's unpaid debt to the extent it is secured by the property. Foreclosure requirements are generally established by state laws and each state has its own statutes, rules, and court decisions pertaining to foreclosures.

Some 23 states, known as judicial foreclosure states, require foreclosures to be reviewed and approved by a court. Nonjudicial foreclosure states have different processes for foreclosures that do not require the creditor to obtain court approval for a foreclosure, but instead impose varying waiting periods and documentation, filing, and notice requirements after a default occurs and before a foreclosure sale may take place. In nonjudicial foreclosure states, the homeowner typically has access to the court in a foreclosure matter only if the homeowner initiates a suit to stop the foreclosure process or seeks protection in a bankruptcy court.

Because mortgage servicers maintain the official accounting of all amounts paid and owed by borrowers, they serve as the critical link between borrowers and mortgage holders. In addition, servicers manage loan defaults, including the negotiation of loan modification and repayment plans with borrowers. Should the servicer decide to initiate foreclosure, it would often do so as the agent for third parties, such as securitization trusts. In this regard, servicers have responsibilities to investors holding residential MBS. Servicers also have responsibilities to borrowers to maintain accurate and complete records of payments received, amounts advanced, notifications made to borrowers, and changes of payment terms with respect to 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 filings contain details of the transactions and the amounts owed. These documents typically include attestations signed by individuals who have personal knowledge of the facts and who are properly authorized to make such assertions. In most jurisdictions, the documents must be signed by these individuals in the presence of a notary, following proper notarization procedures. Lenders and servicers are responsible for ensuring that the individuals who sign these documents are duly authorized and have appropriate knowledge of the facts and circumstances. In addition, lenders and servicers are responsible for ensuring the accuracy of records and the facts recited in the foreclosure documents.

State and local laws govern the recordation process for real estate transfers and mortgage filings and assignments. Given the multiple sales and assignments of mortgage loans that often occur, concerns have been raised regarding investors' or servicers' rights to initiate foreclosure actions. Although state-by-state practices vary considerably, generally the noteholder has the right to initiate foreclosure, once default has occurred, if an original note can be produced and the current holder's ownership is verified. If there is no controversy concerning ownership of the note, but rather an inability to locate original documents, processes usually allow for 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.

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

The Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the Federal Reserve are conducting an in-depth review of practices at the largest mortgage servicing operations. The interagency examinations and reviews focus on foreclosure practices generally, but with an emphasis on the internal control breakdowns that led to inaccurate affidavits and other questionable legal documents being used in the foreclosure process. The agencies are reviewing firms' policies, procedures, and internal controls, including sampling loan files. We have also solicited the views of consumer organizations to help detect problems at specific servicers. The agencies expect the initial on-site portion of our work to be completed by the end of the year. The agencies plan to publish a summary overview in early 2011 that will describe the range of industry practices found in the examinations and identify weaknesses requiring remediation.

The Federal Reserve has supervisory and regulatory authority for bank holding companies and their nonbank subsidiaries, as well as for 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. The Federal Reserve is engaged in both regulation, which involves establishing the rules within which banking organizations must operate, and supervision, which involves reviewing the efforts of banking organizations to abide by those rules and remain, overall, in safe and sound condition.

The Federal Reserve serves as the primary federal regulator for two of the 10 largest servicers affiliated with banking organizations, one a holding company affiliate and the other a state member bank. The Federal Reserve is participating with the other federal banking agencies in examining the foreclosure policies and practices of the other large institutions.

For additional information on foreclosure processes, we have sent a self-assessment questionnaire to other Federal Reserve-regulated institutions that engage in mortgage servicing but are not part of the interagency examination effort.

While quite preliminary, the banking agencies' findings from the supervisory review suggest significant weaknesses in risk-management, quality control, audit, and compliance practices as underlying factors contributing to the problems associated with mortgage servicing and foreclosure documentation. We have also found shortcomings in staff training, coordination among loan modification and foreclosure staff, and management and oversight of third-party service providers, including legal services. It is for this reason that we expanded the review to include an examination of pre-foreclosure loans, or those past due but not yet in the foreclosure process, and certain third-party service providers. As examiners identify weaknesses, they will require firms to take remedial action and, when necessary, require servicers to address resource shortfalls, training and coordination problems, and control failures.

