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On

PROBLEMS IN MORTGAGE SERVICING FROM MODIFICATION TO FORECLOSURE

Before the

Committee on Banking, Housing, and Urban Affairs

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Chairman Dodd, Ranking Member Shelby and the other members of the Committee, thank you for the opportunity to address you today on this important subject.

I. Background and History of the States' Efforts

While the issues of foreclosures, mortgage loan servicing, and loss mitigation efforts are currently receiving substantial attention in the press, they are not new to the Attorneys General. Starting over a decade ago, the Attorneys General and our partners in the state banking departments began numerous enforcement efforts regarding fraudulent behavior by lenders in the origination of subprime mortgages. Beginning with First Alliance Mortgage Company (better known as FAMCO), then followed by the $484 million settlement with Household Finance, and finally the $325 million settlement with Ameriquest Mortgage Company, at that time the largest subprime lender, the States have had a front row seat to the fraud and misconduct in subprime originations.

This fraud, however, was concealed for years by the unprecedented home price appreciation that many areas of the country were experiencing. Due to the race to the bottom in underwriting standards, as soon as borrowers got into trouble they would simply refinance, masking their inability to perform. Accordingly, we knew that as soon as the rapid and unprecedented home price appreciation began to stall, the fraudulent and fragile underpinnings of the market would be exposed and more loans than we could imagine would begin to fail.

Knowing this, my staff began to explore servicing and foreclosure issues in the Spring of 2007. The more we learned, the more concerned we grew as it became apparent that servicers were not in any way prepared to deal with even a moderate volume of foreclosures. Accordingly, in July 2007 my office put out an invitation to every Attorney General in the country to attend a summit on foreclosures. The purpose was to warn our colleagues that a tidal wave was coming and they needed to begin to prepare.

Out of this meeting, a working group of Attorneys General and state bank regulators was formed. This group was later named the State Foreclosure Prevention Working Group ("State Working Group"). At the beginning, a policy decision was made that this would not be a litigation based group, but rather the group would attempt to work collaboratively with the mortgage servicing industry in order to find solutions to the myriad problems standing in the way of effective loss mitigation. Because the problem was mostly contained to subprime loans at that point in time, we set up a meeting with the top 10 largest subprime servicers in September 2007 and another meeting with the next 10 largest in November 2007. At these meetings, we were assured by many of the servicers that they were adequately staffed and prepared for what was coming. Obviously, this did not turn out to be the case.

In addition, it became clear to the States that we wanted to base our decisions on empirical data, not anecdotal stories. Thus, in October 2007, the State Working Group became the first governmental entity — state or federal — to collect data on the servicers' loss mitigation efforts and results. We used this data to publish five reports which provide analysis and commentary on a variety of issues. Reports were published in February 2008, April 2008, September 2008, January 2010, and August 2010. Unfortunately, our data collection was not as robust as it could have been due to the extremely short-sighted direction of the Office of the Comptroller of the Currency which forbad national banks from providing loss mitigation data to the States.

II. The Impact of Securitization on Servicing

Many people still talk about "banks" generically when discussing foreclosure issues. Of course, the old model of a local bank making a loan and then keeping that loan on its books has largely disappeared. Instead, mass securitization of mortgage loans has become the norm. This has produced a radical change in the structure of loan servicing and a misalignment of incentives. Many pages can and have been written on this subject, and I will not attempt to repeat that discussion hear. Described in its simplest form, in most cases ownership of the mortgage loan is no longer aligned with the servicing of that loan. This change has introduced enormous complexity and has made the task of modifying loans and avoiding preventable foreclosures much more difficult.

III. Common Loan Servicing Problems

In order to understand what has been happening with mortgage loan servicing over the last three years, it is essential to understand one basic truth: the current mortgage servicing system was not designed for any of the tasks it is being asked to perform, and it certainly is not equipped to perform such tasks at anywhere near the scope and scale of the foreclosure crisis.

Modern loan servicing was designed to be a no-touch or low-touch money collection system. Instead, servicers have been asked to re-underwrite, or in many cases underwrite for the first time, a massive number of loans. Asking servicers to solve the foreclosure crisis is akin to putting a square peg in a round hole. The servicers, no matter how good their intentions, were simply not designed for this problem. Put on top of that the unprecedented scope and scale of the foreclosure crisis, and the servicers have become completely overwhelmed.

From this premise flow all of the problems which our office and other Attorneys General hear about on a regular basis. For example, we are constantly hearing about borrowers who are asked to resubmit their paperwork because it was lost multiple times. Because servicers are overwhelmed, loss mitigation requests are often delayed and stretched out over long periods of time. As a result, the financial documents originally submitted by the borrower become stale, triggering multiple requests for resubmission. While the servicer is free to lose documents as many times as they want or to take as long as they want, the servicer often demands strict compliance from the borrower. Thus, no matter how many times the borrower has previously submitted his or her paperwork, if the borrower fails one time, the loan modification is denied. Similarly, many borrowers report that after not hearing from their servicer for several months, they will receive a proposed loan modification but will be given a very short time frame (several days) to sign and return the document (along with any required financial contribution). Again, strict compliance is enforced.

