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Testimony by Former President of Clayton Holdings, Keith Johnson, Before the FCIC

David Keith Johnson

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Former President of Clayton Holdings, Inc. and

Former President of Washington Mutual's Long Beach Mortgage

Before the Financial Crisis Inquiry Commission

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Chairman Angelides, Vice-Chairman Thomas, and Members of the Commission, my name is Keith Johnson. I have been in the financial services and banking industry for 30 years. From 1986 to 2000, I was employed by Bank United of Texas ("Bank United") where I held a variety of executive positions involving finance, capital markets, loan origination, securitization and servicing. In 2000, Bank United was sold to Washington Mutual ("WaMu") were I became the Chief Operating Officer of WaMu's Commercial Segment. In mid-2003, I was asked to assist the existing management of Long Beach Mortgage. In June 2005, while remaining an employee of WaMu, I became the acting President of Long Beach Mortgage for approximately 9 months. In May 2006, I left WaMu and became President and Chief Operating Officer of Clayton Holdings, Inc. ("Clayton") the largest residential loan due diligence and securitization surveillance company in the United States and Europe. I left Clayton at the beginning of 2009 shortly after its sale to a private real estate investment fund.

I thank the Commission for the invitation to appear, and I hope that my testimony will assist in your efforts to better understand the causes of the financial crisis. The Commission has asked me to address several topics related to loan securitization, mortgage brokers and their related impact to the Sacramento region and other communities in the Central Valley.

In my opinion, this crisis is not the result of a single cause, but a combination of significant factors operating at the same time and feeding each other. Low interest rates, increased housing goals, creative securitization, lack of assignee liability, compromised warehouse lending, flawed Rating Agency process, relaxed and abusive lending practices, rich incentives, shortfalls on regulation and enforcement provided the fuel to inflate home prices and excess borrowings by consumers.

Financial Factories & Securitization

In addition to the factors previously mentioned, improvements in technology, credit scoring and financial engineering transformed traditional lending platforms into large financial factories. Several of these factories were originating, packaging, securitizing and selling at the rate of $1 billion a day. The quality control process failed at a variety of stages during the manufacturing, distribution and on-going servicing. Traditional regulatory examination procedures were not able to evaluate neither processing exceptions nor their resulting cumulative risk. The lack of accountability and failure by many parties to "present value the pain" allowed for the process to continue. Lastly, the lingering impact of this transformation has been the severing of practical solutions between borrowers facing a financial hardship and the investors with principal at risk.

Many have blamed this crisis on the growth of securitization. I believe that mortgage securitization process was flawed and abused, but can and will be beneficial to the public, as it provides a vehicle for lenders to sell loans in exchange for the capital necessary to make additional loans. Hopefully, this crisis will lead to reform of common sense improvements to bring back a prudent robust securitization market.

Mortgage Brokers

As it relates to doing business with mortgage brokers, I can share with you my experience at Long Beach and observations while at Clayton.

Unlike most large mortgage companies that contain multiple origination channels, retail, direct mail, telephone and refinance desks, Long Beach was a sub prime lender that relied 100% on mortgage brokers.

Broker originated loans was and can be a viable loan production channel. The model serves a purpose in helping financial institutions reach out to the unbanked and underbanked areas.

However, performance data has shown that the broker model became flawed with greed, fraud and deception. Low barriers of entry, lack of regulatory supervision or enforcement, coupled with rich incentives for production created an environment that contributed to the surge in defaults. During my period of time at Clayton, I was able to observe the operations of close to 40 of the largest mortgage originators and servicers in the United States. To late to be effective, it became obvious that the only way to correct the broker model was to shut it down and wait for regulatory reform and enforcement.

