



National Mortgage Servicing Standards: Legislation in the 112th Congress

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Summary

The United States single-family housing market has \$10.5 trillion of mortgage debt outstanding. Servicers play an important role in this market. The owner of a mortgage loan or mortgage-backed security typically hires a servicer to act on its behalf. When loans are current, a mortgage servicer collects payments from borrowers and forwards them to the mortgage holders. If the borrower becomes delinquent, a servicer may offer the borrower an option that could allow the borrower to stay in his or her home, or the servicer may pursue foreclosure.

Following high foreclosure rates and recent allegations of abuse, mortgage servicing has attracted attention from Congress. In addition to hearings and congressional investigations, some in Congress have called for national servicing standards. The most comprehensive proposal, S. 824, the Foreclosure Fraud and Homeowner Abuse Prevention Act of 2011 (Senator Sherrod Brown et al.), and its companion bill in the House, H.R. 1783 (Representative Brad Miller et al.), contain provisions intended to protect investors and borrowers from improper servicing practices. S. 967, the Regulation of Mortgage Servicing Act of 2011 (Senator Jeff Merkley et al.), includes borrower protections in addition to those offered by S. 824 and H.R. 1783.

The servicing standards proposed in S. 824 and H.R. 1783 include provisions intended to ensure that servicers act in the best interest of investors who hold mortgage loans. The proposals would adjust the servicing compensation structure to better align servicer incentives with the incentives of the mortgage holder. Servicers would also be prohibited from purchasing services offered by their affiliates at inflated costs and passing the costs on to investors. In addition, servicers would be prohibited from choosing a loss mitigation option that would benefit their affiliates at the expense of other investors.

S. 824, H.R. 1783, and S. 967 have three major components for borrower protection. First, the three bills would require servicers to establish a single point of contact with the borrower. The single point of contact would be a case manager who is assigned to each delinquent borrower and would manage communications with the borrower. Second, the three bills would prohibit servicers from dual tracking, which means initiating foreclosure on a borrower while simultaneously pursuing a loan modification. Servicers would instead be required to determine whether the borrower is eligible for an alternative to foreclosure before initiating foreclosure. Third, S. 824 and H.R. 1783 would set minimum experience, education, and training levels for loan modification staff and limit caseload levels for individual employees.

Legislation is not the only avenue to setting servicing standards. On August 10, the Consumer Financial Protection Bureau (CFPB) issued proposed rules that would establish mortgage servicing standards that would apply to most mortgages. Servicing standards for some mortgages were also part of the national mortgage settlement and the enforcement actions taken by federal regulators in response to deficient servicing practices by some banks.

Contents

Introduction.....	1
Are Servicer and Mortgage Holder Incentives Misaligned?.....	2
The Principal-Agent Problem and Mortgage Holders.....	2
Specific Conflict-of-Interest Situations.....	5
Servicer Compensation.....	5
Affiliate Relationships.....	6
Servicer Advances.....	8
How are Borrowers Affected?.....	9
Single Point of Contact and Dual Tracking.....	10
Staffing Requirements.....	10
Potential Implications of Standards.....	11

Figures

Figure 1. Volume of Mortgage-Backed Security Issuance.....	4
Figure 2. Servicer Consolidation.....	11
Figure B-1. Percentage of Loan Modifications Involving Principal Reduction.....	16
Figure B-2. Percentage of Loan Modifications Involving Principal Deferral.....	17

Tables

Table 1. Summary of Servicing Standards.....	11
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Appendixes

Appendix A. Non-Legislative Approaches.....	13
Appendix B. Data Analysis of Principal-Agent Problem.....	15

Contacts

Author Contact Information.....	18
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Introduction

In the United States, outstanding mortgage debt in the single-family housing market amounts to \$10.5 trillion.¹ Mortgage servicers play an important role in this market. The owner of a mortgage loan or mortgage-backed security typically hires a servicer to act on its behalf in servicing mortgages. When loans are current, a mortgage servicer collects payments from borrowers and forwards them to the mortgage holders. If the borrower becomes delinquent, the servicer may pursue foreclosure or offer the borrower a workout option that may allow the borrower to stay in his or her home.

Examples of workout options include loan modifications, such as principal balance reductions and interest rate reductions, as well as repayment plans, which allow borrowers to repay the amounts they owe and become current in their mortgage payments. By contrast, mortgage liquidation options result in borrowers losing their homes. For example, in a short sale, the borrower sells the home and uses the proceeds to satisfy the mortgage debt, even if the sale proceeds are less than the amount owed on the mortgage. Foreclosure is similar to a short sale except that it is often involuntary. The home is repossessed and sold by the lien holder. If the sale price does not cover the amount owed, the borrower may have to pay the difference.²

Following high foreclosure rates and recent investigations of fraud and abuse, mortgage servicing has attracted attention from Congress. For example, congressional hearings, as well as state and federal investigations, have addressed allegations of “robo-signing,” in which a small number of individuals sign a large number of affidavits and other legal documents that mortgage companies submit to courts and other public authorities to execute foreclosures.³

To protect borrowers and investors from abuse, some in Congress have called for national servicing standards. The proposed servicing standards include provisions to ensure that servicers act in the best interest of the holders of the mortgage loans and that delinquent borrowers are properly evaluated for loan modifications before foreclosure proceedings are initiated. The most comprehensive bill, S. 824, the Foreclosure Fraud and Homeowner Abuse Prevention Act of 2011 (Senator Sherrod Brown et al.), and its companion bill in the House, H.R. 1783 (Representative Brad Miller et al.), contain provisions to protect investors and borrowers. S. 967, the Regulation of Mortgage Servicing Act of 2011 (Senator Jeff Merkley et al.), also proposes reforms to the servicing industry.

In addition to the legislative proposals, there are other avenues through which servicing standards may be adopted. On August 10, the Consumer Financial Protection Bureau (CFPB) issued proposed rules that would establish mortgage servicing standards that would apply to most mortgages.⁴ Servicing standards for some mortgages were also part of the national mortgage

¹ Board of Governors of the Federal Reserve System, *Household Finance: Mortgage Debt Outstanding*, June 2011, at <http://www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm>.

² See CRS Report R41572, *Incentives and Factors Influencing Foreclosure and Other Loss Mitigation Outcomes*, by Darryl E. Getter.

³ See CRS Report R41491, *“Robo-Signing” and Other Alleged Documentation Problems in Judicial and Nonjudicial Foreclosure Processes*, by David H. Carpenter.

⁴ David Silberman, *Putting the ‘service’ back in ‘mortgage servicing’*, Consumer Financial Protection Bureau, August 10, 2012, at <http://www.consumerfinance.gov/blog/putting-the-serviceback-in-mortgage-servicing/>.

settlement and the enforcement actions taken by federal regulators in response to deficient servicing practices by some banks. **Appendix A** describes the non-legislative proposals.

This report analyzes the potential misaligned incentives in the servicer-mortgage holder relationship and the servicing standards that attempt to address each concern, the servicer-borrower relationship and the relevant servicing provisions, as well as the possible implications of reforming the servicing industry.

Are Servicer and Mortgage Holder Incentives Misaligned?

