# AMERICAN PREDATORY LENDING AND THE GLOBAL FINANCIAL CRISIS

# ORAL HISTORY PROJECT

Interview with

Todd H. Baker

Bass Connections

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PREFACE

The following Oral History is the result of a recorded interview with Todd Baker conducted by Malena Lopez-Sotelo on April 15, 2021. This interview is part of the Bass Connections American Predatory Lending and the Global Financial Crisis project.

Readers are asked to bear in mind that they are reading a transcript of spoken word, rather than written prose. The transcript has been reviewed and approved by the interviewee.

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Malena Lopez-Sotelo: I'm Malena Lopez-Sotelo, a graduate student at the Fuqua School of Business and a member of the Bass Connections American Predatory Lending and the Global Financial Crisis team, and today it is April 15th, 2021. I'm currently in Durham for an oral history interview with Todd Baker, senior fellow at the Richmond Center for Business, and Law, and Public Policy at Columbia University, who has joined us via Zoom. Thank you for joining today, Mr. Baker.

Todd Baker: Thank you very much.

Malena Lopez-Sotelo: I'd like to start by establishing a bit about your background. I believe that you went to Dartmouth College for your undergraduate degree, then went on to receive a Juris Doctorate from Stanford Law School. Is that correct?

Todd Baker: Yes, it is.

Malena Lopez-Sotelo: In the context of your work life, when and how did you become first involved with residential mortgages?

Todd Baker: For the first 20 years of my work life, I was a corporate lawyer working at large law firms, and primarily in two areas: technology and financial services. In the context of financial services, I was a deal lawyer for transactions involving banks, non-banks, broker dealers, and other financial services companies. In that context, I also did securitization work primarily not in the mortgage space, although some of it related to mortgages. I did the first credit card securitization transaction in the mid '80s and did many things relating to mortgages because I had primarily retail banking clients who were large mortgage originators. So when doing mergers and acquisitions, stock offerings, etc., I was intimately involved in their operations and those included mortgages.

Malena Lopez-Sotelo: What attracted you to the mortgage sector?

Todd Baker: Well, I think nothing in particular, it was part of the larger financial services business. It just was a part and parcel of the work I was doing.

Malena Lopez-Sotelo: Can you describe your first role that you consider in the mortgage market space?

Todd Baker: Well, I represented buyers of banks and Savings & Loans as a lawyer that had large mortgage businesses, and buyers and sellers of mortgage banking businesses, which would be non-bank mortgage lenders. Primarily that would have been during the mid- to late 1980s and 1990s. I also represented many of the most active buyers [of] failed Savings & Loans, coming out of the Savings &

Loans crisis at the end of the 1980s. So I was active primarily in the acquisition business related to mortgage lenders.

Malena Lopez-Sotelo: Can you describe the state of the mortgage market in your career around the 1990s leading up to the 2000s?

Todd Baker: The dynamic at that time in the mortgage business was that the traditional mortgage lenders, which were the Savings & Loans, had gotten themselves in substantial difficulty associated with the expansion of their powers to commercial mortgage lending. Many of them had failed at the end of the 1980s and into the early 1990s [and they lost their leadership role]. At the same time there was a significant rise in non-bank mortgage lenders, who used Fannie Mae and Freddie Mac initially as an outlet for the mortgages that they originated. And then ultimately, there grew up a system of private securitizations run by the Wall Street firms that allowed mortgage bankers to originate [and sell mortgage] loan products that were not eligible for purchase by the GSEs [Government-Sponsored Enterprises]. The main originators of mortgages [during that period] were non-banks, so-called mortgage banks, such as Countrywide, which was a large mortgage originator in that period, and some commercial banks which specialized in the area. So, JPMorgan, Wells Fargo, Bank of America, were also large originators. But in general, the trend during that period was the rise and fall-- because they were highly susceptible to the business cycle-- of non-bank mortgage lenders who were primarily selling the mortgages [they originated] and retaining mortgage servicing rights as a business model.

Malena Lopez-Sotelo: Can you define what a non-bank mortgage lender is?

Todd Baker: So, when you think of traditional mortgage lending back in the days when you would go to a local savings bank or Savings & Loan, that institution would make a loan to you and hold the loan on their balance sheet. So, they would raise deposits and those deposits would fund mortgage loan assets on the balance sheet. Banks also did this as part of their larger business, but it was pretty much all of the business of the traditional Savings & Loans who were the main providers of mortgage finance.

The GSEs—the government sponsored enterprises--Fannie Mae and Freddie Mac, and to a lesser extent, Ginnie Mae-- provided an alternative structure. They were set up in order to stimulate further mortgage lending. What they did is they would buy mortgage [loans] that were originated by banks or other [non-bank] companies and finance that purchase by issuing Fannie Mae or Freddie Mac or Ginnie Mae guaranteed mortgage-backed securities [backed by those loans] in the capital markets. They raised capital by [buying], packaging and securitizing so-called "conforming loans", which were loans that met the standards set by those GSEs. What this [GSE structure] did was allow lenders who did not have the capacity to put loans on their balance sheet to originate loans and sell them at a profit to the GSE. The [lender] maintained the servicing for the loans, but shifted the credit risk to Fannie Mae or Freddie Mac [and the ultimate buyers of the securities]. A necessary part of this was a change in accounting for mortgage originations, which was driven by the creation of what's called the mortgage servicing right [MSR]. If you step back a bit and see the [origination of mortgage loans] on a cash to cash basis, you lose money when you originate a mortgage, you make that money back up over time as you receive interest payments, etc., But there are costs associated with originating mortgage. So, at the time of the origination, you have spent more on the mortgage-- you're [in a] loss position. Mortgage servicing rights accounting allowed, particularly non-bank mortgage lenders, to recognize an asset, which was the expected present value of the mortgage servicing payments they were going to receive over time, allowed them to recognize that at the time a mortgage was sold and that then permitted a mortgage originator, which often was not a bank, to originate and sell loans at a gain, at a profit [which would not have been possible] without the mortgage servicing rights, because the mortgage servicing payments are actually received over the length of the term of the mortgage. Had they not been able to do that, each mortgage would have been sold at a loss, and therefore that wouldn't have been a viable business model. So that change in accounting was fundamental to enabling non-banks to enter the mortgage business in size.

