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The Federal Housing Finance Agency's Efforts Related to Mortgage Servicing

I would like to thank the Mortgage Bankers Association for inviting me to speak here today.

As we all know, a few weeks ago the Administration issued a report on reforming the housing finance market. In that report the Administration set forth some options to consider for the long-term structure of housing finance. In the near-term the Administration also set forth a number of recommendations to reduce the overall presence of the government in the mortgage market, which would provide opportunities for private capital to return to the market.

As debate over the future of the housing finance system progresses, the Federal Housing Finance Agency (FHFA) will remain focused on meeting the goals of the conservatorships, which include retaining value in the business operations of Fannie Mae and Freddie Mac (Enterprises) and maintaining their support for the housing market. We look forward to considering the near-term options discussed in the Administration's report consistent with our responsibilities as conservator and regulator.

As the Enterprises continue operating in conservatorship, FHFA has directed them to undertake some joint initiatives to strengthen certain business operations. In our view, these initiatives have value not only for the Enterprises' operations, but also for the broader mortgage market, regardless of the ultimate outcome of housing finance reform. In other words if certain changes can be made that better the overall functioning of the mortgage finance system, we should try to move forward on those changes now.

One of those initiatives is the Loan Quality Initiative (LQI). Under the LQI, FHFA directed the Enterprises to undertake the development of standards to improve the consistency, quality, and uniformity of data that are collected at the front end of the mortgage process. By identifying potential defects at the front end of the mortgage process, the Enterprises will improve the quality of mortgage purchases, which should reduce repurchase risk for originators. The LQI is moving forward and will be phased in over the course of this year and next.

More recently, FHFA announced the Joint Servicing Compensation Initiative. On January 18th, FHFA directed Fannie Mae and Freddie Mac, in coordination with FHFA and the Department of Housing and Urban Development, to consider alternatives for future mortgage servicing compensation for their single-family mortgage loans. The goals of the joint initiative are to improve service for borrowers, reduce financial risk to servicers, and provide flexibility for guarantors to better manage non-performing loans, while promoting continued liquidity in the To Be Announced mortgage securities market.

To meet these goals, any change to mortgage servicing compensation must take account of a number of factors. Among these factors are:

(1) Maintaining liquidity and consumer choice in the mortgage market.

Everybody from borrowers, to originators, to investors has an interest in ensuring liquidity and consumer choice in the mortgage market. Maintaining liquidity in the mortgage market allows originators to offer borrowers the best market rates. Investors have often viewed the current mortgage compensation structure as providing some protection against excessive refinancing solicitation, thereby helping to make prepayment speeds more predictable. Whether or not that remains the case today, and the impact of various alternative compensation structures, is an issue that the joint initiative will be looking at closely.

(2) Ensuring that the servicing business model – for both performing and non-performing loans – is profitable, and available for all sizes of servicers.

The servicing industry has become highly concentrated today, with 10 companies responsible for over 70 percent of the servicing market. Some of this concentration is related to economies of scale, but some may also be related to servicing compensation. The current servicing compensation structure results in the creation of a mortgage servicing right asset, which is difficult to manage and is separate from a servicer's core competency of servicing mortgage loans. In addition, capital requirements for mortgage servicing rights will likely increase for many servicers under Basel III. The extent to which the current servicing compensation structure and alternative structures impact the economic choices of maintaining a servicing platform is an issue the joint initiative will be evaluating.

(3) Ensuring that mortgage originators have flexible execution options.

In today's mortgage market, origination and servicing are closely linked as the value obtained from mortgage servicing under the current servicing compensation model often serves as an offset for origination costs. For Enterprise mortgages, an originator has two choices: retain the mortgage servicing right; or sell or release the mortgage servicing right. As just discussed, retaining the mortgage servicing right may be problematic for some institutions. And while selling or releasing the mortgage servicing right provides an opportunity to monetize value, the value obtained is directly related to the level of demand from organizations that can hold the mortgage servicing right asset, and originators also relinquish their relationship with the borrower. The joint initiative will consider ways to provide flexibility for originators to retain or release mortgage servicing through other structures that do not mandate the holding of a mortgage servicing right asset.

