



**Statement of**

**Edward J. DeMarco, Acting Director**

**Federal Housing Finance Agency**

**Before the**

**Committee on the Judiciary**

**U.S. House of Representatives**

**“Foreclosed Justice: Causes and Effects of the Foreclosure Crisis”**

**December 2, 2010**

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**Introduction**

Chairman Conyers, Ranking Member Smith and members of the Committee, thank you for inviting me to speak with you today about problems in mortgage servicing. The recently-identified deficiencies in the preparation and handling of legal documents to carry out foreclosures are unacceptable. While those deficiencies undoubtedly reflect strains on a system that is operating beyond capacity and was never designed to handle the volume of nonperforming loans that we are seeing today, they also represent a breakdown in corporate internal controls and the integrity of mortgage servicing and foreclosure processing. Servicers and others within the industry may have attempted to expand the resources available to deliver appropriate loss mitigation services, including timely and accurate foreclosure processing, but in some instances those efforts have been inadequate.

Since this latest set of difficulties was identified, I have had a team of managers and staff from the Federal Housing Finance Agency (FHFA) working closely with Fannie Mae and Freddie Mac (the Enterprises) to gauge the full scope of the foreclosure processing problem and to move forward on foreclosures where appropriate. Our goals are two-fold: to ensure that foreclosure processing is done in accordance with the servicer contract and applicable laws, and to protect taxpayers from further losses on defaulted mortgages. Moving forward on foreclosures where appropriate limits taxpayer losses and contributes to the ultimate recovery of domestic housing

markets. Of course, before any foreclosure is completed, we expect servicers to exhaust all alternatives.

With those objectives in mind, I will review the actions that FHFA has taken to date, as well as those underway. Before doing so, I will provide context for understanding the problems that have arisen, including consideration of:

- the role of the servicers, attorneys, and their contractual relationship with the Enterprises when performing loss mitigation and foreclosures and
- the complexities of the system in which state and local laws create a diverse range of requirements that can extend foreclosure timelines, leaving homeowners and homebuyers in limbo, putting home values at risk in neighborhoods with abandoned or vacant properties and slowing the recovery of the housing market.

Today, Fannie Mae and Freddie Mac own or guarantee 30 million mortgages; of those, more than 1.3 million are more than 90 days seriously delinquent. As I have reported to the Committee on prior occasions, the Enterprises have sought to minimize losses on delinquent mortgages by offering distressed borrowers loan modifications, repayment plans, or forbearance. These loss mitigation techniques reduce the Enterprises' losses on delinquent mortgages *and* help homeowners retain their homes. Servicers of Enterprise mortgages know that these loss mitigation options are the first response to a homeowner who falls behind on their mortgage payments.

Yet, for some delinquent borrowers, their mortgage payments are simply not affordable due to unemployment or other hardship and a loan modification is not a workable solution. In other cases, homeowners have decided not to continue payment on their mortgages, perhaps because of the decline in value of their house or because personal circumstances have changed their desire or ability to retain their home. For these cases, the Enterprises offer foreclosure alternatives in the form of short sales and deeds-in-lieu of foreclosure. Such foreclosure alternatives generally are better for the homeowner, the neighborhood, and the Enterprise. Despite these options for a graceful exit from a home, foreclosure remains the final and necessary option in many cases.

The sheer volume of delinquent homeowners has put intense pressure on servicers, including their loan workout efforts and their foreclosure processes. Other hearings and studies have analyzed how and why this has happened. One of our challenges today is to identify the full scope and implications of foreclosure processing problems and to improve the integrity of the foreclosure process at servicers and related parties that are failing to perform to required standards.

### **Breakdowns in the Foreclosure Process and FHFA's Initial Response**

As reports of foreclosure documentation deficiencies emerged at several major servicers, FHFA sought to ascertain the full scope and nature of the problem. On October 1, I issued a statement that said, in part:

“FHFA, as conservator for Fannie Mae and Freddie Mac, supports efforts by the Enterprises to remind servicers and other parties engaged in processing foreclosures to do so in accordance with their seller-servicer agreements and applicable laws and regulations. Where deficiencies have been identified, FHFA has directed the Enterprises to work collectively to develop and implement a consistent approach to address any problems. In addition, FHFA is coordinating with appropriate regulators on this issue. Our goal is to assure the integrity of the foreclosure process and to see that any corrections in processes be tailored to the problem, protecting the rights of borrowers and investors without causing any undue disruption to the mortgage markets.”

On October 13, FHFA built upon its earlier statement by providing the Enterprises and servicers a four-point policy framework for handling foreclosure process deficiencies, including specific steps FHFA expects them to take to assess and remedy the problems. The four points are simply stated:

1. Verify that the foreclosure process is working properly;
2. Remediate any deficiencies identified in foreclosure processing;
3. Refer suspicions of fraudulent activity; and
4. Avoid delay in processing foreclosures in the absence of identified problems.

