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Chairman Capito and Chairman Neugebauer, Ranking Member Maloney and Ranking MemberCapuano, and members of the Subcommittees, thank you for inviting me to testify about mortgage servicing standards. My name is Raj Date and I serve as Associate Director for Research, Markets, and Regulations for the Consumer Financial Protection Bureau ("CFPB" or "Bureau").

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") established the CFPB as an independent bureau within the Federal Reserve System and charged it with ensuring that consumers have the information they need to make financial decisions that are best for themselves and their families. The Bureau will work to promote fairness, transparency, and competition in the markets for mortgages, credit cards, and other consumer financial products and services. The CFPB will set – and enforce – clear, consistent rules that will allow banks and other firms to compete on a level playing field and that will allow consumers to see clearly the costs and risks of financial products.

The Bureau is not yet open for business. But two weeks from now, on July 21st, the Bureau will receive transferred authority from existing regulators to administer federal consumer financial protection laws. And on that day, mortgage servicing will be one of the CFPB's priorities.

Mortgage servicing is important. It is an enormous market, with some $10.4 trillion of principal balances outstanding.[1] It is a market that has been marked by pervasive and profound consumer protection problems, as documented in recent reports by a number of other government agencies.[2] And, importantly, mortgage servicing is a market that is marked by two structural features that make it especially prone to the risk of consumer harm.

The first of those structural features is simple: in the vast majority of cases, consumers do not choose their mortgage servicers. Mortgage servicing rights can be, and quite frequently are, bought and sold among servicers irrespective of the borrowers' consent. There are certainly legitimate and desirable aspects to the liquidity of mortgage servicing rights, but it has a practical disadvantage as well. Let me illustrate with an example. Last week, I had a prescription filled. If my pharmacist had made me stand in a long line, or if she was rude to me, or if she repeatedly lost my prescription paperwork, or if she was impossible to find on the phone, or if she gave me guidance that conflicted with my doctor's, or if she tried to give me the wrong medicine, then next time, I would simply go to a different pharmacist. That's how most consumer-facing markets work. But I get to choose my pharmacist. I don't typically get to choose my mortgage servicer.

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[1] Federal Reserve Statistical Release Z.1, *Flow of Funds Accounts of the United States, First Quarter 2011*, at 96 (June 9, 2011), http://www.federalreserve.gov/releases/z1/Current/z1.pdf.

[2] See *infra* notes 8-23 and accompanying text.

The second structural feature of mortgage servicing that relates to consumer protection is this: the current structure of servicing fees creates a strong incentive to underinvest in adequate technology, people, and processes to handle cyclical spikes in delinquencies.[3] There are two important things to know about these servicing fees. First, the fees are fixed and typically do not go up if loans become delinquent and need more work. Second, these fees are not remotely high enough to properly service high volumes of delinquent loans.[4] The typical fixed servicing fee is 25 basis points (bps) a year for prime fixed-rate loans, 37.5 bps a year for prime adjustable-rate mortgages, and 50 bps a year for subprime loans.[5] For a typical $175,000 loan, that works out to around $440 a year for a prime fixed-rate loan, $660 a year for a prime ARM, and $880 a year for a subprime loan.

At the same time, servicing a seriously delinquent loan can cost well over $1,000 a year.[6] This makes sense, because servicing a delinquent loan requires significantly greater work and expertise. Servicing performing loans is cheap and profitable: it consists of processing loan payments, which is typically highly automated. Servicing delinquent loans, in contrast, takes one-on-one contact with borrowers, costly collection efforts, and specialized staff to re-underwrite loans in order to compare the cost-effectiveness of workouts versus foreclosures. In the private-label market, servicers evaluate cost-effectiveness according to net present value tests

[3] See, e.g., Testimony of Laurie Goodman, Amherst Securities Group, before the Subcommittee on Housing, Transportation, and Community Development of the Senate Committee on Banking, Housing, and Urban Affairs, at 1 (May 12, 2011), http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=484c5b2b-6924-459f-898e-3ae075feeb15.

