WRITTEN STATEMENT

OF DAVID SHERR,
MANAGING DIRECTOR AND GLOBAL HEAD OF SECURITIZED PRODUCTS,
LEHMAN BROTHERS INC.

BEFORE THE
SENATE BANKING SUBCOMMITTEE
ON SECURITIES, INSURANCE, AND INVESTMENT

APRIL 17, 2007

Chairman Reed, Ranking Member Allard, and members of the Subcommittee:

I am David Sherr, Managing Director and Global Head of Securitized Products at Lehman Brothers Inc. I appreciate the opportunity to appear before the Subcommittee today on behalf of Lehman Brothers Inc. ("Lehman"). Lehman, an innovator in global finance, serves the financial needs of corporations, governments and municipalities, institutional clients, and high net worth individuals worldwide. Founded in 1850, Lehman maintains leadership positions in equity and fixed income sales, trading and research, investment banking, private investment management, asset management and private equity. The Firm is headquartered in New York, with regional headquarters in London and Tokyo, and operates in a network of offices around the world. Lehman is pleased to share with the Subcommittee its experience in the subprime mortgage securitization process.

The Mechanics and Incentives of the Subprime Mortgage Securitization Process

The subprime mortgage securitization market is a part of the broader mortgage securitization market. Mortgage securitization was developed approximately 30 years ago. Since then, the mortgage-backed securities market has grown to become the largest fixed income segment of the nation's capital markets, with approximately $6.5 trillion of securitized mortgage debt outstanding as of the end of 2006.

While this Subcommittee is focused on very recent instances of foreclosure, please remember that for three decades mortgage-backed securities have provided, and continue to provide, great benefits to the average American. Because of mortgage securitization, loans for home purchases have become more widely available for all borrowers, including those considered subprime. If not for the innovation of mortgage securitization, the United States would not have become the nation of homeowners that it is today, with homeownership close to its highest level in our history – almost 70 percent overall.

Before securitization became widespread, banks had relatively limited capital available to make loans to prospective homeowners. Their lending activities were constrained because they had no effective means to convert their existing loan portfolios to cash that could be used to make additional loans. There was no liquid market for mortgage loans. With the advent of the securitization market, banks (and other financial institutions) have been able to monetize their existing loan portfolios and to transfer the risk associated with those loans to sophisticated investors. As a result, more money is available to borrowers who wish to buy their own homes, or to refinance their existing mortgage loans on more attractive terms.

Securitization represented a new way to fund America's demand for home mortgages by accessing the significant liquidity of the capital markets. Borrowers continue to take out loans with local banks and state-regulated mortgage companies, just as they always have. Those lenders determine if they want to retain mortgage loans or transfer them into the secondary market either in whole loan form or through securitization. If a lender elects securitization, the loans are assembled into pools by sponsors, such as Lehman. The lenders continue to stand behind their decision to make a loan by making representations about the loan quality. After the rating agencies have completed their review of the pool, the loans are conveyed to a "securitization trust" and interests in the loans are sold to investors in the form of securities. From then on, payments made by borrowers on their mortgage loans are applied to make payments on the securities.

It should be noted that sponsors of mortgage-backed securitizations, such as Lehman, are careful about choosing the lenders with whom they do business. All the lenders selling loans to Lehman are either federally chartered banks or state-regulated originators. Prior to establishing a business relationship with a particular lender, Lehman spends time learning about that lender, its past conduct and its lending standards. Further, Lehman, like other securitization sponsors, performs a quality check on the mortgage loans before purchasing them. These reviews include sample testing to confirm that loans were underwritten in accordance with designated guidelines and complied with applicable law.

The Subcommittee has asked about the "incentives" of the participants in the subprime mortgage securitization process. Consumers benefit because they are able to obtain loans with a greater variety of payment structures. This is especially true for borrowers considered to be subprime, many of whom did not have access to mortgage loans, and so could not purchase their own homes, prior to the creation of the securitization market. Lenders benefit because they are able to free up capital to make additional loans. And investors benefit because mortgage-backed securities present a diverse range of investment options, with investors being able to choose the type of product and risk/reward profile appropriate for their needs.

It cannot be emphasized enough that no participant in the securitization process has any incentive to encourage the origination of loans that are expected to become delinquent. No financial institution would knowingly want to make or securitize a loan that it expected would go into default. Rather, the success of mortgage-backed securities as an investment vehicle depends upon the expectation that homeowners generally will make their monthly payments, since those payments form the basis for the cash flows to bondholders.

The Effect Recent Increases in Defaults and Delinquencies Have Had on the Subprime Securitization Market

The market currently is adapting to changes in the performance of subprime loans, just as it adapts to any other change that significantly affects participants in the mortgage securitization process. Importantly, the interests of all market participants, from the borrower to the investor, are generally aligned with respect to reducing the number of defaults and delinquencies. Everybody loses when the only viable option for managing a loan is foreclosure. Given the general alignment of interests, it is not surprising that the market is adjusting rapidly to minimize foreclosures and improve the performance of securitized loans.

For example, mortgage loans to subprime borrowers are now being underwritten according to stricter guidelines to reflect current market conditions. At the same time, the volume of securitizations has been reduced, as has the range of mortgage products being offered to consumers. Further, financial intermediaries are pushing forward new practices, including contacting borrowers early when their loans appear to be at risk for default. All these adjustments in the market are being driven by the fact that nobody benefits from the underwriting of loans that do not ultimately perform.

We must be careful, however, not to overreact to the increased number of delinquencies and defaults, which could lead to an undue tightening of credit available to prospective homeowners. At the same time that we consider how the market has changed, we should also keep in mind how it has stayed the same. The vast majority of subprime borrowers remain current in their loan obligations. For those borrowers, the mortgage securitization process continues to provide unprecedented access to the capital markets, so that they can purchase their own homes.

Mitigation of Potential Foreclosures

Mortgage securitization structures provide flexibility to avoid foreclosures. Much of that flexibility rests in the hands of the financial institutions that service mortgage pools. Servicers collect principal and interest payments from borrowers, and also make decisions on the administration of the pooled home loans. They have flexibility to work with borrowers so that loan payments will be made, while exercising the right to foreclosure only as a last resort.

Notably, many of the largest servicers are commercial banks, which also hold substantial mortgage loans in their own portfolios. Regardless of whether these banks are managing their own portfolios or servicing loans in a securitized pool, we expect they generally will follow the same prudent “home retention” practices in an effort to avoid foreclosures.

The title of this hearing asks about the “role of securitization” in “subprime mortgage market turmoil.” Because none of the participants in the securitization process benefit from foreclosures, the market has evolved, and will continue to evolve, so as to minimize the number of foreclosures. Servicers are ramping up their “home retention” teams both with respect to early intervention for “at risk” borrowers and loan modification programs for borrowers that are in financial distress. To the extent that the servicer currently lacks any necessary powers to reduce the number of foreclosures in a prudent manner (and Lehman does not believe that such powers are materially lacking), the market will adjust by enhancing the servicer’s flexibility in future contracts. In short, we expect that the subprime mortgage securitization process will continue to create opportunities for a long-ignored segment of the population to join and remain in the ranks of American homeowners.

Thank you again for the opportunity to be here today. I welcome any questions you might have.