The Principal-Agent Problem and Mortgage Holders

Some experts argue that servicers face a host of competing incentives, not all of which encourage the servicer to act in the best interest of the loan holder. These incentives could encourage the servicer to pursue foreclosure when the investor would be best served by a loan modification, or they could encourage the servicer to offer a loan modification when the holders would have preferred foreclosure. The tension between what a servicer has incentives to do and what the note holder would prefer is an example of a principal-agent problem.⁵ The servicer may make decisions about loans that maximize its income rather than maximize the return for the holders of the loans if the holders give the servicer too much flexibility to act.⁶

A principal-agent problem is unlikely when the servicer holds the loans in its own portfolio because, in this case, the principal is the agent and the interests are aligned from the start. The severity of the principal-agent problem differs for other types of mortgage holding arrangements:⁷ investors in private-label securities (PLS)⁸ and government-sponsored enterprises (GSEs).⁹

The principal-agent problem may be of most concern for investors in PLS because of their difficulty in effectively monitoring servicers and in structuring servicing contracts, which are called pooling and servicing agreements (PSA).¹⁰ There are several ways in which private

⁵ Sheila Bair, "Opening Address at Summit on Residential Mortgage Servicing for the 21st Century," Washington, DC, January 19, 2011, at <http://www.fdic.gov/news/news/speeches/chairman/spjan1911.html>.

⁶ Office of the Special Inspector General for the Troubled Asset Relief Program, *Quarterly Report to Congress*, October 26, 2010, p. 160, at http://www.sigtaip.gov/reports/congress/2010/October2010_Quarterly_Report_to_Congress.pdf.

⁷ There are also loans guaranteed by the federal government, but current legislation and academic literature does not focus on those loans so they will not be discussed in this report.

⁸ In housing finance, a private-label security is "a mortgage-backed security or other bond created and sold by a company other than a government-sponsored enterprise (GSE). The security often is collateralized by loans that are ineligible for purchase by a GSE," Financial Stability Oversight Council, *2011 Annual Report*, p. 159, at <http://www.treasury.gov/initiatives/fsoc/Documents/FSOCAR2011.pdf>.

⁹ A government-sponsored enterprise is a "corporate entity that has a federal charter authorized by law but that is a privately owned financial institution," Financial Stability Oversight Council, *2011 Annual Report*, p. 156, at <http://www.treasury.gov/initiatives/fsoc/Documents/FSOCAR2011.pdf>. For more on Fannie Mae and Freddie Mac, see CRS Report R40800, *GSEs and the Government's Role in Housing Finance: Issues for the 112th Congress*, by N. Eric Weiss.

¹⁰ Pooling and servicing agreements (PSAs) are contracts negotiated between the investors and servicers to help guide (continued...)

investors can monitor servicers. Prior to purchasing a share in a mortgage-backed security, investors can get one measure of the quality of a servicer by looking at rating agencies' evaluations of servicers' performances.¹¹ Nevertheless, the servicing rights may still be retained by the servicer affiliated with the loan originator¹² rather than shopped around to the best servicer available. This reduces the investors' ability to influence the choice of a servicer. After the servicing rights have been awarded, investors can monitor the servicer through the trustee¹³ that is hired by investors to act on their behalf. A trustee may replace the servicer if the servicer violates the PSA by failing to act in the best interest of the investor, but close monitoring of servicers may be costly and difficult. Servicers are not required to transparently report information on loan performance to trustees, and, close monitoring of servicers may not be explicitly stated in the PSA for some trustees.¹⁴ Investors also have limited ability to encourage the trustee to monitor the servicer. Investors may have difficulty organizing their efforts to monitor because they may not know who the other investors are or may wish to free ride on the organizing efforts of other investors.¹⁵ However, just because there are difficulties does not mean that they cannot be overcome. With billions of dollars at stake, investors have organized to file lawsuits against servicers and loan originators.¹⁶

In addition to facing minimal monitoring, servicers have some flexibility to determine what action to take with delinquent borrowers. To determine which option to pursue on a non-performing loan, servicers often perform a net present value (NPV) test. In an NPV test, servicers calculate the expected value of multiple loss mitigation and foreclosure options to determine which has the highest benefit for the owner of the loan. Servicers are often required by the loan holder to choose the option that has the highest NPV. Servicers in PLS are generally given discretion¹⁷ in choosing the variables involved in the NPV calculations, which may in theory enable rigging the NPV test to achieve an outcome that increases servicers' income even if better options might exist for investors.¹⁸

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the actions of servicers when borrowers are delinquent on their mortgage payments.

¹¹ Office of the Special Inspector General for the Troubled Asset Relief Program, *Quarterly Report to Congress*, October 26, 2010, p. 160, at http://www.sigtar.gov/reports/congress/2010/October2010_Quarterly_Report_to_Congress.pdf.

¹² Adam J. Levitin and Tara Twomey, "Mortgage Servicing," *Yale Journal on Regulation*, vol. 28, no. 1 (2011), p. 67.

¹³ Working on behalf of the investors, "the trustee's role involves holding transaction cash flows in segregated accounts, notifying investors and rating agencies of covenant breaches and events of default, and managing servicing transfers if the original servicer is no longer able to function as servicer," Moody's, *Moody's Re-examines Trustees' Role in ABS and RMBS*, February 4, 2003, p. 1, at <http://www.moody.com.ar/PDF/Research/Trustee's%20Role.pdf>.

¹⁴ U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Housing, Transportation and Community Development, *Testimony of Laurie Goodman, Amherst Securities Group*, 112th Cong., 1st sess., May 12, 2011, p. 6.

¹⁵ Adam J. Levitin and Tara Twomey, "Mortgage Servicing," *Yale Journal on Regulation*, vol. 28, no. 1 (2011), p. 58, 62.

¹⁶ Carrick Mollenkamp, "Banks Pressed on Sour Home Loans," *The Wall Street Journal*, September 23, 2010, at <http://online.wsj.com/article/SB10001424052748704814204575508143329644732.html>.

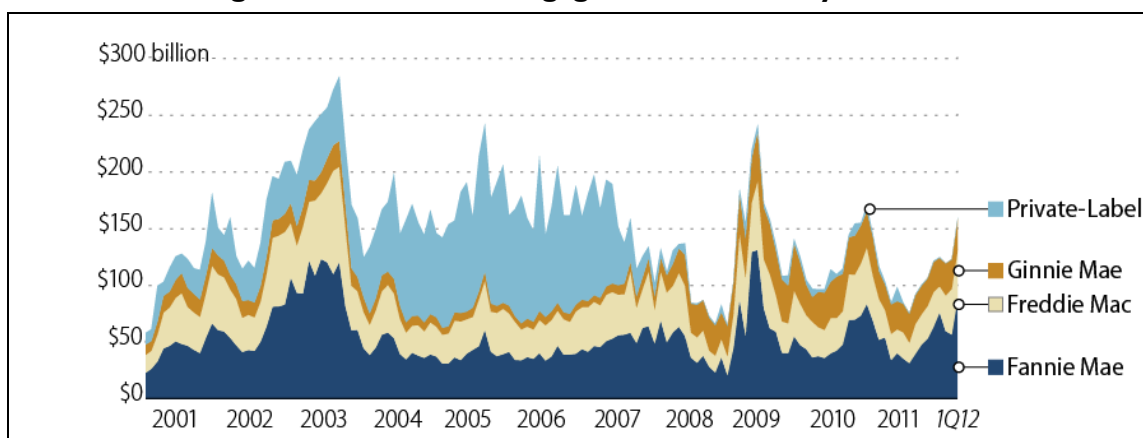
¹⁷ A recent white paper that studied the content of subprime securitization contracts found that servicers are often given general guidelines for modifying loans, such as follow customary servicing standards or service the loans as if they were held in your own portfolio. See John P. Hunt, *What Do Subprime Securitization Contracts Actually Say About Loan Modification? Preliminary Results and Implications*, Berkeley Center for Law, Business and the Economy, March 25, 2009, p. 9.