Malena Lopez-Sotelo: In what ways, do you think, that these changes in accounting practices created incentives for non-bank mortgages?

Todd Baker: They significantly did, because they created a viable business model [for non-balance sheet mortgage lending], although a highly volatile one, because the downside of mortgage servicing rights is that--this is a little complex to explain--but the traditional [conforming] 30-year mortgage, which the GSEs sponsored and acquired, is prepayable at will, which means that if you borrow money and take out a mortgage, you can pay it off because you've sold the property, or because you've prepaid the mortgage at any time. So for the holder of that mortgage does not know whether that 30 year mortgage will be around for 30 years, or for five years, or for two years, or for one year. That's a significant risk in terms of the value of that mortgage [to the holder]. But more particularly, it affects the value of mortgage servicing rights, which are merely the expected cash flows over the period when the servicer is going to be receiving payment for servicing the asset.

So when you capitalize that [cash flow] value [into an MSR asset], you have to make an estimate as to how long the mortgage will be around. The accounting requires you to revalue the [MSR] asset in any period based on your estimate of the likely duration of the mortgage loan asset. As interest rates-- particularly during the period from 1980 through the end of the financial crisis-- went up and down quite a lot, the value of that mortgage servicing right, which was the present value of the expected future cash flows, varied because mortgages were pre-payable. So, when interest rates dropped, people prepaid their mortgages and took out a replacement mortgage [at a lower rate]. When that happened, the mortgage servicing right became less valuable and had to be written down [by booking the change as a loss]. On the other side, if mortgage rates were rising, people who had mortgages below the current rate had no incentive to refinance, and so the duration of that mortgage servicing right extended and the value of the MSR went up. So it created a significant amount of earnings volatility in the mortgage business model associated with interest rate changes. That was not the case if the mortgages were held on a bank balance sheet.

Malena Lopez-Sotelo: In my understanding, you had a pivot from [the] legal to the commercial world. Can you describe that pivot?

Todd Baker: I had many bank clients. My biggest one was Bank of America-- I represented them for many years in mergers and acquisitions-- also Transamerica, Montgomery Securities, Security Pacific, etc., most of the large San Francisco-based financial services companies. I also had Washington Mutual as a client for which I did mergers and acquisitions legal work. I was hired by them at the end of 2001 to be an executive vice president of corporate development. Corporate development in "corporate speak" means the internal mergers and acquisitions function of a company. So, I was hired to essentially be the internal business person doing mergers and acquisition deals and Washington Mutual had been very active in the mergers and acquisitions space over time. So, I left the legal profession and went into the corporate development business.

Subsequently, I took on a new role leading corporate strategy largely because when I arrived in Washington Mutual, I discovered a series of acquisitions that they had made, that I had actually not been involved with, [where] they had bought a bunch of companies that had large mortgage banking operations separate from their [branch-based] lending and banking operations. So, they had bought a number of freestanding mortgage banks and some Savings & Loans and savings banks that had very large [free standing] mortgage lending operations. In doing so, the CEO-- Kerry Killinger-- had set up a goal to be the number one or number two mortgage lender in the country. By doing that, he, unwittingly, changed the [stock market] valuation metrics for the company because, as I mentioned, of the interest rate volatility that mortgage servicing rights and mortgage banking activities add to a business model.

Well, the effect of those [mortgage acquisitions] at Washington Mutual was that the "bank" aspect of Washington Mutual--its traditional business as a deposit taker, lender, etc.-- was overwhelmed by this enormous mortgage origination and servicing business that it had created. The effect of that was to change the price/earnings ratio [PE ratio] of the company substantially downward because of all the interest rate risk associated with mortgage banking operations. Mortgage banks were typically valued at say seven or eight times forward earnings, whereas banks were typically at say 13 or 14 times forward earnings. Washington Mutual had always traded at a slight discount to the banks, which was appropriate for a company that was a Savings & Loan, but at a substantial premium to mortgage banks, and that high relative PE [price to earnings ratio] allowed it to acquire other underperforming Savings & Loans over time, and profitably, [and] essentially combine the operations effectively.

As its PE valuation trended down towards the higher-risk mortgage banking model, it became difficult, or in fact impossible, to acquire banks. As I came in to do corporate development and the expectation was that the company would continue to acquire other banks, this became a problem. So I started analyzing this [question] really from the corporate development standpoint and ultimately was asked to take on a corporate strategy role in addition to the corporate development role.

Malena Lopez-Sotelo: How did Washington Mutual or your team assess candidates for mergers or acquisitions?

