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A REVIEW AND ASSESSMENT OF THE NATIONAL MORTGAGE SETTLEMENT BY ITS MONITOR

JOSEPH A. SMITH, JR.*

Since April 2012, I have served as Monitor of the consent judgments commonly known as the National Mortgage Settlement (the “Settlement”). The obligations of the mortgage servicer parties to the first five of such judgments¹ were satisfied in March 2016. Three consent judgments under the Settlement’s structure remain in effect.² Although the mortgage servicing settlement process is ongoing, completion of the first five consent judgments is an appropriate vantage point from which to review the Settlement and assess its impact and significance. This Article provides such a review and assessment based on my work as the Settlement’s Monitor.

I. EVENTS PRECIPITATING THE NATIONAL MORTGAGE SETTLEMENT

The Settlement was one response to the 2008 financial crisis (the “Financial Crisis”).³ While you can still get into a fairly heated

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1. United States v. Bank of Am. Corp., No. 12-cv-00361-RMC, 2012 U.S. Dist. LEXIS 188892, at *105–06 (D.D.C. Apr. 4, 2012). While Bank of America is the mortgage servicer named in the case, JP Morgan Chase, Bank of America, Citigroup, Ally/GMAC, and Wells Fargo were all subject to the consent judgment. See Consent Judgments, United States v. Bank of Am. Corp., No. 12-cv-00361-RMC (D.D.C. Apr. 4, 2012), ECF Nos. 10–14, for the consent judgment filing for each of the respective parties. These consent judgments are referred to in this article as the “National Mortgage Settlement” or the “Settlement” or the “NMS.”

2. Consent Judgment, Consumer Fin. Prot. Bureau v. Ocwen Fin. Corp., No. 13-cv-02025-RMC (D.D.C. Feb. 26, 2014), ECF No. 12; Consent Judgment, United States v. Suntrust Mortg., Inc., No. 14-cv-01028-RMC (D.D.C. Sep. 30, 2014), ECF No. 65; United States v. HSBC N. Am. Holdings, Inc., No. 16-cv-00199-RJL, LEXIS 59487 (D.D.C. Mar. 14, 2016).

3. For an exhaustive description and discussion of the Financial Crisis, see, for example, THE FIN. CRISIS INQUIRY COMM’N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES (2011), https://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf.

argument about the causes of the Financial Crisis,⁴ I think (perhaps optimistically) that it can be agreed that misconduct and bad judgment in residential mortgage lending was at its epicenter. During the run-up to the Financial Crisis, the U.S. home ownership rate increased significantly, based in part on lending to borrowers who turned out to be unable to repay. The music stopped in 2007 and 2008 when the housing bubble burst, resulting in damage to a number of major real estate markets in the U.S. and financial markets globally. Foreclosures and related bankruptcy filings increased dramatically as a result.

The experience of federal and state government agencies and the courts in dealing with the foreclosure tsunami arising from the Financial Crisis made it clear that the mortgage servicing systems of our largest financial institutions, which had been set up on the assumption that a 1.5% default rate was a bad year,⁵ were overwhelmed by default rates that were much higher than that. The efforts of banks and non-depository servicers to address these deficiencies in capacity were way too little and way too late, and the impact on borrowers and the legal process was severe.

“Robosigning,” a neologism referring to the signing of foreclosure or bankruptcy documents by people with no knowledge of the facts underlying such documents, was a popular catchphrase used to describe the dislocation in mortgage servicing, but the industry’s problem was far deeper and more serious than that. Filing of incomplete, incorrect, and even false documents was all too common, as were lost documents, dual tracking (proceeding with a foreclosure while allegedly processing a loan modification), and abusive if not illegal collection tactics. Worse in some ways was the general unresponsiveness by servicers to distressed borrowers seeking relief, often leaving such borrowers in prolonged and frustrating uncertainty about whether they were going to get relief or lose their homes.

