REMEMBER THE STRESS TESTS?

The other day, I noted that Administration claims that they were helpless to affect what they now depict as loan servicers' "sloppiness" but what really amounts to fraud ignores their decision to stop pushing for cramdown–and with it, leverage over the loan servicers.

I think (though I'm less sure of this) they're ignoring one other source of leverage they once had over the servicers: the stress tests.

First, remember that the top servicers also happen to be the biggest banks. Here is Reuters' list of the top loan servicers.

- Bank of America (19.9%)
- Wells Fargo (16.9%)
- JPMorgan Chase (12.6%)
- Citi (6.3%)
- GMAC (3.2%)
- US Bancorp (1.8%)
- SunTrust (1.6%)
- PHH Mortgage (1.4%)
- OneWest (IndyMac) (1.4%)
- PNC Financial Services (1.4%)

And here is the list the nineteen banks that had to undergo stress tests in 2009.

- American Express
- Bank of America
- BB&T
- Bank of New York Mellon
- Capital One
- Citigroup
- Fifth Third
- GMAC

- Goldman Sachs
- JP Morgan Chase
- Key Corp
- MetLife
- Morgan Stanley
- PNC Financial
- Regions
- State Street
- SunTrust
- U.S. Bancorp
- Wells Fargo

So all of the top mortgage servicers–Bank of America, Wells, JP Morgan Chase, Citi, and even GMAC–had to undergo a stress test last year to prove their viability before the government would allow them to repay TARP funds and therefore operate without that government leverage–which was threatened to include limits on executive pay, lobbying, and government oversight of major actions–over their business. Significantly, all but JPMC were found to require additional capital.

Now, I'm not sure what I make of this. The stress tests were no great analytical tool in the first place. Moreover, the stress tests focused on whether the banks could withstand loan defaults given worsening economic conditions, not whether they could withstand financial obligations incurred because their servicing business amounted to ~~sloppiness~~ fraud.

But in letters between Liz Warren (as head of the TARP oversight board) and Tim Geithner in January and February 2009 discussed foreclosure modification, stress tests, and accountability for the use of TARP funds (Geithner made very specific promises about foreclosure modifications and refinancing which Treasury has failed to meet). And those discussions–and the stress tests–took place as COP reported on the problems with servicer incentives, servicer staffing and oversight, and the lack of regulation of servicers more generally (the COP report came out March 6, 2009; the stress test results were announced May 7, 2009). So at the same time as the Administration was officially learning of problems with servicers, it was also giving those servicers' bank holding companies a dubious clean bill of health. And with it, beginning to let go of one of the biggest pieces of leverage the government had over those servicers.

Beyond that, I'm not sure what to think of any relationship between the stress tests and the servicer part of these banks' business. Rortybomb has an important post examining how this foreclosure crisis may go systemic. If it does, these same banks that eighteen months ago promised the government they could withstand whatever the market would bring will be claiming no one could have foreseen that they'd be held liable for their fraudulent servicing practices. Ideally, we would have identified this as a systemic risk eighteen months ago, and based on that refused to let the big servicers out of their obligations (which would have provided the needed incentive for the servicers not only to treat homeowners well, but to modify loans). Had the stress tests included a real look at these banks' servicing business, these banks might not have been declared healthy.