¹⁸ Office of the Special Inspector General for the Troubled Asset Relief Program, *Quarterly Report to Congress*, October 26, 2010, p. 164, at <http://www.sigtar.gov/reports/congress/2010/>
(continued...)

The GSEs have taken steps to address the principal-agent problem. Even before the Home Affordable Modification Program (HAMP),¹⁹ the GSEs offered financial incentives to servicers for performing approved loan modifications. They quantitatively track servicer performance and recognize their top servicers.²⁰ They also give specific guidelines to servicers for NPV tests.²¹ Because the GSEs have assumed an even larger role in the housing finance system since the beginning of the most recent recession, servicers have an incentive to act in the GSEs' best interest in order to attract new business. Through these reputational, contractual, and financial incentives, the GSEs attempt to minimize the principal-agent problem.

During the housing boom of the mid-2000s, PLS gained a larger share of the market. **Figure 1** shows the volume of mortgage-backed securities issued by Fannie Mae, Freddie Mac, and private-label investors. Fannie Mae and Freddie Mac have assumed a dominant role since the beginning of the most recent recession.

Figure 1. Volume of Mortgage-Backed Security Issuance



Source: Federal Housing Finance Agency, "Conservator's Report on the Enterprises' Financial Performance," Second Quarter 2011.

Given the limitations of monitoring servicers and their flexibility in choosing options for borrowers in default, it is possible that servicers may choose to maximize their income rather than serve the holders' interests. This is more of a concern for PLS, where the principal-agent problem is strongest, and less of a concern for loans held in servicer's portfolio, where incentives are aligned.

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October2010_Quarterly_Report_to_Congress.pdf.

¹⁹ HAMP is part of the Obama Administration's Making Home Affordable program. HAMP provides financial incentives to participating servicers in order to encourage them to provide loan modifications to eligible troubled borrowers. See CRS Report R40210, *Preserving Homeownership: Foreclosure Prevention Initiatives*, by Katie Jones.

²⁰ Larry Cordell, Karen Dynan, and Andreas Lehnert et al., *The Incentives of Mortgage Servicers: Myths and Realities*, Federal Reserve Board, Finance and Economics Discussion Series, Working Paper 2008-46, September 8, 2008, p. 20, at <http://www.federalreserve.gov/pubs/feds/2008/200846/200846pap.pdf>.

²¹ *Ibid.*, p. 18.

Specific Conflict-of-Interest Situations

The principal-agent problem can be manifested in a variety of conflict-of-interest situations. The conflicts are of concern because they can exacerbate such problems as high foreclosure rates and the breakdown in securitization. The conflicts that arise typically have to do with servicer compensation, servicer affiliation with other entities, and servicer advances. Each is discussed below.

Servicer Compensation

Servicers have five primary sources of compensation. The largest form of compensation is the *servicing fee*. Servicers receive a percentage of the unpaid principal balance on the loans they are servicing. Depending on the type of loan, the fee can range from 25 basis points for a prime fixed-rate loan to 50 basis points for a subprime loan.²² Second, servicers earn *float income*. Float income is the interest servicers earn by collecting payments from borrowers at the beginning of the month, earning interest on that money, and then forwarding the borrowers' payments at the end of the month. Third, servicers earn *fee income* from the fees that they charge delinquent borrowers. Other sources of fees include property valuation fees, credit report fees, and notary fees.²³ Fourth, servicers may receive *investment income* by retaining an ownership share in the investment that they are servicing. Fifth, servicers may receive *incentive payments* as part of HAMP or other government programs for each borrower that receives a permanent modification.

Some critics believe that this compensation structure leaves servicers unconcerned about maximizing the value of the underlying loan for investors.²⁴ They argue that servicers are likely to perform a loan workout only if doing so is more profitable for the servicer than foreclosure. This implies that a servicer will only perform a workout if it will earn enough revenue on the reperforming loan before it potentially redefaults to compensate it for the upfront cost of performing the workout. However, critics argue that, under this model, a servicer's decision is independent of the value of the loan and instead depends on the length of time before the loan redefaults and the size of the loan. Servicer compensation does not, therefore, incentivize the servicer to maximize the value of the loan to investors.

S. 824 and H.R. 1783 separate the servicing of borrowers that are current from the servicing of borrowers that are delinquent. Borrowers that are paying as scheduled would be serviced by the traditional primary servicer, whereas borrowers who are at least 60 days delinquent would have their servicing transferred to special servicers that specialize in minimizing losses for investors. The special servicer will be compensated through a fraction of the stream of payments from the entire pool.

²² A basis point is 0.01%. For example, a subprime loan with a \$200,000 unpaid balance would yield (0.0050*200,000) \$1,000 in annual income to the servicer. Servicers are compensated more for subprime loans because those loans often are more costly to service. Subprime borrowers default at a higher rate so servicers spend more to manage those defaults. Larry Cordell, Karen Dynan, and Andreas Lehnert et al., *The Incentives of Mortgage Servicers: Myths and Realities*, Federal Reserve Board, Finance and Economics Discussion Series, Working Paper 2008-46, September 8, 2008, p. 15, at <http://www.federalreserve.gov/pubs/feds/2008/200846/200846pap.pdf>.

²³ Office of the Special Inspector General for the Troubled Asset Relief Program, *Quarterly Report to Congress*, October 26, 2010, p. 161, at http://www.sigtaip.gov/reports/congress/2010/October2010_Quarterly_Report_to_Congress.pdf.

²⁴ The model that follows is based on Adam J. Levitin and Tara Twomey, "Mortgage Servicing," *Yale Journal on Regulation*, vol. 28, no. 1 (2011), p. 72.

The compensation structure for the special servicer is intended to make the servicer indifferent to the type of loss mitigation option and instead encourage it to maximize the NPV for investors. This could better align the interest of the special servicer with the interest of the investors. However, aligning servicer and investor incentives requires addressing both revenue and costs. The legislation addresses servicer compensation issues, but it does not address the costs borne by the parties when defaults occur. A servicer is often reimbursed for foreclosure expenses but not for the added cost of performing a workout option.²⁵ Some claim that this incentivizes servicers to perform foreclosures. It is unclear if the reforms will address this issue by requiring the same treatment of foreclosure and workout expenses.²⁶ Failure to address the costs of servicing distressed loans may still leave the incentive alignment issue unresolved.