Pursuant to that guidance, the Enterprises continue to gather information on the full nature and extent of servicer problems. Since then, only a small number of servicers have reported back to the Enterprises as having some problem with their foreclosure processing that needs to be addressed. Still, these firms represent a sizeable portion of the Enterprises combined books of

business. The issues identified to-date range in size and scope, and may not affect every delinquent mortgage that a particular servicer is handling. Thus, it is difficult to say just how many delinquent Enterprise mortgages may be affected and the degree of difficulty in remediating the deficiencies. The Enterprises are currently working directly with their servicers to ensure that all loans are handled properly and corrections and refile of paperwork are completed where necessary and appropriate. Because the file reviews are being performed case-by-case, the full evaluation will take a substantial amount of time and resources.

As made clear in FHFA's October 13<sup>th</sup> policy framework, if wrongful acts in foreclosure processing are discovered, the appropriate remedies should be undertaken by servicers, regulators, and law enforcement. Simply put, it is not acceptable that servicers and other parties involved in foreclosure processing may not have adhered to state and local laws. As Conservator of the Enterprises, FHFA expects all companies servicing Enterprise mortgages to fulfill their contractual responsibilities, which include compliance with both the Enterprises' seller/servicer guides and applicable law. We expect the same of other parties as well, including law firms working on foreclosure processing of Enterprise loans. Finally, to reinforce the duties undertaken by servicers, the Enterprises have indicated that they may pursue remedies for contractual violations.

### **The Role of the Servicer**

When an Enterprise purchases a mortgage from an originating lender, it contracts with that lender or another bank or financial institution to service the loan. The servicer is the main

communication point for the borrower, accepting all payments and crediting the borrower's account.

When homeowners get behind in payments, the servicer is expected to work with the delinquent borrower to set up a repayment plan, modify the loan, or, if foreclosure alternatives are not viable, begin foreclosure proceedings. Although the Enterprises hold the actual promissory notes through document custodians who maintain these records separate from the servicers, Fannie Mae and Freddie Mac do not themselves accept or process payments or move to modify or foreclose.

For their work, the servicers get paid by the Enterprises and, under the terms of their contracts, each servicer is obligated to follow the procedures established by the Enterprise, including compliance with all appropriate laws. The Enterprises also provide policy guidelines to their seller/servicers. A servicer is contractually bound to comply with this guidance; however, the Enterprises do not review loan files for each and every mortgage they guarantee or purchase. Instead, the Enterprises rely on a representation and warranty (rep and warrant) model under which the loan originator and loan servicer commit that the loan origination and servicing complies with the Enterprise's seller/servicer guide. Under the terms of the servicer contracts, the Enterprises can require the servicer to pay damages if the servicer does not follow the seller/servicer guidelines or force the servicer to buy back the loan if the loan fails to meet the Enterprises' eligibility guidelines.

The majority of Enterprise loans are serviced by a few very large banks. However, there are hundreds of servicers that hold contracts with each Enterprise; many are relatively small institutions. Each servicer typically works on behalf of many investors, including trustees for private label securities, and must follow the procedures and processes set forth in each investor contract. As I will describe further below, we are working with other government agencies to review foreclosure servicing practices and operations, and where we find firms with operational deficiencies, these must be remedied.

### **Attorneys Specializing in Foreclosure Processing**

In order to complete foreclosures, particularly in judicial foreclosure states, servicers often contract with law firms from the Enterprises' approved attorney networks (for servicers of one Enterprise this is required, for the other, it is optional to use the approved network). These law firms have been evaluated by the Enterprises before being added to that Enterprise's attorney network. By adding a firm to its network, the Enterprise has concluded the firm has sufficient capacity and expertise to assist a servicer in need of foreclosure processing services. Recently the capacity of some of these law firms has also been strained by the volume of foreclosures and the burden on the court systems. In light of processing problems we are discussing today, it is evident that both Enterprises must take steps to improve their selection and oversight of the attorneys in their networks.



## **State Foreclosure Processes and Foreclosure Timelines**

Foreclosure proceedings and requirements are established at the state level. Almost half of the states have a judicial foreclosure process that relies on the court system. By contrast, foreclosures in non-judicial states are managed according to state and local laws but handled outside of the court system.

Both systems have protections for homeowners, and to a large extent the essential paperwork and documentation elements are the same across all states, although particular requirements vary from jurisdiction to jurisdiction. In judicial foreclosure states, individual judges may set specific requirements within their courtrooms that are in addition to, or differ from, terms established by other judges in that state. Servicers and law firms involved in processing foreclosures must be aware of and responsive to such particular requirements.

Both judicial and non-judicial states are experiencing growing numbers of foreclosures, which are contributing to long delays between a borrower's default and the completion of an associated foreclosure.

Currently, the time from start to completion of a foreclosure for Enterprise loans in non-judicial states typically takes six months to a year. In judicial foreclosure states, it takes even longer, often 6 months longer than in non-judicial states and in certain judicial states the difference is even greater. Bear in mind, these foreclosure periods begin *after* the loan becomes seriously delinquent, typically about four months.