(4) Increasing flexibility for guarantors to manage non-performing loans.

The current servicing compensation system was not set up to handle increased volumes of non-performing loans, which causes problems from both the guarantors' and borrowers' perspectives. A minimum servicing fee that is part of the mortgage note rate provides income when a loan is performing, but no income for non-performing loans – at exactly the time that more funds need to be expended. This mis-alignment contributes to less than optimal servicer performance in foreclosure prevention efforts and hinders the Enterprises' loss mitigation efforts. A key focus of the joint initiative will be considering compensation structures that better align servicer incentives. Put another way, we are seeking a structure that better aligns the cost of servicing to the servicing compensation received.

These are only a few of the high level issues that the joint initiative will be considering. Changes to servicing compensation are complicated and affect several aspects of the mortgage financing process. Alternatives that the joint initiative may consider include a fee for service compensation structure for non-performing loans as well as the possibility of reducing or eliminating the minimum mortgage servicing fee for performing loans. Many of these issues have been the subject of discussion within the mortgage industry for years. Those are not the only alternatives, and the joint initiative would welcome the consideration of others.

FHFA has created a new web page on the FHFA web site for information related to the joint initiative, and we have posted a background document that compares the most common alternatives that have been considered in the past. Going forward, FHFA will coordinate efforts of the initiative over the next several months to gather feedback from the industry, consumer groups and investors, and from other regulators and government agencies. FHFA expects that this effort will lead to a proposal for a new single-family mortgage servicing compensation model that will benefit from broad public input. Any implementation of a new servicing compensation structure would require a significant lead time to ensure that all participants in the mortgage finance process have sufficient time to adjust to any changes. Any such implementation would be prospective in nature and would not be expected to occur before Summer 2012.

The joint initiative is about developing a servicing compensation model for the future. Clearly the last few years have posed unprecedented challenges for the servicing industry, in spite of efforts to expand the resources dedicated to loss mitigation activities and improve communications with troubled borrowers. While none of us underestimate the difficulties that servicers face, mortgage servicing, especially of delinquent loans, must improve.

To address the near-term issues we are facing today with servicing, FHFA has directed the Enterprises to participate in a separate working group with FHFA. This effort is focused on aligning the Enterprises' current servicing standards and establishing appropriate incentives to encourage and support servicer contact with borrowers in the early stages of delinquency, when evaluation for loan modification or other foreclosure alternatives is most effective. While each of the Enterprises has servicing guides and various procedures in place, greater consistency in servicing practices will ease burdens on servicers and can build on the best practices developed by each of the Enterprises.

The working group will develop consistent timelines and requirements for communications with borrowers, including solicitation for foreclosure prevention options, so that there is no confusion regarding what the two companies expect from servicers. Early intervention and evaluation are critical and we want to ensure that the guidelines are clear and simple to apply, to help all servicers provide homeowners in need with complete and useful information regarding their foreclosure prevention options as well as the opportunity to make decisions without the undue pressure of a looming foreclosure sale.

The working group is also developing an incentive structure that will reward servicers for early engagement, and update the foreclosure processing timelines in recognition of changes in state and local mandates and practices. Each Enterprises' work to develop new standards will now be part of the larger working group effort, and will include consideration of appropriate penalties to encourage efficient resolution and liquidation of properties in cases where foreclosure is necessary. The Enterprises will be moving forward with servicer penalties for last year in the coming weeks, but our goal is to announce the new set of requirements, timelines, incentives, and penalties by the end of the first quarter of this year.

Finally, FHFA is closely involved with other government regulators in the process of developing national servicing standards. The issues we are considering as part of the joint initiative and the near-term working group are closely related to the process of developing national servicing standards. This heightened regulatory coordination between primary and secondary market supervisors should help market participants operate with more uniform regulatory standards and expectations.

I know that members of the panel about to follow me can expand on the initiatives I have just described. Thank you again for inviting me to speak here today.