Affiliate Relationships

Servicers are often affiliated with other entities such as providers of foreclosure services, loan originators, and securitizers. These affiliate relationships may also incentivize servicers to act in ways that are not in the investors' interests. Three types of affiliate relationships that critics cite as sources of potential conflict are described below, together with legislative and other proposed policy options that address each conflict.

First, servicers may be affiliated with organizations that provide foreclosure completion services, such as property preservation companies.²⁷ The opportunity to earn additional income for an affiliate may make the servicer more likely to choose foreclosure as an option. Even if servicers offer foreclosure services themselves, they are reimbursed on a first-priority basis once the house is liquidated.²⁸ This gives servicers an incentive to inflate the true cost of providing the additional services at the expense of investors. In other words, the opportunity to earn additional fees may, for decisions that are on the margin between foreclosing and offering a loss mitigation option, incentivize the servicer to choose foreclosure.²⁹ These additional fees are not required to be broken down in a transparent manner when reported to the trustee, making it difficult for investors to hold servicers accountable.³⁰

²⁵ Investors may be reluctant to reimburse servicers for added loss mitigation expenses because pursuing loss mitigation options that maximize the NPV is the expected function of the servicer. Investors may argue that performing appropriate loss mitigation options is what the servicer is already paid to do. See Larry Cordell, Karen Dynan, and Andreas Lehnert et al., *The Incentives of Mortgage Servicers: Myths and Realities*, Federal Reserve Board, Finance and Economics Discussion Series, Working Paper 2008-46, September 8, 2008, p. 19, at <http://www.federalreserve.gov/pubs/feds/2008/200846/200846pap.pdf>.

²⁶ It is also unclear what will happen if a delinquent loan reperforms. The special servicer may not have the incentive to make the loan reperform if doing so transfers the servicing rights back to the primary servicer.

²⁷ U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Housing, Transportation and Community Development, *Testimony of Laurie Goodman, Amherst Securities Group*, 112th Cong., 1st sess., May 12, 2011, p. 7.

²⁸ Office of the Special Inspector General for the Troubled Asset Relief Program, *Quarterly Report to Congress*, October 26, 2010, p. 162, at http://www.sigtaip.gov/reports/congress/2010/October2010_Quarterly_Report_to_Congress.pdf.

²⁹ Fee income is only one source of servicer compensation. Even if the opportunity to earn additional fee income offered the incentive to foreclose, there are also incentives to not foreclose, such as the opportunity to earn additional revenue from the servicing fee (which is dependent on the unpaid principal balance; foreclosing on a home lowers the unpaid principal balance).

³⁰ U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Housing, Transportation and Community Development, *Testimony of Laurie Goodman, Amherst Securities Group*, 112th Cong., 1st sess., May 12, 2011, p. 6.

Overcharging the investor for fees does not necessarily mean that incentives are misaligned with respect to the foreclosure decision. Fees to the servicer and its affiliates are just one component of the NPV test.³¹ Foreclosure might still be the best option for the investor even if the investor pays more in fees. Overcharges may not be enough to tip the NPV test in some cases.

S. 824 and H.R. 1783 would limit servicers' ability to charge excessive fees for services that may be sold by an affiliate of the servicer. For example, if a borrower is no longer paying for his or her homeowner's insurance policy, the servicer is required to attempt to keep in place or reinstate the borrower's previous insurance policy. If that cannot be achieved, the servicer must provide force-placed insurance that is of similar cost and coverage as a standard homeowner's insurance policy. This proposal would prevent servicers from purchasing above-market rate insurance from an affiliate and passing the cost on to investors.

Other proposals to limit foreclosure fees have called for servicers' fees to be reasonably related to the cost of actually providing a service and to be disclosed more clearly in monthly statements to investors and borrowers.³²

Second, servicers may be affiliated with loan originators or securitizers and lead to "representations and warranties" (rep and warrants) conflicts. Often in the case of mortgage-backed securities, the securitizer or loan originator will establish rep and warrants on the underlying loans that make up the pool for the security. A rep and warrants violation occurs when a loan is not of the type or quality that it was alleged to be at the time of the security's issuance.³³ When detected, the securitizer or originator may be required to purchase the loan out of the pool and place the loan on its balance sheet. The trustee is responsible for enforcing rep and warrant violations. Trustees, however, often do not have the loan-level information or ability needed to track violations, but servicers do have that information.³⁴ Servicers affiliated with the securitizer or originator that would need to repurchase the loan may, therefore, have an incentive to not report the violation. Rep and warrant issues, however, do not necessarily influence the decision of the servicer to offer a delinquent borrower a loss mitigation option or proceed with foreclosure given that this issue does not factor into the NPV test.

To address rep-and-warrant conflicts, some experts have suggested that an independent third party be responsible for protecting investors' interests and be given access to the loan-level information needed to detect rep and warrant violations.³⁵ The compensation of the third party would be structured to incentivize it to act in the best interest of the investors. However, private investors did, in some instances, hire third-party firms before the downturn in the housing market

³¹ For an example of an NPV test, see Federal Deposit Insurance Corporation, *FDIC Loan Modification Program*, at <http://www.fdic.gov/consumers/loans/loanmod/FDICLoanMod.pdf>.

³² U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Housing, Transportation and Community Development, *Testimony of Laurie Goodman, Amherst Securities Group*, 112th Cong., 1st sess., May 12, 2011, p. 6.

³³ Rep-and-warrants violations can occur for many reasons, such as misrepresentations of the income level of the borrower or the occupancy status of the house. U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Housing, Transportation and Community Development, *Testimony of Laurie Goodman, Amherst Securities Group*, 112th Cong., 1st sess., May 12, 2011, p. 8.

³⁴ *Ibid.*, p. 8.

³⁵ *Ibid.*, p. 8.

to perform due diligence on a pool of loans, and this proved to have limited effectiveness.³⁶ Other suggestions include increasing the penalties for violations beyond just repurchasing the loan.³⁷

A third affiliate issue relates to second mortgages. During the housing boom of the mid-2000s, many borrowers took out a second mortgage to help finance the purchase of their home. Servicers of the first lien often retained ownership of the second lien.³⁸ A conflict of interest may arise if a servicer pursues options for a delinquent borrower that ensures that the second lien will be repaid. For example, a servicer whose affiliate owns the second lien may be less likely to agree to a short sale in which the price offered for the house will not cover the amount owed to the second lien holder even if a short sale may be the best option for the owners of the first lien.³⁹ The option that benefits the second lien holder may not necessarily benefit the first lien investors.

A recent study has found that borrowers have often continued to pay their second mortgage even if they could not afford to pay their first mortgage.⁴⁰ The study used a data sample of 1.4 million borrowers covering nearly all U.S. borrowers that had just one first and second lien. It found that the most important reason that borrowers stayed current on their second lien, which is often a home equity line of credit (HELOC), even if they were delinquent on their first lien mortgage was to maintain access to the credit offered by a HELOC. The study found limited evidence that servicers' conflicts of interest concerning second lien ownership could explain borrowers' behavior.