Mishandling of distressed mortgage loans by major servicers not only resulted in consumer complaints; it led to allegations of serious violations of law. Because of the interrelationship of federal and state

4. See *id.* at viii (four of ten commissioners dissenting from the final report).

5. See BD. OF GOVERNORS OF THE FED. RESERVE SYS., CHARGE-OFF AND DELINQUENCY RATES ON LOANS AND LEASES AT COMMERCIAL BANKS (last updated Nov. 18, 2016), <https://www.federalreserve.gov/releases/chargeoff/delallsa.htm> (showing average default rates on residential mortgages as just above 1.5% in the five years preceding the Financial Crisis).

laws in the origination and sale of residential home mortgages, abuses in the mortgage market violated both state and federal law. Each of the consent judgments comprising the Settlement is based on allegations of violations of, “among other laws, the Unfair and Deceptive Acts and Practices law of the Plaintiff States, the False Claims Act, the Financial Institutions Reform, Recovery and Enforcement Act of 1989, the Servicemembers Civil Relief Act, and the Bankruptcy Code and Federal Rules of Bankruptcy Procedure.”⁶ Sorting these claims out in federal and state courts would have involved the expenditure of many millions of dollars and years of effort with little certainty of outcome. So the parties settled.

II. THE NATIONAL MORTGAGE SETTLEMENT

The Settlement was made up of five consent judgments between the United States Government and forty-nine states and the District of Columbia, on the one hand (the “Government Parties”), and five major financial institutions (Bank of America, JPMorgan Chase, Citi, Wells Fargo and Ally) on the other (the “Servicers”). In exchange for a release from liability for the claims mentioned above, the Servicers agreed to three sets of obligations: (i) cash payments to governments and foreclosed homeowners, (ii) soft-dollar relief to distressed and underwater borrowers,⁷ and (iii) adoption of servicing standards or rules of conduct to deal with distressed loans. The Settlement was an agreement by the parties to forego full and final litigation of the claims mentioned above in favor of a resolution that provided substantial and immediate financial payments and relief to governments and consumers in exchange for release of the Servicers from the claims with the largest potential financial and reputational consequences.

The Settlement did not release the Servicers from all potential liabilities arising from their residential mortgage activities. It did not, for example, release them from potential liability for violation of federal fair lending laws. Further, it did not cut off potential claims by

6. *E.g.*, *Bank of Am. Corp.*, LEXIS 188892, at *15.

7. “Distressed” borrowers were delinquent in their payments, generally more than 90 days past due; “underwater” borrowers were current on their mortgage payments but unable to refinance their loans because the value of the mortgaged property was less than the outstanding balance of the related mortgage loan.

aggrieved individual borrowers who wished to pursue them, and it explicitly prohibited the conditioning of relief on a waiver of rights other than in settlement of pending litigation.⁸ Finally, it did not settle potential criminal claims or claims for fraud in the origination and sale of the mortgage backed securities.⁹ This last category of claims has resulted in additional litigation brought both by government and private parties, and has resulted in a number of significant and costly additional settlements.¹⁰

The Settlement was and is the subject of much debate regarding its wisdom, sufficiency, and effectiveness. It has been criticized with varying degrees of subtlety from a variety of viewpoints for: (i) giving inadequate or illusory relief to borrowers; (ii) being a soft extortion by governments that does not meet the actual needs of borrowers; and (iii) failing to hold “too big to fail” banks and their executives accountable for causing the Financial Crisis. While I think much of the criticism fails to adequately credit the Settlement’s achievements, discussed below, it persists nonetheless, likely because of a perceived lack of retribution—namely, jail time for bank executives.

III. ASSESSMENT OF THE NATIONAL MORTGAGE SETTLEMENT

In my view, the Settlement was a valuable and effective resolution of outstanding claims by all of its parties for a number of reasons, including:

- Size and Scope. The Settlement addressed the alleged misconduct of mortgage servicers that accounted for over 50% of the market.¹¹ The

8. See, e.g., *Bank of Am. Corp.*, 188892, at *278–86 (setting out “Claims and Other Actions Exempted from Release” by the state plaintiffs).

