Housing Finance Reform:
Essentials of a Functioning Housing Finance System for Consumers
October 29, 2013

<u>Questions for Ms. Alys Cohen, Staff Attorney, National Consumer Law Center from Chairman Johnson:</u>

1. We saw during the crisis that the interests of servicers, investors, and consumers were not always aligned, partially due to servicer compensation or servicers holding second liens on mortgages that they serviced. Have these issues related to incentive alignments been addressed in existing standards? If not, how should housing finance legislation address these issues?

Answer:

The foreclosure crisis, and the failure of servicers to provide efficient, affordable outcomes for qualified homeowners facing hardship, demonstrate the lack of alignment between servicer interests and those of homeowners, investors and the economy at large. A foreclosure guarantees the loss of future income to the servicer, but a modification also will likely reduce future income, cost the servicer more in the present in staffing, and delay the servicer's recovery of expenses. Moreover, the foreclosure process itself generates significant income for servicers. Income from increased default fees and payments to affiliated entities can outweigh the expense of financing advances for a long time. A dragged out foreclosure process also boosts the monthly servicing fee and slows down servicers' largest non-cash expense, the amortization of mortgage servicing rights, since homeowners who are in default are unlikely to prepay via refinancing. Finally, foreclosure or modification, not delinquency by itself, usually triggers loss recognition in the pool. Waiting to foreclose or modify postpones the day of reckoning for a servicer. But delay can cost a homeowner the opportunity to obtain a modification.

The lack of alignment between servicers and other market players has not been addressed by existing standards and thus housing finance legislation should include several key elements to ensure that servicer interests are aligned with the rest of the market. First, the new housing finance system must require servicers to provide affordable loan modifications that are consistent with investor interests. The housing finance system should promote proven regimes for modifying loans with optimum loan performance and should include a standardized, publically available net present value analysis. This approach should also include limited, government-backed portfolio capacity to hold modified loans. The modification mandate should be included both in the servicer approval requirements and in uniform securitization agreements.

Second, homeowners seeking loan modifications should not be faced with an ongoing foreclosure while they are processing their loan modification request. Instead, such foreclosures should be put on temporary hold rather than subjecting the homeowner to the "dual track" of foreclosure and loss mitigation. Homeowners in foreclosure should be able to obtain a temporary pause to a foreclosure to promote efficient evaluation of a loan modification application. Additionally, in order to promote timely loan modification reviews over foreclosures, dual track protections must be triggered by the homeowner's initial application. A system that brings protections into play only when the homeowner submits a "complete application" invites manipulation of the process based on the servicer's subjective determination of an application's status.

While existing regulations provide some level of protection against dual tracking, stronger GSE rules are nevertheless appropriate. The housing finance system should promote the highest standards for loss mitigation, as it has for home lending. Such progress would promote broader market changes and demonstrate the viability of sustainable loan modification reforms. Dual track protections in GSE reform legislation should be included both in the servicer approval requirements and in the uniform securitization agreements.

Third, the new housing finance corporation (or the bondholders themselves) should be authorized to purchase insurance directly, including force-placed insurance. A mechanism allowing the purchase of force-placed insurance—as well as title insurance and private mortgage insurance—directly from insurers would decrease costs for borrowers and the corporation by circumventing the kickbacks to servicers that drive up insurance prices.

Fourth, the new housing finance system should promote transparency and accountability. An Office of the Homeowner Advocate should be established to assist with consumer complaints and compliance matters. This would help remedy the current situation in which non-compliance problems with GSE loans often go unaddressed. Moreover, loan level data collection and reporting should include demographic and geographic information, to ensure that civil rights are protected and equal opportunity to avoid foreclosure is provided. Aggregate information about complaints and the data about loss mitigation must be publicly available, as HMDA data are. Work to develop the new housing finance system, and to administer and oversee it, should include stakeholders such as community groups and representatives of homeowners, in addition to the corporate stakeholders on the lending and servicing sides.