To address a possible second lien conflict, S. 824 and H.R. 1783 would prohibit a servicer or an affiliate of the servicer from owning a lien that is secured by a property if it is also servicing a different lien on the same property. For example, the servicer could not service the first lien but have its affiliate own the second lien on a home in the pool that it services. Others have put forward less stringent proposals that would require the servicer to disclose its ownership of a second lien and establish a formula to determine how much the subordinate lien should be reduced if the primary lien is also adjusted.⁴¹

Servicer Advances

When a borrower does not pay the full monthly amount that is due, servicers are often required to advance the principal or interest to investors. Servicers are typically reimbursed for these

³⁶ DBRS, *Review Services for the Secondary Mortgage Market*, August 14, 2007, at <http://www.dbrs.com/research/213821/dbrs-issues-report-review-services-for-the-secondary-mortgage-market.html>.

³⁷ U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Housing, Transportation and Community Development, *Testimony of Anthony Sanders*, 112th Cong., 1st sess., May 12, 2011, p. 7.

³⁸ For example, an executive with Bank of America testified during a congressional hearing that, "of the 10.4 million first liens Bank of America services 15% have a second lien with Bank of America." U.S. Congress, House Committee on Financial Services, *Testimony of Barbara Desoer, President, Bank of America Home Loans*, 111th Cong., 1st sess., April 13, 2009, p. 6.

³⁹ U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Housing, Transportation and Community Development, *Testimony of Laurie Goodman, Amherst Securities Group*, 112th Cong., 1st sess., May 12, 2011, pp. 2-5.

⁴⁰ Amherst Mortgage Insight, *Strategic Default and 1st/2nd Lien Payment Priority*, February 17, 2011, p. 15.

⁴¹ Sheila Bair, "Opening Address at Summit on Residential Mortgage Servicing for the 21st Century," Washington, DC, January 19, 2011, at <http://www.fdic.gov/news/news/speeches/chairman/spjan1911.html>.

advances, but do not receive interest on their payments.⁴² This gives servicers an incentive to minimize the amount of time that a loan is in default. Although servicers have the option to charge late fees to the borrower, servicers may still lose money on advances because the advances are basically a zero interest loan to investors.⁴³ This practice may be another reason why servicers might decide not to maximize the NPV of defaults and be concerned about the duration of delinquency or default. Some default periods could be profitable for servicers but other periods could be costly; all periods in which investors do not receive full payment are costly.

Often servicers will only have to advance payments to investors if the servicer thinks the advances are considered recoverable (usually through the sale of the house in foreclosure).⁴⁴ The GSEs will also limit advances to four months.⁴⁵ In addition, servicers are reimbursed for their advances soon after a loan modification. If reimbursement of advances after a loan modification occurs prior to the reimbursement after a foreclosure, then servicers would have an incentive to not foreclose.⁴⁶

S. 824 and H.R. 1783 would prohibit servicers from advancing the delinquent principal and interest for more than three payment periods unless financing or reimbursement is made available to the servicer.

How are Borrowers Affected?

Mortgage servicing is not a consumer-facing market. Servicers are hired by investors and, therefore, are ultimately responsible to the investors. Servicers have an incentive to be concerned with the quality of their interaction with borrowers insofar as investors evaluate servicers by their customer service. For example, servicers may have little incentive to respond quickly to borrowers if investors do not value servicers that respond in a timely manner. Typically, borrowers cannot choose to switch servicers the way they can compare and choose goods and services in most markets. Critics say that the absence of this market-force mechanism makes borrowers vulnerable to servicer abuse.⁴⁷

⁴² Servicers may be reimbursed, but often not until the house is sold. Office of the Special Inspector General for the Troubled Asset Relief Program, *Quarterly Report to Congress*, October 26, 2010, p. 162, at http://www.sig tarp.gov/reports/congress/2010/October2010_Quarterly_Report_to_Congress.pdf.

⁴³ Diane E. Thompson, *Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior: Servicer Compensation and its Consequences*, National Consumer Law Center, October 2009, pp. 23-24.

⁴⁴ *Ibid.*, p. 23.

⁴⁵ Larry Cordell, Karen Dynan, and Andreas Lehnert et al., *The Incentives of Mortgage Servicers: Myths and Realities*, Federal Reserve Board, Finance and Economics Discussion Series, Working Paper 2008-46, September 8, 2008, p. 16, at <http://www.federalreserve.gov/pubs/feds/2008/200846/200846pap.pdf>.

⁴⁶ Mortgage Bankers Association, *Residential Mortgage Servicing for the 21st Century*, White Paper, May 2011, p. 22, at <http://www.mbaa.org/files/ResourceCenter/ServicingCouncil/ResidentialServicingforthe21stCenturyWhitePaper.pdf>.

⁴⁷ U.S. Congress, House Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit and Subcommittee on Oversight and Investigations, *Testimony of Raj Date*, 112th Cong., 1st sess., July 7, 2011, p. 2.

Single Point of Contact and Dual Tracking

S. 967, H.R. 1783, and S. 824 address the absence of a consumer-facing market by requiring servicers to assign a case manager to serve as a single point of contact to each borrower that seeks a loan modification. The case manager would manage communications with the borrower and be available to communicate by telephone and email during business hours. The case manager would also have the authority to decide if the borrower is eligible for a loan modification. If the borrower is deemed ineligible by the case manager, S. 967 would require an independent reviewer to confirm the eligibility status before the borrower is notified. The independent reviewer would be allowed to work for the same servicing company as the primary servicer so long as the reviewer was not under the same immediate supervision as the division that determines loan modifications.

The three bills further address the concerns stemming from the absence of a consumer-facing market by prohibiting dual tracking. Dual tracking occurs when servicers pursue a loss mitigation option while simultaneously initiating the foreclosure process on a borrower. Instead, servicers would be required to determine if the borrower is eligible for a loan modification before initiating foreclosure even if the foreclosure is otherwise authorized under the state's law.

Staffing Requirements

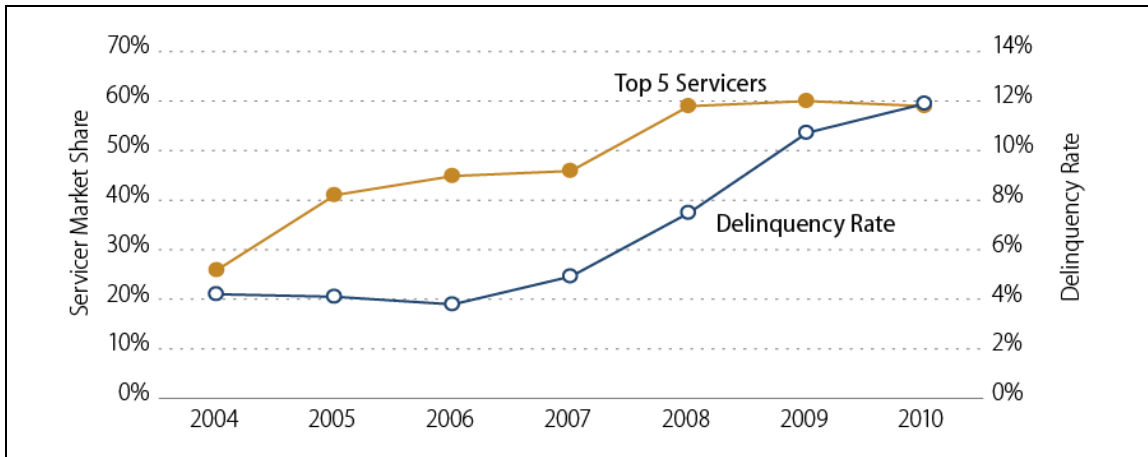
The servicing industry consolidated during the housing boom of the early 2000s. The top five mortgage servicers had a 60% market share by the end of 2009 compared with a 27% share for the top five servicers in 1999.⁴⁸ With relatively low delinquency rates, servicers could invest in automating their transaction processing systems and take advantage of economies of scale.⁴⁹ Servicers found little incentive to invest as heavily in the equipment and personnel required for loss mitigation. Critics argue that this left servicers understaffed when the delinquency rate spiked later in the decade.⁵⁰ **Figure 2** shows how the servicing market consolidated from 2004 to the first quarter of 2010. The rate of servicer consolidation slowed as the delinquency rate increased.