[4] See *id*. at 1.

[5] See, e.g., Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang and Eileen Mauskopf, "The Incentives of Mortgage Servicers: Myths and Realities," Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, Working Paper 2008-46, at p. 15 (2008).

[6] See, e.g., Federal Housing Finance Agency, Servicing Compensation Initiative Pursuant to FHFA Directive in Coordination with HUD, p. 7 (Feb. 2011) (cost of over $1,000 annually for a continuously delinquent loan), http://www.fhfa.gov/webfiles/19719/FHFA_Servicing_Initiative_-_Background_and_Issues_2011-02-14_3pm_FINAL.pdf.

contained in their pooling and servicing agreements with securitized trusts. Nevertheless, private investors are generally too dispersed and lack sufficient information updates from servicers to monitor servicers' performance adequately.

In response to this state of affairs in the mortgage servicing area, the Federal Housing Finance Agency ("FHFA"), in a joint initiative with the U.S. Department of Housing and Urban Development ("HUD"), recently voiced concerns that the flat-fee structure undermines the "optimal servicing of non-performing loans" and was "not designed for current market conditions."[7] Put another way, under the prevailing market standards for servicer compensation, taking on the servicing of a loan is something of a bet on credit. If a loan remains performing, then servicing the loan remains a quite profitable affair. But if the borrower becomes delinquent, then the cost of servicing the loan is likely to be many times greater than the revenue from servicing that loan. If a servicer's portfolio contains many more nonperforming loans than the servicer expected, the servicer stands to lose money.

Unfortunately, when it became clear that servicers had taken on riskier than expected portfolios, they did not simply internalize the higher costs of servicing in an adverse credit environment. Instead, many servicers, when faced with an upswing in mortgage delinquencies, cut corners, often loosening operational protocols and putting inadequate resources into dealing with troubled homeowners.

According to other Federal agencies, the evidence of shoddy practices and underinvestment is striking. In examinations of fourteen major servicers this spring, the Comptroller of the Currency, the Federal Reserve System, and the Office of Thrift Supervision concluded that servicers were "emphasiz[ing] speed and cost efficiency over quality and

[7] Federal Housing Finance Agency, "FHFA Announces Joint Initiative to Consider Alternatives for a New Mortgage Servicing Compensation Structure," News Release (Jan. 18, 2011), http://www.fhfa.gov/webfiles/19716/Servicing_model11811.pdf.

accuracy" in their foreclosure processes.[8] According to these prudential banking regulators, the servicers had "inadequate organization and staffing of foreclosure units to address the increased volumes of foreclosures."[9] Furthermore, a "large percentage" of the servicers' staff "lacked sufficient training in their positions."[10] To give some sense of the degree of this underinvestment, the Government Accountability Office reported that "one servicer that had previously understaffed" its foreclosure functions "increased its document-signing staff from 5 to 80"after the probe of the foreclosure process.[11]

The prudential regulators' examinations uncovered legal violations as well. The regulators found that servicers and their contractors had filed false affidavits in court under oath and disregarded state requirements for notarizations, resulting in "violations of state foreclosure laws designed to protect consumers."[12] These violations, together with other problems the examinations identified, were so severe that they had "an adverse effect on the functioning of the mortgage markets" and posed "significant risk to the safety and soundness of mortgage

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[8] Federal Reserve System, Office of the Comptroller of the Currency, and Office of Thrift Supervision, "Interagency Review of Foreclosure Policies and Practices," at 7 (April 2011), http://www.occ.gov/news-issuances/news-releases/2011/nr-occ-2011-47a.pdf.