9. See, e.g., *id.* at *287–95 (setting out federal claims “specifically reserved and . . . not released”).

10. See Press Release, Dep’t of Justice, Justice Department, Federal and State Partners Secure Record \$13 Billion Global Settlement with JPMorgan for Misleading Inv’rs About Sec. Containing Toxic Mortgs. (Nov. 19, 2013) (announcing a \$13 billion settlement between the DOJ and JPMorgan “arising out of the packaging, marketing, sale and issuance of residential mortgage-backed securities”); Press Release, Dep’t of Justice, Bank of Am. to Pay \$16.65 Billion in Historic Justice Dep’t Settlement for Fin. Fraud Leading up to and During the Fin. Crisis (Aug. 21, 2014) (announcing a \$16.65 billion settlement between the DOJ and Bank of America for the same practices).

11. Larry Cordell, et al., Fed. Reserve Bd., *The Incentives of Mortgage Servicers*:

relief it obtained from the banks included \$5 billion in aggregate cash payments to governments and foreclosed homeowners, which exceeded by a multiple of two to three times, per bank, anything any financial firm had paid in prior settlements.¹²

- Relief to Distressed Borrowers. The Settlement required the granting of approximately \$20 billion in “soft dollar” relief to distressed borrowers, including debt modification or forgiveness, refinancing of underwater loans, and short sale or deed in lieu of foreclosure assistance. This requirement ultimately led to over \$50 billion in gross dollar relief to more than 640,000 families around the country.¹³ This relief came at a time when millions of borrowers needed it and when the parties would have otherwise been in litigation.

Myths and Realities 14 (2008) (showing “Large Servicer Holdings of High-Risk Mortgages” at year-end 2007).

12. Prior to the Financial Crisis, the largest financial institution settlement was the 2003 settlement obligating ten Wall Street firms to pay a total of \$1.4 billion for various conflicts of interest. Press Release, Dep’t of Justice, Ten of Nation’s Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (Apr. 28, 2003) (announcing penalties for implicated firms ranging from \$32.5 million to \$400 million). The Settlement’s \$5 billion cash payment required JPMorgan, Bank of America, Citigroup, Ally/GMAC, and Wells Fargo to pay \$1.08 billion, \$3.24 billion, \$415 million, \$110 million, and \$1.01 billion, respectively. *Summary of National Mortgage Settlement*, CTR. FOR RESPONSIBLE LENDING 11 (Mar. 12, 2012), <http://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/Summary-of-AG-Settlement-3-12-12.pdf>. At the time it was reached, the Settlement was the second largest ever obtained by U.S. attorneys general, the largest being the \$206 billion 1998 Master Tobacco Settlement. Because the disparity between the settlements in the total dollar amount is undoubtedly great, the overall breadth of the NMS may be better reflected by its similarities to the Master Tobacco Settlement in its imposition of sweeping institutional reform. For more on the Master Tobacco Settlement, see TOBACCO CONTROL LEGAL CONSORTIUM, THE MASTER SETTLEMENT AGREEMENT: AN OVERVIEW (2015), <http://publichealthlawcenter.org/sites/default/files/resources/tclc-fs-msa-overview-2015.pdf>.

13. OFFICE OF MORTG. SETTLEMENT OVERSIGHT, ORIGINAL SERVICERS’ FINAL COMPLIANCE UPDATE 13 (Mar. 3, 2016), <https://www.jasmithmonitoring.com/omso/wp-content/uploads/sites/4/2016/02/Original-Servicers-Final-Compliance-Update-2.29.2016.pdf>.

- Establishing Servicing Standards. The Settlement also required the banks to comply with over 300 servicing standards, or rules of conduct, in their handling of distressed home loans.¹⁴ These rules went into effect at a time when the Consumer Financial Protection Bureau (“CFPB”) was just organizing itself and before Richard Cordray had been confirmed as Director. The CFPB ultimately issued final servicing rules (similar to but not the same as the NMS servicing standards), which are now in effect.¹⁵ The Settlement’s rules governed a substantial portion of the market before the CFPB rules were issued and when the finality of such rules was in doubt.¹⁶
- Cooperation Among Governments and Across Party Lines. As noted above, the Federal Government, forty-nine States and the District of Columbia were parties to the Settlement. Each of the consent judgments contained an agreement between the governments not only on settlement terms, but also a cooperative governance structure.¹⁷ The Settlement was the

14. See, e.g., *United States, v. Bank of Am. Corp.*, No. 12-cv-00361-RMC, 2012 U.S. Dist. LEXIS 188892, at *181–215 (D.D.C. Apr. 4, 2012). Spreadsheet view available at <https://www.jasmithmonitoring.com/omso/wp-content/uploads/sites/4/2014/05/Servicing-Standards-Spreadsheet-1.xlsx>.