⁴⁸ Office of the Special Inspector General for the Troubled Asset Relief Program, *Quarterly Report to Congress*, October 26, 2010, p. 163, at http://www.sigtaip.gov/reports/congress/2010/October2010_Quarterly_Report_to_Congress.pdf.

⁴⁹ A 2007 study found that mega servicers can service performing loans at a monthly cost of approximately \$4/loan, large servicers at a cost of \$6/loan, and small/medium servicers at \$7/loan. See Federal Housing Finance Agency, *Servicing Compensation Initiative pursuant to FHFA Directive in Coordination with HUD*, February 2011, p. 8, at http://www.fhfa.gov/webfiles/19719/FHFA_Servicing_Initiative_-_Background_and_Issues_2011-02-14_3pm_FINAL.pdf.

⁵⁰ See the discussion of the enforcement actions taken by the regulatory agencies in **Appendix A**.

Figure 2. Servicer Consolidation



Source: Servicer market share data from Federal Housing Finance Agency, “Servicing Compensation Initiative pursuant to FHFA Directive in Coordination with HUD,” February 2011; delinquency rate data from the Federal Reserve Bank of New York, “Quarterly Report on Household Debt and Credit,” August 2011.

Notes: The delinquency rate measures the fraction of the total outstanding mortgage balance that is at least 30 days delinquent as of the first quarter of each year.

To address concerns about staffing, S. 824 and H.R. 1783 mandate staffing requirements that set minimum experience, education, and training levels for loan modification staff. The legislation also proposes caseload limits for individual employees.

Potential Implications of Standards

Table 1 summarizes the issues and the reforms proposed by S. 824, H.R. 1783, and S. 967.

Table 1. Summary of Servicing Standards

Issues	Reform Proposals	S. 824 and H.R. 1783	S. 967
Misalignment due to compensation structure	Require a special servicer for delinquent borrowers	X	
Relationship with provider of foreclosure services	Limitation on fees charged to investors	X	
Rep and warrant conflicts	Third-party reviewer; increased penalty		
Ownership of 2 nd lien	Prohibit owning 2 nd lien	X	
Servicer advances	Limit servicer advances to three payment periods	X	
Absence of a consumer-facing market	Require a single point of contact; prohibit dual tracking	X	X
Understaffed servicers	Limitations on caseloads and requirements for training, education levels, and experience of staff	X	

Source: Table compiled by CRS.

The servicing standards may align servicers' incentives with investors' interests and protect borrowers from abuse, but could come at the expense of higher interest rates and closing fees for borrowers and lower returns for investors.⁵¹ Just as servicers receive higher compensation for handling subprime mortgages that are more costly to service than prime mortgages, all borrowers could expect rates to increase as servicers would need to be compensated for the added cost of hiring and training more personnel to meet proposed regulations.⁵² Servicers may experience reduced revenues as a result of the limitations on the fees servicers can charge and restrictions on ownership of second liens. Hence, borrowers might be required to pay higher rates or closing costs.

In addition, some believe that higher costs for servicers could accelerate the consolidation of the servicing industry and squeeze out community banks.⁵³ Servicers may satisfy the increased staffing requirements by taking advantage of the economies of scale offered by large call centers and automated transaction processing. If the proposals require that the special servicer for delinquent loans be from a different company than the primary servicer (as opposed to the special servicer being part of the same company as the primary servicer), then the servicing market may further segment into a few large primary servicers and smaller special servicers. If special servicers are also subject to similar regulations about customer service, then they would be subject to the same pressures to consolidate as the primary servicers. If the lack of competition in the servicing industry was one of the factors driving the need for servicing standards, some may ask whether the standards are self-defeating.

⁵¹ Adam J. Levitin and Tara Twomey, "Mortgage Servicing," *Yale Journal on Regulation*, vol. 28, no. 1 (2011), p. 89.

⁵² For more on the potential costs of requiring a single point of contact and prohibiting dual tracking, see Mortgage Bankers Association, *Residential Mortgage Servicing for the 21st Century*, White Paper, May 2011, pp. 23-24, at <http://www.mbaa.org/files/ResourceCenter/ServicingCouncil/ResidentialServicingforthe21stCenturyWhitePaper.pdf>.

⁵³ U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, *Testimony of Jack Hopkins, President and CEO of CorTrust Bank*, 112th Cong., 1st sess., August 2, 2011.

Appendix A. Non-Legislative Approaches

In addition to the legislative proposals, servicing standards may be adopted through other avenues. On August 10, the CFPB issued proposed rules that would establish mortgage servicing standards that would apply to most mortgages.⁵⁴ The proposed rules have two main components: reforms to the billing and general operations that would impact all borrowers and reforms to aid delinquent borrowers. The reforms to the billing and general operations include adding more information to the regular monthly billing statements, requiring borrowers to be notified of upcoming rate and payment changes, simplifying the process of reporting errors, and protecting consumers against unnecessarily paying for force-placed insurance. The reforms to aid delinquent borrowers include requiring servicers to contact borrowers who are at least 30 days late, provide easy access to staff, establish reasonable data and information policies and computer systems, and evaluate some delinquent borrowers for foreclosure alternatives.

In addition, the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision are taking enforcement actions against 14 servicers.⁵⁵ When examining the servicers, the agencies found “unsafe or unsound practices and violations of law, which have had an adverse impact on the functioning of the mortgage market.”⁵⁶ The enforcement actions require servicers to establish a compliance program (subject to regulator approval) that includes some of the reforms already mentioned in this report. For example, servicers will have to improve their staffing and training as well as have a single point of contact to assure that communications are timely during the loan modification and foreclosure processes.⁵⁷ The regulatory agencies also plan to impose monetary sanctions.⁵⁸ The agencies’ enforcement actions may have a significant effect because the 14 servicers represent more than two-thirds of the servicing market.⁵⁹ The actions taken by the regulatory agencies do not preclude other federal or state regulatory and law enforcement agencies from taking additional actions. For example, as part of the national mortgage settlement, five banks agreed to meet certain servicing standards.⁶⁰

The Federal Housing Finance Agency, which regulates Fannie Mae and Freddie Mac, has directed the GSEs to require their servicers to adopt servicer reforms. Through the Servicing Alignment Initiative, Fannie and Freddie will establish consistent policies and processes for servicing

⁵⁴ Consumer Financial Protection Bureau, “Summary of Proposed Mortgage Servicing Rules,” at http://files.consumerfinance.gov/f/201208_cfpb_summaries_proposed_rules-consumers.pdf.