In addition, last month the Treasury Department rated the performance of the largest servicers participating in the *Making Home Affordable* program, ranking them on identifying and contacting homeowners; homeowner evaluation and assistance; and program management, reporting, and governance. Treasury determined that six of the servicers needed moderate improvement and four needed substantial improvement in the first quarter of 2011. None of the servicers needed only minor improvement. Department of the Treasury, Making Home Affordable: Program Performance Report Through Apri1 2011, at 16 (June 2011), http://www.treasury.gov/initiatives/financial-stability/results/MHA-Reports/Documents/April%202011%20MHA%20Report%20FINAL.PDF.

[9] Federal Reserve System et al., *supra* note 8, at 3.

[10] *Id*. at 7.

[11] Government Accountability Office, "Mortgage Foreclosures: Documentation Problems Reveal Need for Ongoing Regulatory Oversight," at 26 (GAO-11-433, May 2011).

[12] Federal Reserve System et al., *supra* note 8, at 3-4, 5, 8; Government Accountability Office, *supra* note 11, at 26.

activities."[13] These findings were the basis for formal enforcement actions by the agencies, resulting in consent orders against all fourteen servicers.

Poor servicing practices have inflicted hardship on borrowers, investors, and the country as a whole. As has been widely reported, servicers frequently did not answer distressed borrowers' calls or letters in a timely fashion, and often simply lost their paperwork.[14] Servicers sometimes charged homeowners inaccurate fees that could make "it more difficult for [the] borrowers to bring their loans current."[15] In extreme cases, borrowers suffered wrongful foreclosures and lost their homes. Among those affected were servicemembers on active duty who were foreclosed upon in violation of the Servicemembers Civil Relief Act.[16] Similarly, there were cases where servicers had approved borrowers for loan modifications, but subsequently foreclosed on those same borrowers; the prudential regulators' report also acknowledged that borrowers could have their loss mitigation options curtailed as a result of the servicers' "dual-track" processes.[17] In testimony this May, Federal Deposit Insurance Corporation Chairman Sheila Bair, commenting on the examinations' scope, stated that "we do

[13] Federal Reserve System et al., *supra* note 8, at 4-5, 7.

[14] See, e.g., Cordell et al., *supra* note 5.

[15] Federal Reserve System et al., *supra* note 8, at 5. See also Government Accountability Office, *supra* note 11, at 41 (weaknesses in servicers' foreclosure processes "could result in inaccurate fees and charges assessed against a borrower"); Goodman Testimony, *supra* note 3, at 6-7 (to compensate for their low servicing fees on delinquent loans, servicers "often mark up fees [for foreclosure and related services] considerably," "making it harder for a borrower to become current").

[16] Federal Reserve System et al., *supra* note 8, at 3; Government Accountability Office, *supra* note 11, at 28.

[17] Federal Reserve System et al., *supra* note 8, at 3, 5; Government Accountability Office, *supra* note 11, at 41 ("borrowers could find their loss mitigation options curtailed because of dual-track processes that result in foreclosure even when a borrower has been approved for a loan modification").

not yet really know the full extent of the problem" and that "the horizontal review only looked at processing issues."[18]

Investors too were injured by servicing failures. Excessive fees charged to borrowers by servicers for services related to defaults increased loan losses to investors.[19] Similarly, servicers' failure to invest in adequate loss mitigation operations resulted in costly foreclosures in situations where loan modifications would have resulted in greater recovery to investors.[20] Investors have also raised concerns about irregularities in the documentation of their ownership interests.[21]

Adding to this harm is the damage to the nationwide housing market. The prudential regulators specifically found that the weaknesses in foreclosure processes "slow[ed] the clearing of excess inventory of foreclosed properties and [led] to extended periods of depressed home prices."[22] Widely publicized weaknesses in foreclosure processes have also hurt home buyer confidence,[23] likely further impairing the housing markets.

In the Dodd-Frank Act, Congress took important steps that will correct flaws in the federal regulation of mortgage servicing. As the Government Accountability Office has found, to date, federal oversight of mortgage servicers' activities has been "limited and fragmented."[24]

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[18] Statement, Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, on Oversight of Dodd-Frank Implementation: Monitoring Systemic Risk and Promoting Financial Stability, before the Senate Committee on Banking, Housing, and Urban Affairs, at 22 (May 12, 2011), http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=94d50f1a-75eb-4586-b025-76e44870816b; Government Accountability Office, *supra* note 11, at 28.