Todd Baker: Standard corporate finance techniques at the time. We looked at the net present value of the combination, and so you were essentially looking at what would happen with the two companies together-- would branches be closed, would personnel be laid off, would there be synergies, other expense synergies by eliminating the sort of corporate activities, home office activities of a target. And then you looked at revenue synergies as well. Would you be able to take the superior Washington Mutual retail banking model and apply it to what were often sort of sleepy Savings & Loans and generate significant additional growth for doing that.

In fact, for many, many years, Washington Mutual had been quite successful in doing that. The dynamics of that [M&A value] are affected in the banking area by a variety of other regulatory requirements related to capital, risk management issues to the extent that the company that you're acquiring has a different business from what you've been doing. And also the pure financial metrics associated with paying with stock and issuing shares for an acquisition and what the impact would be on the earnings per share of the surviving entity after the transaction. So all the traditional things that one looks at in any corporate acquisition were applied here. The opportunities were quite significant over time because Washington Mutual was a superior business model to most of the Savings & Loans that it acquired over time, and was able to improve operations and create new value.

Malena Lopez-Sotelo: What were some of the attributes that made Washington Mutual different or more competitive than its competitors? And can you give a couple of examples of those competitors?

Todd Baker: Well, the main difference was its retail banking model was excellent. It was really customer focused, it was friendly, it was open, it advertised itself at the time as sort of the non-bank that is not going to treat you like a number, but provide personal service. They were very effective at creating new branch formats, friendly, open, branch layouts. They had excellent training of the branch staff. So its greatest strength was in its retail banking model. The mortgage business by contrast was essentially a [commodity business]-- it was very hard to differentiate in that business because of the presence of the GSEs and the standardization of product and everything else. Competition was more on price and timing than it was on customer service-- you were not necessarily converting any of your mortgage customers into permanent customers to create long-term value. It was a very transactional business.

Malena Lopez-Sotelo: And at the time, in your early 2000s role, what kind of geographies was Washington Mutual serving at the time?

Todd Baker: When I first encountered them as a lawyer, they were essentially a Seattle and some parts of Washington and area lender. By the time I joined in 2001, they had acquired pretty much all of the large Savings & Loans on the west coast and therefore the biggest market was California, but they'd also acquired other operations in New York City, Texas, Florida, a few other states, and it started de novo [branching] not through acquisitions. They'd opened branches in most of the major US urban markets, so they had branches in Chicago, Atlanta, the Texas markets, Colorado. They had selected markets that they considered to be particularly attractive and opened new branches there as well. They were national, and at the time probably had the biggest national scope [of any retail bank]. The large US banks were also consolidating at the same time-- Bank of America, Wells Fargo, JP Morgan, were creating national franchises-- but Washington Mutual was probably slightly ahead of them at that time. So they had a national franchise, but it was very heavily focused in a few large states, particularly California, Texas, and Florida.

Malena Lopez-Sotelo: Can you describe one of Washington Mutual's successful mergers or acquisitions?

Todd Baker: Well, they had many, but a sort of paradigm case would be they acquired Home Savings [Home Savings of America], which was the largest Savings & Loan in California and had been for many years. [It was] probably the largest one in the country at one point, a very successful traditional Savings & Loan, that had a good customer service model, but [was] somewhat sleepy, was underperforming relative to its potential, and Washington Mutual acquired that company probably, I can't remember the exact date, but in the late 1990s, and was able to convert it effectively to the Washington Mutual branch banking model. By doing so-- in addition to some other acquisitions it had done in California, Great Western Financial and a few others— it became if not the largest, the second or third largest bank in California.

Malena Lopez-Sotelo: Can you describe the process to convert an acquired or merged bank to the WaMu [Washington Mutual] banking model?

Todd Baker: Well, there's the technical conversion, which involves a very complicated process of moving deposit and loan accounts from one core system to another, so that involves converting your deposits and your loans to the Washington Mutual information technology platform. There's a whole process around that. But more important than that is the change in brand, retraining people for the product set that Washington Mutual created, and essentially reforming or changing the culture of the acquired company to the culture of the Washington Mutual retail bank platform.

Malena Lopez-Sotelo: Were there any challenges associated with bringing a merger into that banking model?

Todd Baker: Always, because people don't like change. Washington Mutual was quite adept at doing it. And because at least the retail banking business was an open, friendly, clear lines of control, clear direction, positively oriented organization, generally they did a very good job with conversions. Acquired employees were happy, and they worked out well. So it had a long successful track record of taking underperforming financial institutions and bringing them into the higher performing Washington Mutual model.

Malena Lopez-Sotelo: To my understanding Long Beach Mortgage was one of those acquired banks. How did Long Beach Mortgage come into play with Washington Mutual?

Todd Baker: Long Beach wasn't a bank. Long Beach was an acquisition that happened some years before I got there. At the time, Washington Mutual was… as I mentioned earlier the CEO Kerry Killinger had this idea that he wanted to be the number one or number two mortgage originator in the country. That was a popular theory of the time coming out of a lot of management consultants, Tom Peters and others, who said you needed to be dominant in some business. And so they were picking up mortgage lenders, some of them associated with banks, for instance the Dime Savings [Dime Savings Bank of New York] acquisition and with American Savings [Bank] and a few others. And then they also bought, I believe, some freestanding [nonbank] mortgage originators. What Long Beach Mortgage was, I believe, was the correspondent subprime lending business of the mortgage operation of a guy named Roland Arnall, who was best known later as the CEO of AmeriQuest Mortgage, a much larger subprime lender. He [Arnall] had at some point or other split off different parts of his operations and Long Beach became an independent company and then it was eventually acquired by Washington Mutual.

