Oral Testimony of Joseph R. Mason

Joint Economic Committee Hearing on

"Current Trends in Foreclosure and What More Can Be Done To Prevent Them."

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Cannon House Office Building Room 210

Thank you Congresswoman Maloney, Senator Schumer, and Committee Members for inviting me to testify today.

Recent history is rife with examples of subprime servicer problems and failures, resplendent with detail on best – and worst – practices. The industry has been through profitable highs and predatory lows, over time reacting to increased competition with greater efficiency and, where sensible, increased concentration reflective of scale economies in processing and knowledge.

Servicing is nothing if not a service industry, motivating borrowers to pay the loans under the servicer's own management even when the borrower cannot afford to pay others.

But intensively customer service-based enterprises such as servicing are hard to evaluate quantitatively, so that proving a servicer's value is difficult even in the best business environment. Unfortunately, today's is not the best business environment, so proving servicer value has now become crucial to not only servicer survival, but the survival of the market as a whole.

There are seven key reasons why servicers are facing difficulties with today's borrowers:

1. Modification is Expensive. Modified and defaulted loans can cost thousands of dollars per loan per year to service, compared to roughly fifty dollars for performing loans.

2. Arrearages are a Drag on Profits. Servicers have to pay investors as if the loan was current until the servicer resolves the delinquency, whether through modification or foreclosure.

3. Mortgage Servicing Rights Values Decline. When loans default, servicing fees end, so the values of the loan servicing contracts decline.

4. Increased Fees are only a Partial Fix. It is difficult to convince investors to accept a doubling of servicing fees, and even that will not cover typical increased costs. Servicers are reluctant to impose fees directly on borrowers, however, as those fees have been viewed as per se predatory in the past.

5. When Servicers are Threatened, Employees (and Expertise) Flee. Reduced servicing staff, particularly with respect to the most talented employees that have other options, will have a demonstrably adverse affect on servicing quality.

6. Servicer Bankruptcy Creates Perverse Dynamics. While most securitization documents stipulate a transfer of servicing if pool performance has deteriorated or if the servicer has violated certain covenants, which are expected to generally precede bankruptcy. The problem is that the paucity of performance data makes it difficult for the trustee or the investors to detect servicer difficulties prior to bankruptcy to make the change.

7. Default Management is More Art than Science. While modifications can be a useful loss mitigation technique when appropriate policies and procedures are in place, servicers that are unwilling or unable to report the volume, type, and terms of modifications to securitized investors or regulators may be poorly placed to offer meaningful modifications.

The main drawback with current policy is therefore that the industry can use modification to game the system and investors are wary. There are four major reasons for investor concern.

1. Aggressive Reaging makes Delinquencies Look Better than they Really Are. Investors know that redefault rates on modified loans are high, so calling the modified loan "current" again immediately is disingenuous at best.

2. Aggressive Representations and Warranties also Skew Reported Performance. At their best, representations and warranties help *stabilize* pool performance. At their worst, representations and warranties inappropriately *subsidize* the deal. In practice, it is difficult to decompose the difference between stabilization and subsidization.

3. Reaging and Representations and Warranties are used to Keep Deals off their Trigger Points. Residual holders, nay, servicers, however, continue to push for lowering delinquency levels, no matter how artificially, in order to maintain positive residual and interest-only strip valuations that can keep them from insolvency. Aaa-class investors are therefore at the mercy of servicers who are withholding information on fundamental credit performance in lieu of modification.

4. Current Industry Reporting does not Capture even the Most Basic Manipulations. Servicers that utilize unlimited modifications or modifications without appropriate controls could end up necessitating *greater* credit enhancement to maintain credit ratings, whether because of servicer capabilities or the possibility for delaying step-down by skewing delinquencies.

The State Foreclosure Prevention Working Group's *first* Report in February 2008 acknowledged that senior bondholders fear that some servicers, primarily those affiliated with the seller, may have incentives to implement unsustainable repayment plans to depress or defer the recognition of losses in the loan pool in order to allow the release of overcollateralization to the servicer.

Regulators can therefore do a great service to both the industry and borrowers in today's financial climate by insisting that servicers report adequate information to assess not only the success of major modification initiatives, but also performance overall. The increased investor dependence on third-party servicing that has accompanied securitization necessitates substantial improvements to investor reporting in order to support appropriate administration and, where helpful, modification of consumer loans in both the private and public interest. Without information, even the most highly subsidized modification policies are bound to fail.