Recent regulatory changes have been made to improve the broker channel and I would encourage additional supervision and enforcement. For me, one of the underlying conflicts with the broker model is the question of “whom does the broker work for?” The main problem is that, counter to common perception, mortgage brokers do not represent the borrowers who pay them for advice. Instead, they are more like independent salespeople who are often paid as much by the lenders in addition to the borrowers they represent. When brokers are paid commissions by both parties to a loan transaction, confusion results about whom the brokers actually "work for."

In my opinion, the broker should be acting as a fiduciary of the borrower, and have the responsibility for making sure that the borrower understands and benefits from the transaction by receiving fair terms. A criticism of this approach is that implementing will have an adverse impact on the low to moderate-income applicants. I would suggest to you that the benefits would tilt toward the consumer, with alternatives to encourage financial institutions to invest in low to moderate housing.

Issues impacting Sacramento and Central Valley

As it relates to the Sacramento and other communities in the Central Valley, I have three areas of concern.

Special Servicing

Effective loan servicing, foreclosure avoidance and loss mitigation are necessary to help families work through a financial hardship. Servicer incentive, the borrower’s lack of financial literacy and the threat of investor litigation are limiting effective loan servicing.

Current servicing fees provide little to no economic incentive for servicers to spend the time, money and effort working with a borrower to arrive at a fair solution. For some servicers, the most profitable path is to move the loan to foreclosure. Special Servicing should be engaged which has incentives to cure defaults and avoid foreclosure. My recommendation for all future securitizations (including Fannie Mae, Freddie Mac and FHA) is that once a loan goes 90 days delinquent it is assigned to a Special Servicer who will evaluate the collateral and borrower's financial condition and perform a "Lowest Cost Solution" that will take into consideration loan modification, short-sale, deed-in-lieu, foreclosure etc. The Special Servicer will receive a market rate of compensation based on their results.

As for financial literacy, I have worked with many delinquent borrowers and it clear that we have not stressed in our education system skills and knowledge necessary to make financial decisions. There has been much press about the streamlined modification processes offered during the past two years. I have worked with borrowers in educating them and helping them complete the modification checklists. However, the process is still complicated by the lack of borrower's financial knowledge and communication barriers.

The last servicing issue relates to fear of litigation from investors. The legal and loss waterfall structures of legacy securitizations are creating conflicting incentives for investors to resolve delinquent loans via modifications. My recommendation is to follow, the FDIC in their "Low Cost Solution" process for all delinquent loans. The "Lowest

Cost Solution" should be followed regardless of the impact to structured waterfall losses. Servicers who adopt the "Low Cost Solution" methodology should be held harmless from investor litigation.

Foreclosed Inventory of Homes

The second concern for the Sacramento region and other communities in the Central Valley is the increased inventories of abandon homes resulting from foreclosure. Empty homes do not pay the salary of schoolteachers, police and fire departments. The compounding impact of vacant homes is a real threat to the recovery of a community. The issue of unsold inventory is also linked to my third concern for the area, the availability of credit to purchase homes.

Availability of Credit

Home prices are down, inventory for sale has increased, credit standards have tightened and prospective homebuyers will have difficulty meeting the down payment requirements. One suggestion, which I found to work during the 1980's Texas recession, is to promote an active "Loans to Facilitate the Sale of Foreclosed Homes" program. Ironically, this is a program of relaxed underwriting guidelines. Borrowers would qualify based on their existing rental or housing income being equal to or lower then a fully loaded (principal, interest, taxes and insurance) mortgage payment that amortizes over a 30 year period. The program would encourage minimum down payments, but be willing to offer 100%+ financing that rolls in all the closing costs.

One would argue that relaxed underwriting and 100% loan to value loans put us into this mess, why would we ever use this to pull us out? I would offer these factors as defense, home values have significantly declined reducing the risk on collateral, absorption helps to slow any further price deterioration, communities and neighborhoods become more stable with higher comparables and real estate taxes are being paid to support infrastructure.

Again, I thank the Commission for the invitation to appear. I appreciate the opportunity to share my views, and would be happy to answer any of your questions.