Roland, interestingly, had he not died in a timely fashion, would probably have been the poster child for subprime. We wouldn't have been talking about Angelo Mozilo [at Countrywide], we would've been talking about Roland Arnall. He was really the mastermind of most of the large subprime mortgage companies that came out of Orange County, in California-- most of them were located there. Long Beach Mortgage was a small correspondent-- might've done some wholesale as well-- subprime lender that was acquired sometime in the 1990s and was operated as part of the much, much larger Washington Mutual mortgage operations. Because Washington Mutual was a huge player in the prime mortgage space, primarily fixed rate, GSE eligible or conforming mortgage loans, and then some adjustable rate mortgages which were heavily held on the balance sheet.

Maybe 3% or 4% of the total [WAMU mortgage] originations were subprime originations that Long Beach did not hold on their balance sheet but sold into the secondary market. Long Beach was a very small part of the larger mortgage business there. Although it did operate fairly separately, and because it was a subprime lender, had different products than those provided by the major part of the Washington Mutual mortgage business.

Malena Lopez-Sotelo: You used the term subprime, how would you define that term?

Todd Baker: The typical definition in those days was, 660 or below FICO [score].

Malena Lopez-Sotelo: It looked like after this acquisition, WaMu shifted its focus to more organic growth. Do you agree or disagree with that assessment?

Todd Baker: Long Beach was a tiny acquisition in Washington Mutual's acquisition history. Washington Mutual bought billions and billions of dollars of banks and Long Beach was a small mortgage banking acquisition. It hung around for a while, but the larger story of Washington Mutual is Washington Mutual realized that it overplayed its hand in mortgage by about 2002 or 2003, and sort of started reducing the size of the mortgage business and emphasizing the banking business. It had another, what you might call subprime business, which was called WM Finance, it was the former Great Western Finance. That was a “second mortgage” lender, similar to Household Finance and other typical finance company lenders. WM Finance was considerably larger than Long Beach Mortgage. I sold WM Finance in, I think, 2004.

Long Beach was sort of a problem child. WaMu didn't really know what to do with it. For risk management reasons, it couldn't be too large because of the risk profile of subprime loans, and it had, as I said, a different product set, a different branding, and until it became a problem, it was largely left to operate on its own. It wasn't allowed to grow substantially at all. And it had, I understand-- although one of the interesting things about the way the company was operated is I wasn't privy to any of this information-- I understand there were negative internal audit reports about its operations that caused, at various times, the central risk operation in Seattle to crack down on activities there.

Malena Lopez-Sotelo: What were some of the goals that Long Beach had and how did those change over time?

Todd Baker: Again, Long Beach was a tiny part of the larger mortgage operation. It was there largely because the theory was that within appropriate risk management parameters, you could capture some additional value from the higher gain on sale margins that were typical in subprime lending, but you had to do it carefully because in terms of your overall capital and credit risk profile, it was critical to balance risk and reward. It was viewed as marginally beneficial to the overall operation to the extent that it could slightly improve the mortgage financial results at an appropriate risk level. As I said, it was a [correspondent or] wholesale operation, so people in the branches never saw or heard of it. It was a separate operation, and it was operated separately from the rest of the mortgage business. It had more typical subprime loan products, the 2/28 and

3/27 mortgages were typical products. Those were not available or of interest to prime customers. Different products, different everything.

Malena Lopez-Sotelo: You mentioned that these entities operated pretty much separately. What were leadership interactions like between both entities?

Todd Baker: Because it was buried deep in the mortgage business, I personally never had any interactions with the people running it. It was just a part of a larger mortgage operation. Up in central headquarters, I was dealing with the heads of the mortgage business, and Long Beach was just a very small part of a very large operation. The issues that I dealt with from a strategy standpoint were more associated with the problems that the larger part of the mortgage operation and the prime part of the business were creating for the valuation of the company. Because the volatility created by the enormous mortgage servicing right asset that was constantly being created and revalued in the prime mortgage bank, was the thing that was affecting the stock market value of the company and, as I said, Long Beach was not relevant really to the question of what the [stock market] value of the company was.

Malena Lopez-Sotelo: In this lead up to 2008, what were Washington Mutual's loan origination channels?

Todd Baker: The way the mortgage business was operated in those days, there were essentially three channels: retail, wholesale, and correspondent. Retail was, you had a sales force, they were primarily dealing with real estate brokers who were looking for financing for their customers who were buying houses. That was by far the most profitable channel. There was wholesale, where mortgage brokers, who were individuals who ran little mortgage businesses, would, for a referral fee, essentially provide mortgages to be originated by Washington Mutual. The key thing about wholesale is the mortgage broker didn't have a balance sheet, so essentially a wholesale loan was originated by the lender, in our case Washington Mutual, even though it was sourced by the mortgage broker. And then there was correspondent, which was where a third-party lender-- could be another bank, often was-- originated loans, and then essentially sold them at, or after origination to Washington Mutual, but Washington Mutual had no customer contact. So those were the three channels, and Long Beach was in subprime, I believe primarily doing correspondent. My memory on that is very hazy.

Malena Lopez-Sotelo: Can you define what a correspondent channel is?