15. Real Estate Settlement Procedures Act (Regulation X), 12 C.F.R. §§ 1024.30–41 (2016).

16. Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act (Regulation X), 78 Fed. Reg. 10696, 10701-02 (Feb. 14, 2013) (to be codified at 12 C.F.R. pt. 1024) (discussing the regulatory framework for mortgage servicing prior to the CFPB and Regulation X). Additionally, on October 11, 2016, the District of Columbia Circuit ruled that the CFPB was unconstitutionally structured, in violation of Article II of the Constitution, but held that it would strike down only the provision of Dodd-Frank Act limiting the President to removing the single director of CFPB for cause in order to remedy constitutional violation. *PHH Corp. v. Consumer Fin. Prot. Bureau*, 839 F.3d 1, 8–9 (D.C. Cir. 2016). On February 16, 2017, the D.C. Circuit granted the CFPB’s petition for rehearing en banc, scheduling PHH’s brief to be due March 10th and the CFPB’s brief to be due March 21st, with oral arguments to be heard on May 24, 2017. *Petition for Rehearing En Banc Granted, PHH Corp.*, 839 F.3d 1 (No. 15-1177).

17. See, e.g., *Bank of Am. Corp.*, LEXIS 188892, at *181 (establishing “[a] committee

first major post-Dodd-Frank enforcement action in this regard, in contrast to the pre-Dodd-Frank world where State-Federal jurisdictional conflict was common.¹⁸ It is also at least interesting to note that of the forty-nine State Attorneys General who signed on, twenty-five were Democrats and twenty-four were Republicans.

- Enforcement Through Supervisory Means. In order to ease compliance concerns, the Settlement set up a “Monitor” to oversee the banks’ performance.¹⁹ The employment of a monitor has become increasingly common in financial and other settlements. The NMS is somewhat unique in that it established a detailed supervisory approach to oversight—visitation and measurement by testing—under which the Monitor was to function. As Monitor, I hired a small army of professionals through whom I confirmed that the banks had: (i) granted all of the “consumer relief” to distressed borrowers required by the Settlement and (ii) complied with the Settlement’s servicing standards. This confirmation was not a formal audit; rather, it was validation of the bank’s own assessment through agreed statistical sampling of their

comprising representatives of the state Attorneys General, State Financial Regulators, the U.S. Department of Justice, and the U.S. Department of Housing and Urban Development” to facilitate enforcement of settlement terms).

18. Compare *Watters v. Wachovia Bank, N.A.*, 550 U.S. 1, 12 (2007) (holding that National Bank Act did not preempt state registration and inspection requirements for a federally chartered bank and its state-chartered mortgage subsidiary), and *Cuomo v. Clearing House Ass’n*, 557 U.S. 519, 529 (2009) (holding that the Comptroller’s regulation purporting to preempt state law enforcement was not a reasonable interpretation of the National Bank Act) with Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act (Regulation X), 78 Fed. Reg. at 10706 (“The Bureau has considered each of these comments relating to the cumulative impact of mortgage regulation, including the mortgage servicing rules; the potential for inconsistent results with current servicing obligations, including State law and the National Mortgage Settlement.”).

19. See, e.g., *Bank of America Corp.*, LEXIS 188892, at *185-86 (providing that “[i]t shall be the responsibility of the Monitor to determine whether Servicer is in compliance with the Servicing Standards and the Mandatory Relief Requirements”).

performance. In operation, the Settlement resembled the supervisory work I did as North Carolina Commissioner of Banks. Given its structure, the choice of a supervisor rather than a prosecutor to act as Monitor is understandable.