It is important to recognize that the extent of these problems is not the same across all firms. Nonetheless, the problems are sufficiently widespread that they suggest structural problems in the mortgage servicing industry. The servicing industry overall has not been up to the challenge of handling the large volumes of distressed mortgages. The banking agencies have been focused for some time on the problems related to modifying mortgage loans and the large number of consumer complaints by homeowners seeking loan modifications. It has now become evident that significant parts of the servicing industry also failed to handle foreclosures properly.

While we are still in the process of determining the extent of these problems and the required supervisory response, it is clear that the industry will need to make substantial investments to improve its functioning in these areas and supervisors must ensure that these improvements occur. Moreover, fixing the problems in the mortgage servicing industry may also require thinking about some fundamental structural changes to the current mortgage system. I will discuss the issue of structural solutions to these issues in more detail later in my testimony.

Investor repurchase requests

The cost associated with foreclosure documentation problems, including robo-signing, are not the only potential liabilities facing financial institutions in the wake of the mortgage and housing crisis. As losses in MBS have been escalating, investors in MBS and purchasers of unsecuritized whole loans are more frequently exploring, and in some cases asserting, 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 mortgages in the securitization pools, or sold as unsecuritized whole loans, did not conform to representations and warranties made about their quality – specifically that the loan applications contained misrepresentations or the underwriting was not in conformance with stated standards.

The potential liability associated with contract claims in securitizations is usually called put back risk because many of the relevant agreements permit the buyer of the mortgages to put them back to the seller at par. Buyers can demand that the seller or another party that makes representations repurchase the mortgages if defects are found in the underlying loan documentation or in the underwriting that conflict with the sale agreements. 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. At the time of the put back, the mortgage loan may have become seriously delinquent or entered into default. Because underperforming mortgages are typically valued substantially less than par, the put back transfers any potential loss from the buyer back to the original seller or mortgage securitizer.

Given the poor performance of the mortgage assets, investors, including the Government Sponsored Enterprises (GSEs), have sought to pursue put back claims through various legal avenues, including requesting that mortgage servicers provide underlying mortgage files and the requisite documents. A GSE will generally buy a loan out of an MBS pool when the loan becomes 120 days delinquent. The GSE will then conduct a review of the delinquent loan file, and if it finds that the loan did not comply with its underwriting standards, it will request that the loan be repurchased by the originator/seller or that the GSE be made whole on any credit losses incurred.

During the third quarter of 2010, Fannie Mae collected $1.6 billion in unpaid principal balance (UPB) from originators, and currently has $7.7 billion UPB in outstanding repurchase requests, $2.8 billion of which has been outstanding for more than 120 days. Freddie Mac has $5.6 billion UPB in outstanding repurchase requests, $1.8 billion of which has been outstanding for more than 120 days. As of the third quarter of 2010, the four largest banks held $9.7 billion in repurchase reserves, most of which is intended for GSE put backs.

There are also pending claims by some investors alleging that underwriters and sponsors of securitizations failed to comply with the federal securities laws covering the 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 back to the parties that sold the loans or underwrote the offerings.

While the full extent of put back exposure is for this reason hard to specify with precision, the risk has been known for some time and has been an ongoing focus of supervisory oversight at some institutions. However, in light of recent increased investor activity, the Federal Reserve has been conducting a detailed evaluation of put back risk to financial institutions. We are asking institutions that originated large numbers of mortgages or sponsored significant MBS to assess and provide for these risks as part of their overall capital planning process.

Supervisory responses

The revelation of documentation flaws in foreclosure processes raise two kinds of questions for supervisors: First, what actions are appropriate and sufficient to respond to problems identified at specific regulated banking organizations? Second, what does the failure of supervisory examinations to uncover these flaws counsel for future supervisory practice?