Todd Baker: Well, the difference in the correspondent channel is that the loan originator, typically was another bank--an actual bank, but sometimes another type of nonbank mortgage lender that had the capacity to fund the mortgages itself. The key difference in the correspondent channel is that the-- Washington Mutual in this case-- the ultimate bank, buys the loan on a so-called servicing-released basis. So it buys both the loan and the servicing rights from another lender that has actually originated the loan. Whereas in the wholesale channel, Washington Mutual originates the loan, although it didn't source the loan, a mortgage broker sourced the loan and was paid for facilitating the transaction. Usually the mortgage broker dealt with all the paperwork, but on Washington Mutual loan documents, whereas in the correspondent case, it was originated by the other lender on its own loan documents and then sold.

Malena Lopez-Sotelo: You mentioned role of brokers in the origination channel process...

Todd Baker: Two types of brokers. There's real estate brokers, like the person you'd go to buy or sell your house, then there's mortgage brokers, who are essentially mortgage originators who theoretically shop around for the best deal for their customers and provide access to mortgage loans.

Malena Lopez-Sotelo: Can you describe the incentives in place for both types of brokers by Washington Mutual?

Todd Baker: No. All those programs changed over time, and so I have no idea now what they were then. Typically, a mortgage broker received a payment at the time of the origination which was associated with the value of the loan. The constant issue with mortgage brokers was making sure that the structure was set up so that they weren't incentivized to create a bad loan for their own customers, because there's a fundamental issue around brokers in that context. But I have no idea what the compensation arrangements were, except that they were regulated and of concern in setting incentives properly for the customers and the mortgage brokers. And correspondent was same thing. There was a release premium paid for the loan, and typically you didn't have any insight into the economic arrangements that the originator had because you were paying for a closed loan, as opposed to, in the mortgage, in the wholesale [origination channel] context where, you were being offered a loan with particular terms and deciding, on an individual loan basis, whether you wanted to fund that loan or not.

Malena Lopez-Sotelo: You mentioned that Washington Mutual purchased loans. What did Washington Mutual do with those loans they purchased, for example, when they sold or securitized?

Todd Baker: For every loan that they made or purchased they had to make a decision [about] hold[ing] it on the balance sheet [or not]. [They would usually sell it to the GSEs] if it was a conforming loan. The better economic solution sometimes was to pull it and sell it to Fannie Mae or Freddie Mac. That was a large part of the business. For every mortgage lender today, it's the dominant part of the mortgage business-- very few loans end up on the balance sheet. Then occasionally there were opportunities for private securitization, where you could pool your own loans and sell them into the securities market. Washington Mutual did a small amount of that, later in its life.

But the basic choices were hold, sell [to the GSEs] or securitize through [Wall Street]. Then there was another option, which related to the way the capital rules worked for, mortgage lending. You could sell your loans to Fannie Mae and Freddie Mac, but hold the [resulting GSE] securities on your balance sheet, and the advantage there was when you securitized them with Fannie or Freddie, they had the Fannie or Freddie guarantee. They were considered significantly lower risk assets for [regulatory] capital purposes. And so if you held loans in mortgage-backed securities, you were required to put up less capital against them on your balance sheet. So you had whole loans on your balance sheet and you had [GSE-guaranteed] mortgage-backed securities that you retained on your balance sheet. You had mortgages that you sold to third parties [or securitized yourself].

Malena Lopez-Sotelo: When did this guarantee come into play? how did you see the market react to that?

Todd Baker: In my entire life it had been there. Freddie and Fannie had been around-- one of them was established after the Depression, and one of them was much later. But they were essentially government sponsored enterprises which acquired loans and turned them into guaranteed securities. They were a growing part of the mortgage [business]. There was also Ginnie Mae, which was a fully governmental activity that did the same thing for loans to veterans and certain types of low-income loans. Essentially, they were a way to provide liquidity to the mortgage market during the period in the forties and fifties and sixties, when the government was very intent on encouraging home ownership. they're still extant today.

Malena Lopez-Sotelo: You mentioned that Long Beach at one point became a problem. When did concerns begin to arise regarding its performance?

Todd Baker: I don't recall. There were some legal issues with the way they were doing things. And then, ultimately, they were shut down because the central risk management function and the CEO [Killinger] got increasingly concerned about the state of the mortgage market in the 2005 - 2006 period. Over time, particularly as a warning signs continued, Washington Mutual essentially exited [prime] correspondent business, exited the [prime] wholesale business, exited subprime Long Beach, and that happened during the more crazy period of the couple of years prior to the great financial crash when it was clear that the mortgage business was getting out of control. Washington Mutual massively downsized its mortgage business - really the height of its mortgage business was probably about 2001. If you look at the numbers, the origination volumes dropped off pretty substantially every year. And they cut out the - what were viewed as - higher risk, lower value pieces of the business, which would be correspondent, wholesale and subprime, and tried to hold onto the to the retail mortgage originations, which were viewed as more related to the local communities that were being served by the retail bank.

Malena Lopez-Sotelo: It sounds like the changes occurred very gradually over a decade time period. Did executives at the time think that those observed issues were temporary or transient?

Todd Baker: Like everyone else in the mortgage business, nobody really understood the extent to which the massive creation, particularly of private [AAA-rated] mortgage-backed securities, was providing excess liquidity, which was contributing to the asset bubble that emerged when the Fed bailed out the dot com boom by lowering interest rates. There was a huge increase in global investment in mortgage-backed securities-- both private and government mortgage-backed securities. There was an extended period of home price appreciation. And the difficulty was, there were a variety of accepted beliefs about mortgage risk, which turned out to be wrong. Another belief was that, based on the last four or five incidences in the US, mortgage related recessions were a regional phenomenon.