- Supervision by a Federal Judge. Unlike a number of other settlements, the National Mortgage Settlement was and is under the continuing jurisdiction of a court, in this case, the United States District Court for the District of Columbia. The court reviewed and accepted the filing of Settlement documents before performance of its terms began in 2012, and has exercised continuing jurisdiction ever since. This ongoing court supervision has accomplished a number of important goals for the Settlement: (i) independent and continuing judicial review and oversight of both its terms and implementation; (ii) public access to the reports I have filed as Monitor; and (iii) a venue for the resolution of collateral claims and disputes.
- Limited Duration. Each consent judgment that is part of the Settlement has a defined term that ends with a “hard stop.” The servicing standards of the original five judgments “sunset” as to each of the servicer parties in October of 2015, and my final report on their compliance was filed with the court in March of 2016.²⁰ Three consent judgments remain in effect today, but each of them also has a hard stop in 2017 or 2018. After sunset, each servicer remains

20. OFFICE OF MORTG. SETTLEMENT OVERSIGHT, ORIGINAL SERVICERS’ FINAL COMPLIANCE UPDATE 13 (Mar. 3, 2016), <https://www.jasmithmonitoring.com/omso/wp-content/uploads/sites/4/2016/02/Original-Servicers-Final-Compliance-Update-2.29.2016.pdf>.

subject to regulation by the CFPB and the States.

Although I did not participate in the negotiation of the Settlement, I am—I hope pardonably—biased in its favor. It met a clear public need by establishing binding rules on the handling of distressed mortgage loans while the CFPB was being stood up and caused the major banks to provide a substantial amount of badly needed debt relief to distressed borrowers. Having done its work, it now ends.

IV. LESSONS FROM THE NATIONAL MORTGAGE SETTLEMENT

So, what lessons do I take away from my service as Monitor? First, the regulation and supervision of consumer finance generally—and home mortgage finance in particular—is an exercise in the management of complexity. Servicing of consumer loans is a systems-driven activity that is well suited to the handling of loans that are current and performing and ill-suited to the handling loans that are not. The legal requirements confronting financial services firms in handling distressed loans, including state foreclosure laws, federal and state consumer protection laws, and bankruptcy are complex and vary from jurisdiction to jurisdiction and court to court. Programming servicing systems to deal with federal and state legal and regulatory requirements is mind-numbingly complex, expensive, and prone to error. Compliance is costly and non-compliance is risky and potentially costlier. These risks and costs may lead to further or continued concentration of the financial services industry and marginally increased costs and reduced availability of credit to consumers.

The Settlement accommodated these difficulties by making performance subject to rigorous rules measured by tests with reasonable margins of error. Absent this fault-tolerant approach, two solutions to the complexity problem, neither very satisfactory, suggest themselves: (i) conformity of our legal and regulatory practices to the requirements of large institutions' systems; or (ii) admission that compliance with all applicable law cannot be done by systems and must be done manually, with the attendant increase in cost and loss of efficiency. Pick your poison.

Second, time-limited and properly supervised interventions like the Settlement can be a valuable augmentation of more permanent

regulatory regimes. Such interventions can be tailored to a specific problem and adapted to changing circumstances quickly and flexibly. While they aren't a cure-all, such interventions are useful tools that have the added benefit of self-liquidation. There is potential for focused, effective, and limited government here if governments and regulated industries will use them.

Finally, the interests of all stakeholders to financial settlements are best served by openness in terms of process and implementation. As noted above, my reports to the court were public; further, with the help of very skilled communications experts, I reported to the public in a summary and relatively non-technical way. My operations were conducted through a not-for-profit corporation whose financial statements were audited and made public. While these features of the NMS did not satisfy all of its critics, I think they went a long way to establishing trust in its integrity.

I hope that these lessons are at least considered as the post-Dodd-Frank regulatory structure for consumer finance develops; however, it is not clear that they will be. To date, the National Mortgage Settlement is "one of a kind."

V. FINAL THOUGHTS

Years after the Financial Crisis, there remains a significant amount of distrust in government, the financial system, and in settlements that bring the two together. It is highly unlikely that any settlement can meet the popular desire for retribution. The cost/benefit analysis from both government and financial services firms that lead to settlements is cold, complex, and difficult to explain. This doesn't mean it's wrong to settle; just that the settling parties have to rebut a number of negative presumptions about their motives and perhaps their competence.

I believe the National Mortgage Settlement supports the proposition that fostering public trust and confidence in settlements is best achieved by open processes and clear disclosure of results. Whether the National Mortgage Settlement is emulated in the future or not, I hope its lessons are not lost.