⁵⁵ The 14 servicers are Ally Bank/ GMAC, Aurora Bank, Bank of America, Citibank, EverBank, HSBC, JPMorgan Chase, MetLife, OneWest, PNC, Sovereign Bank, SunTrust, U.S. Bank, and Wells Fargo.

⁵⁶ Federal Reserve System, Office of the Comptroller of the Currency, Office of Thrift Supervision, *Interagency Review of Foreclosure Policies and Practices*, April 2011, p. 13, at <http://www.occ.gov/news-issuances/news-releases/2011/nr-occ-2011-47a.pdf>.

⁵⁷ Federal Reserve System, Office of the Comptroller of the Currency, Office of Thrift Supervision, *Interagency Review of Foreclosure Policies and Practices*, April 2011, p. 13, at <http://www.occ.gov/news-issuances/news-releases/2011/nr-occ-2011-47a.pdf>.

⁵⁸ The Federal Reserve System, *Press Release*, April 13, 2011, at <http://www.federalreserve.gov/newsevents/press/enforcement/20110413a.htm>.

⁵⁹ Federal Reserve System, Office of the Comptroller of the Currency, Office of Thrift Supervision, *Interagency Review of Foreclosure Policies and Practices*, April 2011, p. 3, at <http://www.occ.gov/news-issuances/news-releases/2011/nr-occ-2011-47a.pdf>.

⁶⁰ The five banks are Ally/GMAC, Bank of America, Citi, JPMorgan Chase, and Wells Fargo. See National Mortgage Settlement, at <http://nationalmortgagesettlement.com/>.

delinquent loans in four areas: borrower contact, delinquency management practices, foreclosure timelines, and loan modifications/foreclosure alternatives.⁶¹ The initiative prohibits dual tracking during the first 120 days of delinquency but does not require (though it does encourage) designating a single point of contact. Because of the large role that Fannie and Freddie play in the housing market,⁶² the reforms have the potential to significantly affect the servicing industry. FHFA is also working with the Department of Housing and Urban Development through the Servicing Compensation Initiative to reform the servicing compensation structure for Fannie and Freddie servicers.

⁶¹ Federal Housing Finance Agency, *Frequently Asked Questions- Servicing Alignment Initiative*, April 28, 2011, p. 1, at <http://www.fhfa.gov/webfiles/21191/FAQs42811Final.pdf>.

⁶² See **Figure 1**.

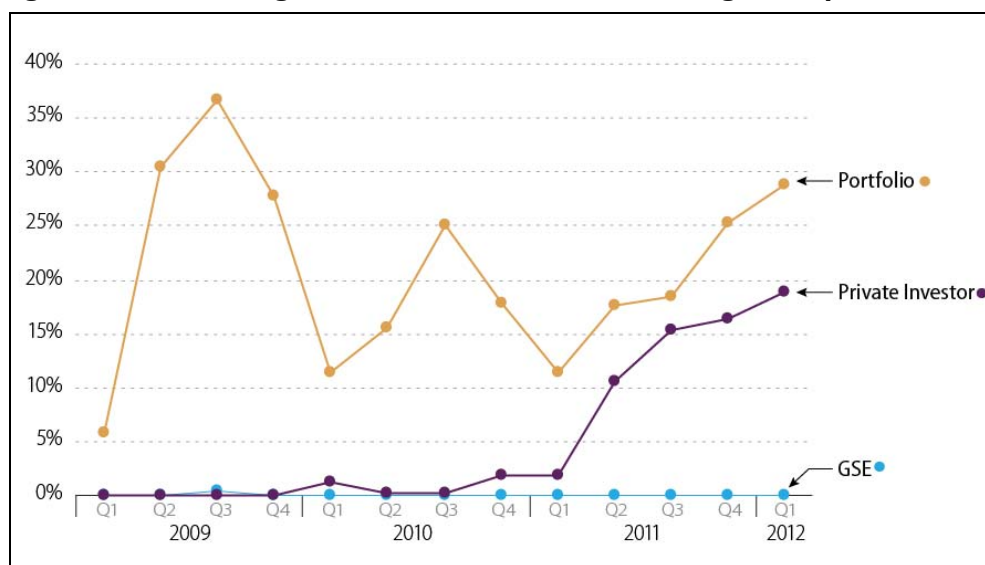
Appendix B. Data Analysis of Principal-Agent Problem

Servicers are constrained in their dealings with delinquent borrowers by contractual agreements with the owners of the loans, but the contracts may be vague enough to allow servicers the flexibility to choose the workout option that is in their best interest. Servicers' relationships with affiliates, the requirement to advance payment or interest, and servicers' compensation structures may influence decisions about loss mitigation options. If the option that is selected contrasts with the interest of the investor, then the servicer might profit at the investors' expense. Because incentives influence servicer actions in conflicting ways, economic theory alone is insufficient to determine whether the net effect of servicers' incentives is to offer too many foreclosures, too many loss mitigation workouts, or the wrong type of workout. The potential principal-agent problem is reexamined in this section to see what data trends might suggest.⁶³ A comparison is presented of how loans are serviced when owned by the servicer versus when loans are serviced for a GSE or PLS. Assuming that a servicer that keeps its loans in portfolio is less likely to have a principal-agent problem, the loans serviced for GSEs should be serviced differently. The differences are expected to be even more exaggerated when comparing loans serviced for PLS to loans held in portfolio due to the stronger principal-agent problem in PLS.

A principal-agent problem may most strongly manifest itself when looking at the data on principal reductions. Servicers are compensated primarily on the unpaid principal balance of the loans they are servicing. Therefore, they have an incentive to not reduce the loan principal if other options are available.

Figure B-1 shows the frequency with which principal reductions are performed when loans are held in servicers' portfolios and when serviced for a GSE or for a PLS. The data span the first quarter of 2009 to the first quarter of 2011. For example, of all the loan modifications performed in the fourth quarter of 2009 for loans held in a servicer's portfolio, 27.7% included a principal reduction.

⁶³ The data is taken from the OCC and OTS Mortgage Metrics Reports, which can be accessed at <http://www.ots.treas.gov/?p=Mortgage%20Metrics%20Report>. The reports contain data from eight national banks (Bank of America, JPMorgan Chase, Citibank, HSBC, MetLife, PNC, U.S. Bank, and Wells Fargo) and one thrift (OneWest Bank). Collectively, the nine institutions represent 63% of all first-lien residential mortgages outstanding in the United States. For more on the data, see *OCC/OTS Mortgage Metrics Loan-Level Data Collection: Field Definitions*, April 20, 2009, at <http://www.occ.gov/publications/publications-by-type/other-publications-reports/mortgage-metrics-q2-2009/loan-level-data-field-defin-q2-2009.pdf>.

Figure B-I. Percentage of Loan Modifications Involving Principal Reduction

Source: OCC and OTS Mortgage Metrics Report.