The Great S&L [Savings & Loan] collapse towards the late 1980s was largely restricted to Texas, Arizona, New Mexico and a couple of other states, and real estate prices stayed stable or increased everywhere else. There was a fundamental risk management idea that a [national] residential real estate recession was not likely to happen.

Another issue was tied to the method of credit assessment that came out - for the period after say 1980, consumer credit was evaluated based on statistical analysis of performance history, and this was the rise of the so-called FICO score— from Fair Isaac, [Fair, Isaac and Company] and other providers who assessed [credit risk] based on a whole variety of inputs and [predicted] probability of loss associated with mortgage originations. Their models were quite detailed, quite effective within their own internal limitations.

But those internal limitations were not really well understood. The fundamental problem was that they were backward looking as they still are today. And if you look at, for example, the risk of a particular type of mortgage, and this came up a lot, because during the mortgage boom - the last part of the mortgage boom - there were a variety of loosened underwriting standards associated with things like self-reported income that were justified because there were 15 or 20 years of backward-looking data that showed that that particular input was not indicative of [poor] credit quality. In other words, you could safely lend to someone who self-reported income, because looking back, we had 20 or 30 years of data showing that, over time, those loans performed if not the same, but in some measurable relationship to other loans, and so it could be priced from a risk-based pricing standpoint.

Risk-based pricing [for mortgage loans] also became fundamental, at the same time [as credit scoring]. ...You had statistical data that attempted to differentiate between the risk content of different types of people and different types of loan situations. But what couldn't be seen was [environmental changes]-- a rising tide associated in part with global liquidity trends -

investments in US mortgage [securities] internationally were rising [as were housing] prices and there was enormous mortgage liquidity, which allowed easy refinancing and gave some bad signals, because things like self-reported income loans had not been through a really major downturn. There were only some of these regional downturns to look at, and their performance in many cases had been helped by rising real estate prices.

The signals that backward-looking data were giving about credit risk were often overwhelmed by these larger environmental factors, including rising general housing prices that essentially gave false signals about absolute risk. So the risk models were highly rigorous and done, at the time, by the best people doing that. But the challenge was what they [really] predicted well was how different borrowers would perform relative to each other. They didn't effectively capture absolute performance because they were unable to take into account these larger environmental factors were propping up this major investment boom in US residential real estate. I think the limitations of that type of modeling was not well understood.

Now that being said, every good lender, and this was the case at Washington Mutual too, had very serious stress case analyses in the mortgage portfolio. Those stress case analyses were typically based on— look at the worst thing that happened in Texas in 1988 and add 50% to it, and something like that was in all those models. And in fact, in reality, the capital that was available to banks, et cetera, was sufficient to manage the expected losses [those models predicted]. No one effectively expected the level of national losses that actually occurred when the financial crisis hit, as the nature of all the financial shenanigans going on at AIG and the Wall Street banks were exposed and those things played into an immediate withdrawal of mortgage liquidity and a massive, although relatively short-term, reduction in real estate values. The odd thing is today real estate values are significantly higher than they were at the peak of the boom in 2008. So, as you know, ultimately real estate value recovered, but what was not understood is that you could have something as severe as a 30%, you know, generalized reduction in [national] real estate values. The models were predicting something more like 10%.

Malena Lopez-Sotelo: You mentioned soft reported income as a part of the loan origination process. How did the impact of using this type of process affect the rest of Washington Mutual versus Long Beach?

Todd Baker: It was never a significant portion of anybody's loan originations. I just use it as example of - what are the inputs to mortgage loan origination process? FICO score, loan to value ratio, that is the down payment essentially that's put in there, level of income, and there are other inputs as well, but what you saw during that period - this was the challenge for the banks and particularly a bank like Washington Mutual (which, again, early in the decade had thought it wanted to be a leader in mortgage originations--it had given up that idea well before the financial crisis). They were competing against non-regulated or very lightly regulated, non-bank mortgage lenders who ... were selling primarily through Wall Street.

So they sold loans to, and securitized them through, Wall Street. And essentially, the incentive to cut standards of mortgage origination was very significant for them because Wall Street could sell the securities backed by as many of those loans [as they could make]. Again, based on that kind of backward-looking credit analysis that was popular at the time. For the big banks, the struggle was how to compete in the mortgage business when there's a race to the bottom by unregulated players. Every bank struggled greatly with us in terms of, to what extent to follow standards down and ultimately, all of the banks, partly because they were regulated and, partly because their risk tolerance was significantly less, didn't follow all the way, but they followed some and they tried to do it in a risk neutral way. And they tried to make sure that they were putting up enough capital for the risks they were taking.

They were challenged particularly by really large [nonbank] players, like Countrywide, which was the dominant mortgage lender at that time, along with Wells Fargo, that had as its business a much more significant piece of subprime lending. What you saw [in the market] is this constant struggle by the regulated banks to maintain volume of business, while not getting too deep into the riskier areas. Whereas the mortgage banks, particularly the subprime mortgage banks - which remember were the first ones to fail, I think in around 2006 - essentially that business was done and over, because they essentially had gotten too far over their skis and the performance of the loans started to deteriorate first there. The independent subprime businesses went out of business in 2006. I think we shut down - I can't remember when we shut down Long Beach mortgage - but effectively around the same time.

Malena Lopez-Sotelo: On the topic of the 2000s time range, to what extent, if at all, did figures within your firm or yourself express concerns about the changing nature of credit?

