Sarah Bloom Raskin: Creating and implementing an enforcement response to the foreclosure crisis

Speech by Ms Sarah Bloom Raskin, Member of the Board of Governors of the Federal Reserve System, at the Association of American Law Schools Annual Meeting, Washington DC, 7 January 2012.

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Thank you and happy New Year. It is a pleasure to be with you today as you meet to discuss so many pressing and important issues. I know there has been much discussion at this conference about the public function of law schools and I commend you for tackling this essential challenge. In my speech today, I hope to add to the conversation a little bit by presenting a simple argument, that laws and regulations must be enforced, and enforcement must be part of what we teach lawyers and future lawmakers to study. What we think of as the rule of law encompasses not merely theories of the process by which public laws and regulations are created through particular legislative and administrative procedures, and not merely theories of how laws and regulations are interpreted by courts. The rule of law includes enforcement itself. The rule of law compels us to consider whether a rule has been crafted in such a way that it is capable of being complied with and capable of being enforced effectively by state actors. The rule of law also involves decisions about whether there has been compliance, and if not, what should be done about it.

The failure of timely enforcement leads to the entrenchment of bad practices and an increase in the costs of correction. For example, turning to what will be the focus of my comments today – the role of mortgage servicers in the foreclosure crisis – the longer it takes for mortgage servicers to make the operational adjustments necessary to fix their sloppy and deceptive practices, the costlier and more difficult it becomes for them to sort them out and correct them.

More fundamentally, a failure by regulators to enforce the laws and regulations as strong antidotes to financial misconduct and unsafe and unsound practices by the institutions they regulate establishes de facto acquiescence to the dominant norms of the financial marketplace. At that point, our laws become the resting place for unfair practices and broad disrespect for the law generally. This is a phenomenon that Shakespeare's Angelo observed in "Measure for Measure" when he said:

> We must not make a scarecrow of the law,
> Setting it up to fear the birds of prey,
> And let it keep one shape, till custom make it
> Their perch and not their terror.

For sure, different regulatory regimes could have different answers regarding the best way to enforce laws and regulations. As law professors teaching both the substance of law and the practice of law, I imagine you find ways within your courses and scholarship to discuss theories of enforcement – for example, the use of private rights of action versus enforcement by regulatory agencies; different enforcement tools such as memoranda of understanding, consent orders, and cease and desist agreements; how these different enforcement tools are sequenced; and whether and when violations of law should be publicized.

In answering all of these questions, there is consensus that public enforcement should be used in addressing pervasive regulatory problems. Today I want to talk about how home mortgage foreclosures hurt the pace of an economic recovery, and how important it is that the severe misconduct that has been uncovered in the mortgage servicing sector be addressed through intensified public enforcement of the law as part of the overarching effort to rebuild our damaged communities and neighborhoods.

Mortgage servicing and the economy

The economic downturn that began in late 2007 and worsened considerably in the autumn of that year resulted in the worst recession in many decades. Although recovery from the recession officially began in the third quarter of 2009, the pace of recovery has been modest, resulting in an unemployment rate that has remained at or above 8.5 percent since mid-2009. This sustained high unemployment rate – with all the attendant social consequences, including lost income and family strains – has contributed to an unprecedented number of mortgage foreclosures throughout the nation.

This wave of foreclosures is one of the factors hindering a rapid recovery in the economy. Traditionally, the housing sector, buoyed by low interest rates and pent-up demand, has played an important role in propelling economic recoveries. The increase in housing sales and construction often is accompanied by purchases of complementary goods, like furniture and appliances, which magnify the effect of the housing recovery.

However, six years after house prices first began to fall, the pace of the economic recovery remains slow. Nationally, house prices have fallen by nearly one-third since their peak in the first quarter of 2006, and total homeowners' equity in the United States has shrunk by more than one-half – a loss of more than $7 trillion. The drop in house prices has had far-reaching effects on families, neighborhoods, small businesses, and the economy, in part because so many American families – more than 65 percent – own their homes. The fall in house prices has caused families to cut back on their spending and has prevented them from using their home equity to fund education expenses or start small businesses. The decline in house prices has also impeded families from benefiting from the historically low level of interest rates, as perhaps only half of homeowners who could profitably refinance have the equity and creditworthiness needed to qualify for traditional refinancing.[1]

Throughout the successive waves in foreclosures that have occurred since 2007, problems in mortgage servicing have emerged and persisted. These problems have included critical weaknesses in mortgage servicers' foreclosure governance processes, foreclosure document preparation processes, and oversight and monitoring of third-party law firms and other vendors. Collectively, these problems have hampered the ability of the courts and the markets to work through the foreclosure inventory in an efficient manner.