Some reasonable delays in the foreclosure process have been expected, appropriately so over the past two years, as new loss mitigation programs, such as loan modifications, have been introduced. These programs have often been accompanied by temporary foreclosure moratoria so that homeowners in the foreclosure process could be assessed for a modification. Servicers are obligated to follow Enterprise guidelines, including evaluating homeowners' for eligibility for the various foreclosure mitigation programs I described earlier.

While FHFA remains committed to ensuring borrowers are presented with foreclosure alternatives, it is important to remember that FHFA has a legal obligation as Conservator to preserve and conserve the Enterprises' assets. As I have said before, this means minimizing losses on delinquent mortgages. Clearly, foreclosure alternatives, including loan modifications, can reduce losses relative to foreclosure and benefit homeowners and neighborhoods, adding some measure of stability to local housing markets. But when these alternatives do not work, timely and accurate foreclosure processing is critical for minimizing taxpayer losses. The direct effect on taxpayers is thus: when an Enterprise-guaranteed mortgage is delinquent four months, the Enterprise removes the mortgage from the mortgage-backed security in which it was funded, paying off the security investors at par. The delinquent mortgage then goes on the balance sheet of the Enterprise, funded with debt issued by the Enterprise, debt supported by the Treasury Department's Senior Preferred Stock Purchase Agreement. While awaiting foreclosure (or some foreclosure alternative), that loan is generating no revenue because the borrower has stopped paying, but the Enterprise must keep paying interest on the debt supporting the mortgage. The

cost of the delay is why it is critical to FHFA's responsibilities as Conservator to ensure timely processing of foreclosure actions – the cost is ultimately borne by the taxpayer.

When a homeowner falls behind on their mortgage payments, servicers operate on a single track, working through loss mitigation options with the homeowner, typically beginning with the HAMP program and followed by other loan modification programs or other foreclosure alternatives. When all loss mitigation alternatives have been exhausted, the servicers are expected to initiate the foreclosure process. Furthermore, the Enterprises have instructed servicers to suspend foreclosure processing when loss mitigation activities reach certain milestones. At times, simultaneous actions are necessary because of the long timeframes of the foreclosure process and because borrowers are not always responsive to foreclosure alternative offers.

While the Enterprises have established foreclosure time limits in their seller/servicer guides, no servicers have been penalized in recent years for exceeding those limits, largely because state and local legal requirements, loan modification efforts, the unprecedented volume, and various foreclosure moratoria have greatly contributed to delays. During this year, FHFA has been working with each Enterprise to improve servicers' adherence to these timelines, and to apply penalties where justified, but the recent set of issues have further complicated that effort.

Deficiencies in the foreclosure process, including problems with affidavits, notaries, and improper practices, appear to be the result of inadequate resources for and oversight of servicing operations. The pressure from high volumes of foreclosures working through the system has

surfaced fault lines in the foreclosure process that remain the responsibility of management at these companies to identify and fix.

### **Other Actions Being Taken & Matters for Consideration**

All of us – regulators, lawmakers, investors, and the general public – want answers to the questions raised by this most recent breakdown in our housing finance market and we want them now. Much work is underway to assess the characteristics, extent, and location of these problems and conclusions must await the completion of this work. Regulatory agencies including FHFA are carrying out important examination activities that will better inform the issue. Thus, identification of further actions or regulatory responses must await the results of these examinations and evaluation of the information developed.

My colleagues can speak to the examination activities they are leading, some of which include FHFA participation. In particular, FHFA is participating in a multi-agency examination of the Mortgage Electronic Registration Systems (MERS). FHFA is reviewing the Enterprises' practices with regard to oversight of their counterparties, which have been lacking in the past. Neither FHFA nor the Enterprises have any regulatory authority with regard to mortgage servicers. FHFA's authority is limited to the Enterprises and, as I have noted, the Enterprises' relationships with mortgage servicers are contractual, not regulatory.

I do not support a blanket moratorium on foreclosures. The adverse consequences of a moratorium outweigh the argued benefits. The costs to neighborhoods, taxpayers, and investors

would be enormous. Our focus should be on fixing problems where they are found and then moving forward expeditiously with foreclosure proceedings where foreclosure alternatives have been exhausted and where no process deficiencies have been identified or they have been remedied. Delay is costing taxpayers money and creates undesirable incentives for homeowners to stop paying their contracted mortgage obligations.

To date, Fannie Mae and Freddie Mac, as well as other parts of the housing finance industry, have relied on a rep and warrant model, whereby one party commits to follow a set of standards and the other party trusts that commitment, unless and until a clear violation or breach is identified. FHFA is reviewing the Enterprises' practices in enforcing reps and warrants and FHFA expects adherence to those contract terms with regard to mortgages they purchase and with regard to mortgage servicing.

FHFA remains committed to working with fellow regulators to enhance our oversight of the foreclosure process and to ensure market participants adhere to state and federal laws. To further our efforts at bringing stability to housing finance, our approach needs to continue to focus on offering troubled homeowners an opportunity to remedy their payment difficulties. Failing that, homeowners should be offered foreclosure alternatives but, after that, foreclosure must proceed in a legal and timely manner for the sake of neighborhoods, investors, and taxpayers.

Thank you for this opportunity to testify. I would be glad to answer any questions.