Todd Baker: Well, not to toot my own horn, but my contribution to Washington Mutual was that I was the great opponent of the mortgage business. Because, as I mentioned initially, I was brought in to acquire other banks and build the retail franchise and the valuation discount which the mortgage business had created for Washington Mutual from a price/equity ratio standpoint was impeding that. So I was asked to do a strategic plan [to address that PE ratio issue]. I had the help of some terrific people internally, particularly a woman named Melba Bartels, who's now the CFO of Boeing Employees Credit Union, BECU, and we came up with a plan essentially to diversify the business away from mortgage [lending] back to the core [retail and business] banking franchise. In particular we had the idea that we should be investing in new asset categories, such as credit cards, commercial banking, multi-family lending, and trying to reduce the earnings proportion of the business that was associated with the mortgage business.

I think we did that strategic plan in maybe 2002 or 2003, I can't recall. This was highly unpopular [internally] because the mortgage business was still a dominant part of the company. It had been, in my view, badly mismanaged - the people who were running it failed to consolidate all the different mortgage lenders that they had acquired. They had a plan to create a new software platform for all the mortgage lending and servicing - that was an ignominious failure. But they essentially did a very poor job in consolidating and managing this large set of different mortgage companies that they had ultimately acquired.

The strategy that my team proposed was essentially to move Washington Mutual into the banking space more actively because its core competency was in the retail banking. And from a balance sheet standpoint, finding uncorrelated businesses to balance off the high volatility of the mortgage business was critical to creating long-term value.

It took a couple of years for that view of the world to be accepted [at WaMu]. I think it probably [helped] that Washington Mutual had some serious difficulties with mortgage servicing rights volatility around that same period. The result of that was a shift in strategy towards trying to move away from the mortgage business. That's why the mortgage originations declined so much. We acquired a large credit card company at my initial suggestion. We acquired some commercial bank activities, sold some other businesses, including that finance company that I mentioned: WM Finance. WM Finance was another piece of mortgage risk [elimination], but we failed to execute the big [merger] deal that would have fundamentally shifted the balance of the company towards a more traditional banking mix.

There were a couple of [merger] deals that got very close, but, for a variety of reasons ... that have to do with CEOs and their desires for their own futures, they didn't happen. As things got a little more difficult, we also came up with a plan to spin off a big piece of the mortgage business, but an odd aspect of accounting for past acquisitions meant that in order to do that, the company would have had to recognize a large paper loss, not a large cash loss, but a large paper loss, on so-called 'goodwill' created in an earlier acquisition. That derailed that prospect, at the CEO's behest. And, so, there was a significant effort, within the company.

Washington Mutual didn't fail because of inadequate capital. There's a long story as to why it was the only company of that period that was allowed to fail that has to do more with politics and Wall Street versus Main Street than it does with its fundamentals. Where Washington Mutual went wrong is … that it fundamentally misunderstood the risks of being that large a player in the mortgage business in the late 1990s through the early 2000s, became too large in a volatile business and misunderstood, along with the rest of the world, the consequences that would have.

There's another thing that was going on, which was [the move to] so-called "mark to market "accounting. Some people decided the accounting profession needed to change its historical method for accounting for a variety of assets [and liabilities] and in doing so, they created tremendous volatility in financial results, associated with estimated market values. That became, deadly to the system as a whole, not so much to Washington Mutual, but the system as a whole. When the financial crisis resulted in the inability to trade assets and the inability to find prices for assets, particularly mortgage assets, mark to market accounting caused the recognition of losses well beyond fundamental loss, based on [estimated] market prices, and that caused this cascading effect - caused Lehman Brothers to fail and AIG to fail and the cascading effect on the financial markets in general.

So, Washington Mutual is largely used as an example of the excesses of the period, because it's the only one of the banks that failed. It failed because the FDIC decided to seize it 10 days prior to the time when the government guaranteed all of the debt of all other banks. If it had lived 10 days longer it would have survived along with all the other banks. Because of having failed, it became a familiar target for people talking about activities at the time.

Despite the fact that, like many mortgage originators in retrospect, it made loans that it would not have made had it known better, it was essentially both a participant and a victim of the financial crisis, [because] it was an active player in the mortgage business. It bore the brunt of the collapse of that business associated with some of its own activities, but largely from things that were happening in the national and international financial markets, which unfortunately it was unable to predict. From my own standpoint, the company ran out of time [because] large companies move slowly, politics are a big factor in getting things done at large companies, and there wasn't enough time to move the aircraft carrier and rebalance out of mortgages sufficiently to avoid a lot of the consequences of the crisis. But I will say, if you look at its own activities and compare it to the mortgage activities of JP Morgan or National City, or Wells Fargo or Bank of America, there's really no difference. It was no worse and no better than any of the other large [bank] players in the mortgage business.

Malena Lopez-Sotelo: Why do you think Washington Mutual wasn't allowed to live 10 days longer?

Todd Baker: Well, you can read what Sheila Bair and [Hank] Paulson and others have to say about it. You can read what Kerry Killinger has to say about it. He's written a book recently. I don't really want to get into that. It was a political decision made for reasons that in retrospect were a mistake. Paulson and Bernanke and others have repeatedly said they made a mistake. They shouldn't have allowed Washington Mutual to fail. They were reeling from the Lehman Brothers experience and, frankly, more focused on the money center banks. There's a lot of history there, but it's just not appropriate given that the people are still alive to tell tales. I have my own views, which are pretty strong on the thing. We made our bed, but we were not treated as were other people who were sleeping in similar beds. Let's put it that way.