Significant judicial resources are being expended on resolving the legal problems related to mortgage servicing. Indeed, the dockets of federal courts, bankruptcy courts, and state courts include numerous cases involving a wide range of troubling issues, such as claims of missing or forged promissory notes; claims that mortgage servicers have foreclosed on the houses of active-duty U.S. soldiers who are legally eligible to have foreclosures halted; sworn affidavits containing false "facts" that homeowners were in arrears for amounts not yet due; claims of falsifications of documents required to transfer ownership of the mortgage; allegations of false affidavits claiming homeowners owe fees for services never rendered; and claims of false affidavits overstating how much homeowners are behind on their payments.

And this is a sampling of the legal issues related just to mortgage servicing. There is another galaxy of vexing issues surrounding recordation and title issues and claims related to an entity called the Mortgage Electronic Registration System, or MERS. Significantly, the necessarily slow pace of a judicial response to these legal issues hinders the ability of the housing market to regain function and become a driver of a more-robust economic recovery.

[1] See Board of Governors of the Federal Reserve System (2012), "The U.S. Housing Market: Current Conditions and Policy Considerations (PDF)," white paper (Washington: Board of Governors of the Federal Reserve System, January).

Response to misconduct

In addition to the effect on the macroeconomy, this current judicial morass reflects profound and pervasive misconduct in mortgage servicing. It also calls for timely public enforcement. While the courts sort out – one by one – the mortgage servicing cases, the Federal Reserve, together with other federal and state regulators, must create, implement, and complete an enforcement response. Accordingly, in 2010, the Federal Reserve and the other federal banking agencies began a targeted review of mortgage servicing problems at 14 large, federally regulated financial institutions that had significant market concentrations in mortgage servicing.

From these examinations, the agencies found significant problems with the mortgage servicing and foreclosure processing at all 14 of them, which collectively represent more than two-thirds of all mortgage servicing volume nationally. The problems found by the agencies pose risks to the safety and soundness of the institutions, impair the functioning of mortgage markets, and diminish overall accountability of mortgage servicers to homeowners. As a result of these findings, in April 2011 the Federal Reserve issued formal enforcement actions requiring the four mortgage servicers that it regulates and the holding companies of six national bank servicers regulated by the Office of the Comptroller of the Currency (OCC) to address the deficient practices in residential mortgage loan servicing and foreclosure processing.[2] The OCC and the Office of Thrift Supervision simultaneously issued actions against mortgage servicers, resulting in enforcement actions against 14 banking institutions with mortgage servicing operations.

The enforcement actions are cease and desist orders and are legally enforceable in federal court. The enforcement orders require, among other things, the mortgage servicers to submit corrective action plans addressing the errors discovered during the targeted reviews and to implement practices designed to prevent future abuses in the loan modification and foreclosure process. The plans must be acceptable to the Federal Reserve. And to be acceptable, for example, the plans must detail ways the mortgage servicer will increase and enhance the staffing and other resources allocated to the mortgage servicer's loan modification and foreclosure departments. Such requirements relate to the failure of mortgage servicers to provide adequate staffing to carry out residential mortgage loan servicing, loss mitigation, and foreclosure activities. The increased resources required by the enforcement orders are meant to improve a homeowner's ability to readily obtain information and assistance from the mortgage servicer and to decrease errors made by mortgage servicers when modifying loans or pursuing foreclosures. The corrective action plans also must address other significant mortgage servicing and foreclosure-governance shortfalls and must be designed to ensure compliance with state and federal mortgage servicing and foreclosure laws. They must also improve foreclosure management information systems; establish robust controls and oversight over the activities of third party vendors; and strengthen communication with borrowers during loss mitigation and foreclosure processes.