Loans held in portfolio saw more principal reductions than those owned by GSEs or PLS. The difference could be attributed to the principal-agent problem. However, alternative hypotheses may also explain the outcome. It is possible that the different mortgage holders own different types of loans.⁶⁴ Principal reductions may yield the highest NPV for portfolio loans but not for private investors' or GSEs' delinquent loans.⁶⁵ There may also be contractual differences facing servicers for each of the mortgage holders. Fannie and Freddie servicing guidelines do not allow for loan modifications involving principal reduction.⁶⁶ Servicers for private investors may also be limited by their pooling and servicing agreements in their ability to offer principal reductions.⁶⁷ Servicers for private investors may be less likely to reduce principal because they are concerned about being sued for choosing an option that an investor believes not to be in his or her best interest.⁶⁸ Investors may be more familiar with foreclosure or other forms of loan modification

⁶⁴ Loans held in servicers' portfolios reportedly tend to be nonconforming loans with increased risk characteristics and geographic concentration in weaker real estate markets, whereas GSEs have a greater percentage of prime loans. No background is given on PLS loans. Office of Comptroller of the Currency, Office of Thrift Supervision, *OCC and OTS Mortgage Metrics Report*, First Quarter 2011, p. 14,17, at http://www.ots.treas.gov/_files/490078.pdf.

⁶⁵ For an analysis of why principal reduction may not be pursued, see Chris Foote, Kris Gerardi, and Paul Willen, *The seductive but flawed logic of principal reduction*, Federal Reserve Bank of Atlanta, March 9, 2011, at <http://realestateresearch.frbatlanta.org/rer/2011/03/seductive-but-flawed-logic-of-principal-reduction.html>.

⁶⁶ Office of Comptroller of the Currency, Office of Thrift Supervision, *OCC and OTS Mortgage Metrics Report*, First Quarter 2011, p. 27, http://www.ots.treas.gov/_files/490078.pdf; see Fannie Mae, *Fannie Mae Single Family 2011 Servicing Guide*, June 10, 2011, pp. 706-67, at <https://www.efanniemae.com/sf/guides/ssg/svcg/svc061011.pdf>.

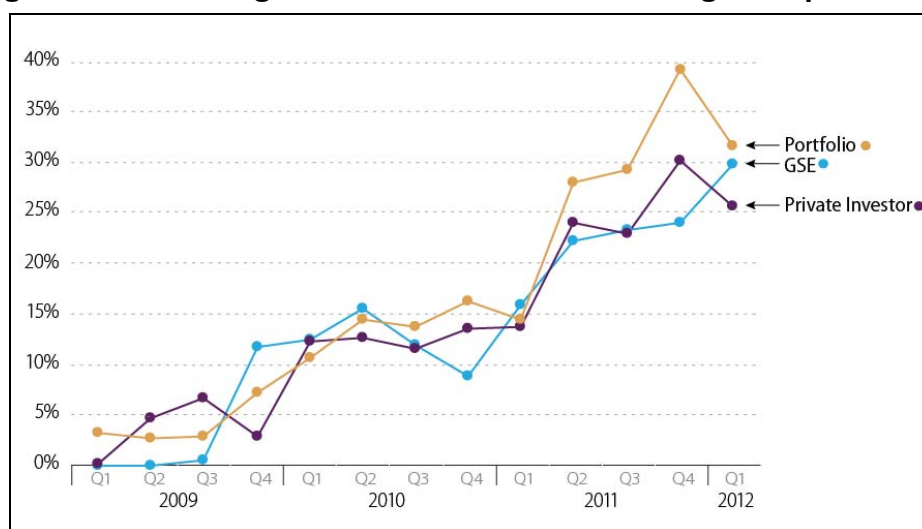
⁶⁷ One study noted that PSA bans on mortgage modification are rare, but the analysis is based on a relatively small sample of securitizations. See John P. Hunt, *What Do Subprime Securitization Contracts Actually Say About Loan Modification? Preliminary Results and Implications*, Berkeley Center for Law, Business and the Economy, March 25, 2009, pp.7-8.

⁶⁸ Larry Cordell, Karen Dynan, and Andreas Lehnert, et al., *The Incentives of Mortgage Servicers: Myths and Realities*, Federal Reserve Board, Washington, D.C., Working Paper 2008-46 of the Finance and Economics Discussion Series, September 8, 2008, p. 23, at <http://www.federalreserve.gov/pubs/feds/2008/200846/200846pap.pdf>.

and therefore be less likely to question a servicer than if a principal reduction is offered to the borrower.⁶⁹

Other forms of loss mitigation yield similar problems in attempting to isolate the impact of the principal-agent problem. **Figure B-2** shows the frequency with which a principal deferral⁷⁰ is used in a loan modification. The use of principal deferral varies over time and the difference between its usage for loans held in portfolio versus loans serviced for GSE and PLS also varies. The amount of that variation that is attributable to the principal-agent problem is not captured in this model because there are too many differences across types of holders.

Figure B-2. Percentage of Loan Modifications Involving Principal Deferral



Source: OCC and OTS Mortgage Metrics Report.

These two examples illustrate the difficulty in attempting to isolate the principal-agent problem in the data on loan modifications. The principal-agent problem cannot be measured without loan-level information as well as data on the limitations imposed by the pooling and servicing agreements.⁷¹ Such detailed data are not available. Others have tried to determine if there is a

⁶⁹ However, there have been few instances of investor litigation in response to a servicer's loan modification decision. See Diane E. Thompson, *Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior: Servicer Compensation and its Consequences*, National Consumer Law Center, October 2009, p. 8.

⁷⁰ Principal deferral modifications are modifications "that remove a portion of the principal from the amount used to calculate monthly principal and interest payments for a set period. The deferred amount becomes due at the end of the loan term." In a principal reduction modification, a portion of the principal amount is permanently forgiven. Office of Comptroller of the Currency, Office of Thrift Supervision, *OCC and OTS Mortgage Metrics Report*, First Quarter 2011, p. 10, at http://www.ots.treas.gov/_files/490078.pdf.

⁷¹ Regulators have reviewed servicers' foreclosure activities, but have not focused extensively on servicers' loan modification processes. See Federal Reserve System, Office of the Comptroller of the Currency, Office of Thrift Supervision, *Interagency Review of Foreclosure Policies and Practices*, April 2011, p. 2, at <http://www.occ.gov/news-issuances/news-releases/2011/nr-occ-2011-47a.pdf>.

causal link between securitization and increased foreclosures⁷² (possibly due to a principal-agent problem), but the results are inconclusive.⁷³

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⁷² See Tomasz Piskorski, Amit Seru, and Vikrant Vig, *Securitization and Distressed Loan Renegotiation: Evidence from the Subprime Mortgage Crisis*, Chicago Booth School of Business Research Paper No. 09-02, April 15, 2010.

⁷³ See Manuel Adelino, Kristopher Gerardi, and Paul S. Willen, *What Explains Differences in Foreclosure Rates? A Response to Piskorski, Seru, and Vig*, Federal Reserve Bank of Boston, Working Paper 10-2, at <http://www.bos.frb.org/economic/wp/wp2010/wp1002.htm>.