Perhaps the biggest problem is that loss mitigation and foreclosure exist simultaneously on parallel tracks. This leads to problems when the left hand does not know what the right hand is doing. Thus, we all hear stories of borrowers who thought they were approved for a loan modification receiving a notice of a foreclosure sale. In short, the fundamental fact that servicing systems are being asked to perform a task for which they were not designed has predictably led to a wide range of problems in implementing loss mitigation solutions.

IV. The Mortgage Foreclosure Multistate Group

In a classic example of why it is wise to continue to support our constitutional framework of federalism, the States were able to react very quickly to the recent robo-signing reports. In very short order, all 50 Attorneys General and a committee of state banking regulators representing all 50 states formed a multistate group to address this problem. We were able to do this for several reasons. First, state officials are much closer to the problems in loan origination and servicing than our federal counterparts. Quite simply, citizens know who their State Attorney General or banking department is and are much more likely to contact us than a 1-800 number in some far away location, particularly when it comes to real estate and foreclosures, both of which are inherently local issues. Second, the long standing relationships formed over the past decade in our mortgage origination enforcement actions and more recently, the work of the State Foreclosure Prevention Working Group, allowed us to mobilize quickly. As in our previous efforts, we are continuing our valuable partnership with our state bank regulator counterparts.

Because we are in the midst of our investigation, I am necessarily constrained as to how much I can comment on the specifics. However, I can make some general comments.

First, some have attempted to describe the issue of "robo-signing" as being a mere technicality. This argument shows a certain type of arrogance. The home is not only the centerpiece of family life, but it is by far the biggest purchase that many people will make in their life, and for many their biggest asset. The state foreclosure laws are the official method by which the family home can be taken away. Given such high stakes, strict compliance is expected. Others have suggested that the only relevant facts are that the borrower owes the money and has to pay it back. Such statements miss the point entirely. We do not say in a criminal prosecution that it is ok for the prosecutor to fabricate evidence, so long as the defendant is in fact guilty. The outrage over robo-signing is about due process, protection of private property rights, and the rule of law. In judicial foreclosure states, robo-signing is a fraud on the court. Such issues are of the highest importance.

That being said, I would like to make it clear that the multistate investigation is about more than robo-signing. After all, robo-signing is only a symptom of the much larger problems with the mortgage servicing system. Thus, the multistate group intends to look at issues regarding the accuracy of the information used by servicers in the foreclosure process, as well as issues such as the imposition of various servicing related fees and force placed insurance. The multistate group is also interested in some of the issues that are being raised regarding the ability or inability of servicers and investors to show proper chain of title.

However, the biggest issue is fixing the loan modification system. In many ways, there is not currently a coherent loss mitigation system. Instead, there exists a system of "Russian roulette" where whether or not a borrower receives a modification that will save the family home depends in large part on who picks up the phone on the other end. In essence, those who are lucky enough or persistent enough to get to the right person are the ones who receive quality modifications, regardless of the facts of their case. This has to change.

To be clear, the States do not believe that every foreclosure is a tragedy that must be avoided. To the contrary, we have consistently stated over the last three years that we are only interested in modifications where the cash flow from the modification exceeds the expected proceeds from a foreclosure sale. In industry parlance, this is a net present value positive modification. Such a modification is a win for the servicer, the investors who own the loan, the borrower, and the community at large. We strongly believe, however, that many borrowers, who under a strict economic analysis should receive a modification, are falling through the cracks. We must find a way to make sure that all borrowers who have the desire to keep the home and qualify for a modification, receive that modification.

V. Conclusion

In recent weeks, many have opined that the temporary halt on foreclosures and foreclosure sales by several servicers was greatly damaging the economy. With all due respect, it is the foreclosures in the first instance that pose the greatest threat to the economy. While certainly it does not make sense to allow vacant properties to linger, and such properties should be sold if possible, the looming shadow inventory of homes that will become real estate owned and the millions of foreclosures yet to come is the true threat that must be avoided. Foreclosures at the scale we are currently experiencing, and unfortunately will continue to experience for some time, are a public policy issue. It is well past time to once and for all tackle the issue of foreclosures and loan modifications with the resources and urgency it deserves.

As set forth above, the Attorneys General and the state banking regulators have been discussing various issues and quite frankly warning the servicing industry for over three years. Unfortunately, the mortgage servicing industry has been slow to recognize the problems and instead responded with a series of half-steps, based on the hope that a recovery in the market was just around the corner. Instead, the situation has become worse and worse, forcing servicers and secondary market investors to take steps that a relatively short time earlier were off the table. We believe that there have been many missed opportunities over the past few years and are deeply disappointed that our many previous attempts at working with the servicers have not been as successful as we had hoped. However, the States are determined that this time, we will find lasting solutions to the foreclosure crisis.