Malena Lopez-Sotelo: … Over the last decade, we have seen a number of different narratives emerge to explain the financial crisis. How do you understand what caused that crisis?

Todd Baker: Well, there were many causes, some of which I've referred to here. The biggest was around leverage and the fundamental shift of the financing of much of the economy from banks to Wall Street, and in particular, the rise of mortgage securities as semi-equivalents to zero risk treasury securities in international finance - they became collateral for a variety of complicated vehicles. Wall Street got very creative in adding leverage through different types of securities, and what they created was a financial system that was overly dependent on the value of US mortgage-backed securities— a global financial system. When confidence in US real estate values and the value of those mortgage-backed securities, which were being used as collateral for a variety of other leveraged borrowings all over the world, [weakened], the system essentially collapsed and, government intervention was required. The so-called shadow banking system is another way to refer to that same issue--enormous pools of finance being created outside of the regulated financial system. That happened in smaller entities, like subprime mortgage originators, but it was, happening all over the world in terms of so-called special purpose vehicles, which were raising money often collateralized by US mortgage-backed securities and using them for [unrelated] financing purposes.

So, the underlying issue was that all this resulted in leverage--meaning the amount of credit being extended in the overall global economy --to rise substantially.

This coincided with some probably mistimed actions by the Federal Reserve, associated with the dot com crash, and the so-called "moral hazard" that interventions by the Fed created, in that the Fed appeared to be intervening to support stock values, bond values, et cetera. So there was a lot happening in the larger global economy.

And then the second thing was something for which the US can only blame itself-- a lack of regulatory attention to the impact that non-regulated lenders had on the rest of the financial system. So the non-regulated mortgage lenders in particular pushed the edges of prudence and accelerated the origination of credit that should never have been originated and abusive practices. What you particularly see is the impact, the most telling part about subprime is when you look at the impact that subprime lending had on minority communities. Because many minority communities had significant equity in their houses and subprime lending and the way in which it was promoted encouraged lots of people to borrow money on the equity in their houses, which they couldn't repay.

That resulted in a massive destruction of particularly black [home] equity value. In retrospect, if you look at, particularly the unregulated part of the lending sector, but specifically if you look at, what happened in the lending in minority communities, you'll see that there were many practices that were permitted during that period that should never have been. That's one of the reasons why I've contributed to the rest of my career, essentially to - after I left [WaMu], I had two other jobs running corporate strategy for large banks - but, since I've retired, my [academic] research is entirely focused on ways in which potentially technology can help the financial sector provide safer products for minority communities and low-income communities.

I'm very focused on the lessons I learned during that period about the impact of risk-based pricing, the impact of proper underwriting standards, but more generally the need to look at outcomes in financial products. So, I essentially look at what are the actual results of particular financial products and, how those results should be the focus of our regulation, right? Because in many cases-- subprime lending is a very good example of this - payday lending is another good example, the incentives of the participants from the financial services industry are not well aligned with customers. That is a fundamental problem that you see at the edges of consumer financial services, where you also have an enormous disparity in knowledge and expertise--and obviously money-- between the provider of financial services and the person who's using it.

The big lesson to me [comes from] the subprime piece. I think that the larger piece of the mortgage crisis is more attributable to stuff that happened in a variety of places around the world. And no one could be pointed to as the sole source. But the practices of subprime lenders, and that would include somebody like Long Beach Mortgage which in retrospect was clearly disconnected from the interests of its customers, [were inexcusable]. No amount of belief that people should have personal financial freedom should in my view allow products to be created which in their core have the expectation that a very significant number of the people taking out the products are going to have bad results.

Essentially you have to look at what those [customer] outcomes will be, and if the financial product is not providing positive outcomes for the people who use it, then it should be banned. We're still having - those are still the battle lines in terms of freedom of choice versus consumer protection that govern this space. What's interesting is that one would think that after the great financial crisis, there would have been an effective resolution of this larger question, and it's still up for grabs. I published a piece recently [proposing a system] of outcomes-based regulation that, if people had adopted before the financial crisis, perhaps the subprime piece of it wouldn't have happened. But, unfortunately, [in] a much reduced way, that problem still exists. So probably [subprime] mortgage lending is not so much of a problem today, but other types of lending to low-income working people, which take advantage of the problems created by the vast differences in wealth and income, are still around.

Malena Lopez-Sotelo: … Looking back on the crisis over a decade later, what do you see as its most important lessons for mortgage lenders?

Todd Baker: Mortgage lenders? Ability to repay is critical. Any lending that relies on collateral value is fundamentally unsound. I think as a general matter, mortgage lenders have learned that lesson. Mortgage lending is far more conservative than it was then. You could argue that [conservative lending standards] hurts some parts of the population, and that is probably true, but if the alternative is the type of activity that existed prior to the crisis, then we're all better off without it. But, yeah, mortgage lending is considerably more conservative and any risk model now, instead of assuming a 10% risk outcome for a home price depreciation has to take into account far more serious cases because now they exist in historical record. So some of the problem with the backward looking analytics approach has been solved by the fact that we had a really bad experience, which makes those models more conservative.

Malena Lopez-Sotelo: Thank you, Mr. Baker, that concludes our interview for today. Thank you so much for being here.

Todd Baker: It's my pleasure.

[END OF SESSION]