With respect to the question of actions aimed at specific institutions, the Federal Reserve and the other federal banking agencies have significant supervisory and enforcement tools that can be used to address certain types of deficiencies in the foreclosure and mortgage transfer process. For example, numerous enforcement tools are available to address safety and soundness issues such as inadequate controls and processes, weaknesses in risk-management and quality control, and certain types of compliance weaknesses in foreclosure operations. These tools include supervisory enforcement actions that require an institution to correct deficient operations in a prescribed period of time and Civil Money Penalties (CMPs) for egregious actions. The agencies may also lower examination ratings, which can result in limiting the permissible activities and affiliations of financial firms and trigger other supervisory reviews and limitations, and restrict the ability of institutions to expand. The agencies also have the authority to assess CMPs on individuals who are responsible for violations, to issue cease and desist orders on responsible individuals, or, if the statutory criteria are met, to remove them from banking. In addition, we may make referrals to law enforcement agencies, or require institutions to file Suspicious Activity Reports, as appropriate.

Although the examinations are not yet fully completed, based on what we have already learned, the Federal Reserve expects to use many or all of these tools through the course of our review of foreclosure and other mortgage matters. In particular, the Federal Reserve has already emphasized to the industry and to institutions we supervise the importance of addressing identified weaknesses in risk-management, quality control, audit, and compliance practices. The problems that are evident to date raise significant reputation and legal risk for the major mortgage servicers. These weaknesses require immediate remedial action. They will also affect the rating assigned by Federal Reserve supervisors to management of bank holding companies, even where the servicing activity was in a banking subsidiary of a holding company. In addition, the federal banking agencies expect that employees are adequately trained and have sufficient resources to appropriately review the facts and circumstances of files when preparing documents, and that legal processes are fully and properly followed. Banking organizations also must ensure quality control for third-party service providers, including legal services.

With respect to future supervisory practice more generally, two points for increased emphasis are already apparent. First, this episode has underscored the importance of our using the new authority given the Federal Reserve in the Dodd-Frank Wall Street Reform and Consumer Protection Act to send our examiners into non-bank affiliates of large bank holding companies, including those in large institutions that have become bank holding companies only in the last couple of years.

Second, our experience suggests that the utility of examining and validating internal control processes within firms may extend beyond improvements to the specific processes subject to the exam. We have found that problems in foreclosure practices do not seem as pervasive in institutions in which we had previously examined other internal control processes, found shortcomings, and insisted on corrective action. While we would not draw strong conclusions from such a limited experience, it seems possible that a firm may improve its general approach to control processes once it has been required to remedy problems in discrete areas. If this relationship is borne out, it could be a significant advance in supervisory practice, insofar as resource constraints will always limit the number of supervisory examinations.

Possible need for structural solutions

Beyond remedial or punitive measures directed at specific firms and future-oriented changes in supervisory practice, structural solutions may be needed to address the range of problems associated with mortgage servicing. Similarly, the foreclosure documentation problems are another reminder of the degree to which foreclosure has been preferred to mortgage modification, notwithstanding various efforts to change this imbalance. Here again, a more structural solution may be needed.

The explosive growth of securitization as a vehicle for financing mortgages was accompanied by the emergence of a sizeable mortgage servicing industry – that is, a group of firms servicing mortgages that they did not own or, in many cases, that they had not originated. While there have surely been economies associated with this industry, there have also been chronic problems. It has been increasingly apparent that the inadequacy of servicer resources to deal with mortgage modifications – an area that was a point of supervisory emphasis – was actually a reflection of a larger inability to deal with the challenges entailed in servicing mortgages in many jurisdictions and dealing with a complicated investor base. For example, foreclosure procedures are specifically the province of real property law governed by the states, and can vary not only by state, but also within states and sometimes even within counties. With or without regulatory changes, it is quite probable that servicer fees to securitization trusts will increase to reflect the costs associated with the complexities of the contemporary mortgage model.