[19] See, e.g., Goodman Testimony, *supra* note 3, at 6.

[20] Goodman Testimony, *supra* note 3, at 2-4.

[21] See, e.g., Bair Statement, *supra* note 18, at 22-23; Dan Fitzpatrick, *BofA Nears Huge Settlement*, Wall Street Journal, June 29, 2011.

[22] Federal Reserve System et al., *supra* note 8, at 6; Government Accountability Office, *supra* note 11, at 42.

[23] Federal Reserve System et al., *supra* note 8, at 6.

[24] Government Accountability Office, *supra* note 11, at 14.

The two key consequences of this flawed regulatory structure have been the lack of comprehensive federal standards for mortgage servicers, and the lack of any direct federal oversight of non-depository servicers.

In creating the CFPB, Congress vested the agency with sufficient jurisdiction and powers to protect consumers in all mortgage servicing activity – regardless of the servicer's charter or locale. While the CFPB can address consumer protection, a comprehensive approach that also protects investors, the financial sector, and the housing market requires the coordinated action of many federal regulators, including the FHFA and the prudential regulators. The Bureau will be working together with these and other agencies to the maximum extent possible.

In overseeing mortgage servicing, the CFPB has a variety of tools – including supervision and supervisory guidance, enforcement, and rulemaking – at its disposal. The Dodd-Frank Act authorizes the CFPB to promulgate consumer protection standards for the entire mortgage servicing industry, and to ensure compliance with those standards by large depository institutions, their affiliates, and nonbank servicers. The Bureau will receive rulemaking authorities under various federal laws relevant to mortgage servicing, consisting both of authorities that will transfer to the Bureau from other agencies, including the Federal Reserve Board, HUD, and the Federal Trade Commission, and new rulemaking authorities granted by the Dodd-Frank Act. But new regulations take many months to promulgate, and homeowners are facing problems here and now. In this regard, it is important to note that the Dodd-Frank Act leveled the playing field by placing independent nonbank mortgage servicers under CFPB supervision. The CFPB will use its authorities to help ensure that all mortgage servicers have adequate systems and procedures to ensure compliance with federal law.

In using these authorities, the Bureau will work together with the prudential regulators and other agencies to ensure the efficient and effective exercise of its responsibilities and to improve the functioning of the mortgage servicing market. The Secretary of the Treasury and federal regulators have issued a call for national servicing standards.[25] To that end, the federal prudential regulators, together with HUD, the Treasury Department, and the FHFA, have formed an interagency working group to collaborate on national mortgage servicing standards. Earlier this year, these agencies invited the CFPB to join the working group, and we have participated in the group ever since.[26] Although the CFPB does not yet have rulemaking or supervisory authority over mortgage servicing, our staff is working hard to prepare to assume these responsibilities when the agency becomes fully operational. We look forward to continuing the interagency discussion and coordination to make sure the rules of the road for servicing are fair and clear for consumers, servicers, and the broader market.

Chairmen Capito and Neugebauer, Ranking Members Maloney and Capuano, thank you for the opportunity to testify.

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[25] See Government Accountability Office, *supra* note 11, at 32-34; Written Testimony of Secretary Timothy F. Geithner Before the House Committee on Financial Services, March 1, 2011; Testimony of John Walsh, Acting Comptroller of the Currency, before the Committee on Banking, Housing, and Urban Affairs, United States Senate, February 17, 2011; Statement by Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing and Urban Affairs, United States Senate, December 1, 2010; Speech by Sheila Bair, Chairman of the Federal Deposit Insurance Corporation, at the Mortgage Bankers Association's Summit on Residential Mortgage Servicing for the 21st Century, January 19, 2011.

[26] See Government Accountability Office, *supra* note 11, at 34.