Finally, in order to ensure that the housing system meets its goals, there must be strong regulatory levers for securing compliance, including robust monitoring, reporting and supervision.

2. Post-crisis, there have been a number of actions taken related to mortgage servicing, including the CFPB rule, the FHFA's mortgage servicing alignment initiative, the FHFA's servicing compensation discussion paper, and enforcement actions by the prudential regulators. Please comment on the effectiveness of these efforts, and whether there are recommendations or findings from these actions that should be incorporated into housing finance legislation.

Answer:

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While a number of government actions and initiatives have called attention to the need for reform of the mortgage servicing industry and have in many cases moved the ball forward, the results have been incomplete at best. Below I review the various actions individually. What they have in common is that they leave several important pieces of work undone. As noted above, important work still to be done includes: a mandate to provide affordable NPV-positive loan modifications to qualified homeowners facing hardship, a full pause in foreclosure for homeowners seeking loan modifications until such review is completed, and a dismantling of the reverse competition that characterizes the force-placed insurance system. Broader systemic changes relating to transparency and accountability also are still needed.

The Consumer Financial Protection Bureau should be commended for initiating a significant set of rules governing mortgage servicing. The new rules, set to take effect in January, address a wide array of servicer duties. Yet, while the rules provide substantial procedural protections to homeowners, including the requirement to review a completed loan modification application prior to initiating a foreclosure, they still subject many homeowners already in foreclosure to the “dual track” of foreclosure and loan modification. The rule also relies on a servicer finding that a “complete” application has been submitted—a term that easily can be gamed by servicers, who are the party defining that term. The CFPB also declined to include the key component needed to align servicer incentives with those of the rest of the market: a mandate for servicers to provide homeowners with affordable loan modifications when doing so is consistent with investor interests. While the CFPB rules include some enhanced protections on force-placed insurance, a new GSE system is uniquely positioned to affect how such insurance is bought and administered. Finally, even where the CFPB protections are strong, the rules appear to apply only the first time a person faces hardship in the life of a loan. Many homeowners will face more than one hardship over the decades they may be repaying a loan.

Various enforcement actions by state and federal agencies, including state Attorneys General and the prudential regulators, have been able to substantially increase the amount of principal reduction offered by mortgage servicers and to provide limited direct compensation to homeowners harmed by abusive servicer practices. Moreover, the National Mortgage Settlement was the first action that established substantial standards for servicer conduct. These federal and state measures, however, have been primarily retrospective and the standards themselves are temporary.

FHFA’s work touches servicing in several ways. First, the FHFA Servicing Alignment Initiative, like the CFPB rules, requires loan modification reviews to be completed prior to foreclosure while still allowing homeowners in foreclosure to be subjected to foreclosure during many loan modification reviews. It also goes beyond what the CFPB has established by setting up a modification waterfall. Yet the GSE guidelines for “standard” modifications, while providing flexibility by not being keyed to a net present value (NPV) analysis, are not adequately focused on homeowner affordability because they operate based on a percentage of payment reduction not a target debt-to-income ratio. Second, with regard to force-placed hazard and flood insurance, the current system, in which the GSEs reimburse servicers for force-placed hazard and flood insurance, has resulted in vastly inflated prices for borrowers and, when borrowers default, the GSEs and taxpayers. Lender-placed insurers and servicers do not have the incentives to control premium costs. A new GSE system is well situated to address problems in the insurance market through the direct purchase of insurance. FHFA recently had an opportunity to improve this situation and declined.

Third, FHFA announced that it will be charging more for mortgages in states with long foreclosure timelines. We believe this policy is misguided (and the incoming FHFA director Mel Watt has announced that he will delay implementation of the policy pending further study). While some states with better consumer protections have longer foreclosure timelines, in most cases the protracted timeframe is not due to a delay mandated by the rules themselves, but by the unwillingness of servicers to follow those rules. Better consumer protection rules prevent avoidable foreclosures, which ultimately saves money both for the GSEs and for communities while protecting home values and the housing market. It does not appear, however, that FHFA factored the long-term savings achieved in states with stronger homeowner protections into their cost calculations. Homeowners engaging in prospective borrowing in those states should not be penalized on the front end for living in a state with better foreclosure protections, and for the failure of servicers to properly comply with those protections. Moreover, delay in foreclosure is multi-layered. Rather than penalizing consumers, FHFA should continue encouraging servicers to process loan modification and foreclosures expeditiously, particularly as consumers are hurt by foreclosure delays, while servicers are not.