Many of the corrective action plans mandated by the enforcement actions require mortgage servicers to change the way they conduct critical aspects of their business. For example, the corrective action plans require improved communications with borrowers before a foreclosure may proceed. In particular, the mortgage servicer must thoroughly explore loan modification options with the homeowner. The mortgage servicer must also improve the way it communicates with homeowners by establishing a "single point of contact" for homeowners in loss mitigation or foreclosure to use when they need help from the mortgage servicer in addressing problems. By having a single person at the mortgage servicer with whom to communicate, homeowners should be able to receive more reliable, accurate, and prompt

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[2] Board of Governors of the Federal Reserve System (2011), "Federal Reserve Issues Enforcement Actions Related to Deficient Practices in Residential Mortgage Loan Servicing and Foreclosure Processing," press release, April 13.

information about their mortgages, modification options, and the status of any foreclosure actions.

These orders also require each firm to hire an independent consultant to review the firms' past practices to identify specific cases in which these practices resulted in financial injury to specific consumers. This enforcement technique, known as a "look-back," is the current subject of much debate in the mortgage servicing context because it requires firms to use an independent consultant. The consultant reports both to the enforcing agency and to the firm, allowing the agency to better monitor and judge the completeness of the look-back.

Requiring an independent review of certain banking operations is not a new enforcement tool. Historically, independent reviews have most often been required by the Federal Reserve in connection with a banking organization's money-laundering or Office of Foreign Assets Control (OFAC) sanctions-compliance programs. Independent reviews typically require the regulated entity to hire a third party to do more time-intensive work than the regulator has already done. The examiners have perhaps found a problem and want the institution, at its own expense rather than taxpayer expense, to do more extensive scoping and remediation.

Monetary penalties and transparency

The enforcement actions against these 14 institutions and the associated corrective action plans are only a start in a comprehensive enforcement response to the foreclosure crisis. Monetary penalties for the deficient practices in mortgage loan servicing and foreclosure processing also must be imposed against the 14 institutions. The Federal Reserve and other federal regulators must impose penalties for deficiencies that resulted in unsafe and unsound practices or violations of federal law, just as state banking commissioners and state attorneys general impose penalties for violations of state law. The Federal Reserve believes monetary sanctions in these cases are appropriate and plans to announce monetary penalties. One purpose of monetary penalties, when they are appropriately sized, is to incentivize mortgage servicers to incorporate strong programs to comply with laws when they build their business models. This is an operational purpose, but as mentioned earlier, monetary penalties also remind regulated institutions that non-compliance has real consequences; the law is not a scarecrow where the birds of prey can seek refuge and perch to plan their next attack.

It is also worth noting the obvious, which is that Congress enacted some of the laws that are allegedly being violated – they are public laws. Their efficacy must be evaluated and re-evaluated by the public. This means that enforcement of laws must occur in a manner that permits an appropriate public evaluation. There is currently a lively debate about the appropriateness and value of transparency regarding the regulatory remediation required by the enforcement actions entered into with the 14 mortgage servicers. The fact that this public debate is occurring is entirely appropriate, and underscores the importance that Americans place on enforcement in the mortgage servicing context.

The cease and desist orders against the 14 large mortgage servicers are publicly available; they have been fully disclosed. The corrective actions that the mortgage servicers are undertaking pursuant to the enforcement actions in an appropriate format also need to be shared with the public. Not only is the public directly and significantly affected by how the acts of mortgage servicers have contributed to the state of the economy, but cities, neighborhoods, and communities have a direct and significant interest in the role that mortgage servicers play in the value of a homeowner's investment.

Conclusion

Too many of the practices in the mortgage servicing industry have been developed and defended solely on the basis of "standard industry practice," but many practices were not only standard, but shoddy. This has proven true, I might add, on the underwriting and secondary-market sides of the business, and we are seeing courts reject many of those practices.

Appropriately tailored enforcement against these mortgage servicing practices is necessary as one way to rebuild an important sector of the housing market. Accordingly, current deficiencies must be corrected.

What's more, financial institutions need to understand that they are responsible for assessing the effects their actions will have on consumers and the country as a whole, and factor those considerations into their business decisions. We should not forget that effective enforcement of our laws can animate our efforts as policymakers, regulators, business innovators, legal educators, and lawyers in creating the conditions that must exist for the emergence of an improved mortgage-servicing model that hinders neither economic growth nor homeowners' legal security. If a law is worth having, the law is worth enforcing.

Thank you.