The impetus for change in the mortgage servicing industry is likely only to increase as the advantages of servicing rights for regulatory capital purposes become limited after the new Basel III requirements are implemented.[1] It is possible that servicing issues can be satisfactorily addressed through the actions of the various primary regulators. However, in light of the range of problems already encountered, and the prospect of further changes in the industry – including the possible migration of more servicing activity to non-banking organizations – it seems reasonable at least to consider whether a national set of standards for mortgage servicers may be warranted.

The case for concerted, coordinated action is much clearer with respect to the slow-moving pace of mortgage modifications. Regardless of the findings that emerge from the examinations underway, and remedial actions required to correct past mistakes, this episode has again drawn attention to what can only be described as a perverse set of incentives for homeowners with underwater mortgages. Homeowners who try to obtain a modification of the terms of their mortgages are all too frequently subject to delay and disappointment, while those who simply stop paying their mortgages have found that they can often stay in their homes rent free for a time before the foreclosure process moves ahead. Moreover, many homeowners believe, reportedly on the basis of communications from servicers, that the only way they can qualify for modifications is by stopping their mortgage payments and thus becoming delinquent.

Quite apart from the impact upon families who lose their homes, the dominance of foreclosures over modifications raises macroeconomic concerns. 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 three quarters of this year, we have seen a further 2 million foreclosure filings, and an additional 2.3 million homes were in foreclosure at the end of September. All told, we expect about 2.5 million foreclosure filings this year and next year and about 2.4 million more in 2012. While our outlook is for filings to decline in coming years, they will remain high by historical standards. Currently, more than 4.5 million mortgage loans are 90 days or more past due or in foreclosure. These numbers compare to just 520,000 permanent loan modifications executed under the Treasury Department's Home Affordable Modification Program (HAMP) and an additional 1.6 million proprietary loan modifications by servicers participating in the HOPE NOW Alliance program.[2]

The Federal Reserve believes that in most cases the best way to assist struggling borrowers is a mortgage modification allowing them to retain their home with an affordable mortgage payment. In a housing market where values have declined so much, following a period in which all actors relied upon rising house prices to sustain mortgage practices, foreclosures simply do not make sense as a preferred response. 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 liquidation price that is 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

---

1 The proposed Basel III capital rules would simultaneously introduce a specific minimum common equity ratio and define "common equity" so as to limit or exclude consideration of items that may not provide the loss absorbing capacity that common equity is supposed to represent.

2 Written testimony of Phyllis Caldwell, Chief of Homeownership Preservation Office, U.S. Department of the Treasury, before the House Financial Services Subcommittee on Housing and Community Opportunity hearing on "Robo-Signing, Chain of Title, Loss Mitigation and Other Issues in Mortgage Servicing," November 18, 2010.

potential buyers a forthcoming decline in neighborhood quality. In the end, an overhang of homes awaiting foreclosure is unhealthy for the housing market and can delay a recovery in housing markets and the broader economy.

Several possible explanations have been suggested for the prominence of foreclosures: the lack of servicer capacity to execute modifications, purported financial incentives for servicers to foreclose rather than modify, what until recently appeared to be easier execution of foreclosures relative to modifications, limits on the authority of securitization trustees, and conflicts between primary and secondary lien holders. Whatever the merits and relative weights of these various explanations, the social costs of this situation are huge. It just cannot be the case that foreclosure is preferable to modification for a significant proportion of mortgages where the deadweight costs of foreclosure, including a distressed sale discount, are so high. While some banks and other industry participants have stepped forward to increase the rate of modifications relative to foreclosures, many have not done enough. We need renewed attention in many quarters of government and the financial industry, and among investors in mortgage-backed securities, to the lagging incidence of modifications.

Conclusion

In conclusion, I regret to say that the hangover from the housing bubble of this past decade is still very much with us, as revealed both in the inadequate capacity of mortgage servicers and the continued impact of foreclosed homes on the housing market. While bank regulatory agencies can and should respond to specific failings that are being identified in our interagency examination, there is a strong case to be made that broader solutions are needed both to address structural problems in the mortgage servicing industry and to accelerate the pace of mortgage modifications or other loss mitigation efforts.

Thank you very much for your attention. I would be happy to answer any questions you might have.