Finally, FHFA has failed to reform how servicers are compensated. FHFA worked with the GSEs and HUD to propose changes to the structure of servicer compensation but failed to make any changes. Moreover, the joint proposal did not address the misaligned incentives in the current compensation system. Nothing in the proposal tied servicer compensation closely to either the actual cost of servicing loans or the performance of the loans. Servicers under the current regime profit from their own bad behavior because they are permitted to retain all ancillary fees. Any new system should promote a modified fee-for-service model, coupled with rigorous servicing standards and limited ancillary fees. Such a model could improve servicing for both homeowners and investors, as long as it also restricts the incentive to push a loan into default servicing in order to recover enhanced compensation and fees.

3. S.1217 specifies that a new government agency, the Federal Mortgage Insurance Corporation (FMIC), will approve mortgage servicers for participation in the government-guaranteed secondary mortgage market, and may suspend their approval if certain minimum standards are not met. What role should the FMIC have in the ongoing regulation of servicers? Should the FMIC have enforcement, supervisory, or examination powers?

Answer:

Homeowners are unable to choose their mortgage servicer. Thus, the FMIC’s role in approving mortgage servicers takes on even greater importance because it is the primary means for assuring that servicers comply with appropriate standards. These standards should include requirements for servicers to provide sustainable loan modifications consistent with investor interests and to otherwise structure their loss mitigation operations to align servicer incentives with those of investors, homeowners and communities. In order to provide the FMIC with the necessary tools to promote these outcomes, it should have enforcement, supervisory and examination powers and should also coordinate with prudential regulators. In order to promote timely responses to compliance challenges, the FMIC also should house the Office of the Homeowner Advocate, which would serve as a locus at FMIC for consumer complaints and resolution of individual compliance-related matters. While enhanced government authority would promote better outcomes, legislation also should provide homeowners with a private right of action to enforce their rights to proper mortgage servicing on FMIC-insured loans.

Questions for Ms. Alys Cohen, Staff Attorney, National Consumer Law Center from Senator Reed:

1. In an earlier hearing, Martin S. Hughes, Chief Executive Officer of Redwood Trust Incorporated, recommended that we establish servicer performance triggers to serve as benchmarks and as objective means for possible removal of the servicer. This is similar, but not identical, to a provision I pushed in the FHA Solvency Bill which was cleared by this Committee thanks especially to Chairman Johnson, Ranking Member Crapo, Senators Brown, Merkley, and Warren. Could you please discuss why servicer performance triggers would be helpful to consumers?

Answer:

While homeowners are able to choose their lender, the servicer is designated by the owner of the loan and the homeowner has no choice in the matter. Thus, when a servicer does not properly fulfill its duties a homeowner does not have the option of terminating the relationship with the servicer in favor of one who provides better customer service. While servicers work for investors, a variety of circumstances, including a collective action problem, often make it difficult for investors to hold servicers responsible for non-compliance with servicer duties. In a newly reformed GSE system, the FMIC or similar corporation is in the best position to hold servicers accountable for performance on an individual and systemic basis. The contractual relationship between the servicer and FMIC gives the FMIC the ability to establish parameters concerning servicer performance. By establishing triggers to be used as benchmarks for performance and potential removal of a servicer, the FMIC would be able to implement a transparent and uniform system of accountability. Such a setup would benefit consumers who otherwise have little leverage to address servicer misconduct. Moreover, the market in general would benefit because servicer conduct and incentives would be better aligned with other stakeholders.