

AMERICAN PREDATORY LENDING AND THE GLOBAL FINANCIAL CRISIS

ORAL HISTORY PROJECT

Interview with

Joseph A. Smith

Bass Connections

Duke University

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PREFACE

The following Oral History is the result of a recorded interview with Joseph A. Smith conducted by Kate Karstens on December 19, 2019. 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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Interviewee: Joseph A. Smith
Interviewer: Kate Karstens

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Kate Karstens: I'm Kate Karstens an undergraduate student at UNC Chapel Hill and member of the Bass Connections team for American Predatory Lending and the Global Financial Crisis. It's Monday, December 9, 2019. I am at the Duke University School of Law for an oral history interview with Joseph A. Smith, a partner at Poyner Spruill and non-resident fellow at Duke University's Global Financial Markets Center. Joe, thank you for joining me today.

Joseph A. Smith: You're welcome. Happy to be here.

Kate Karstens: I'd like to start by establishing a little bit of your background. You attended Davidson College for undergraduate and received your JD from the University of Virginia, correct?

Joseph A. Smith: That is correct, yes.

Kate Karstens: When in your career did you first become involved with residential mortgages

Joseph A. Smith: Other than having a residential mortgage ... I was general counsel in my first bit of private practice here in North Carolina. I practiced law in New York and then came here – long and circuitous route, in the late '80s. I actually foreclosed on a bunch of people's houses, in the downturn in the late 1980s. So I suppose you could say it was then. In later times when I had been to conferences with people talking about the mortgage crisis. The devil made me do it. I would ask people, anybody else here ever been foreclosed on or actually foreclosed on anybody. And I was usually the only one.

I was then general counsel of a bank holding company in eastern North Carolina. And although we had some residential mortgage foreclosures, most of the foreclosures we were having were commercial, that is to say businesses, which had pledged real estate as a portion of the collateral for business loans. And so I had some experience there. And then when I returned to North Carolina after a brief stint in Washington practicing law, I became Commissioner of Banks. I was made Commissioner of Banks in 2002, and that was several years after the adoption of the anti-predatory lending law and the mortgage licensing law. And so almost immediately I became involved with residential mortgage lending because I became essentially the de facto regulator of non-bank mortgage lenders in North Carolina. And so that was really when I got deeply involved in mortgage lending.

Kate Karstens: Can you talk to me a little bit more about your first role where you said that you foreclosed on a lot of home mortgages?

Joseph A. Smith: Yes. When I came to North Carolina — Lord knows I probably get the dates wrong — it was 1988, '89. It was right in the aftermath of the S&L [Savings & Loan] Crisis. There was a downturn in the economy, and there was also a downturn in business generally. And so, as a business lawyer, you did what you had to do to stay in business, to keep practicing here and make money. And so there were a number of out-of-state lenders in particular who had made a mortgage loans to people in North Carolina and people couldn't pay. They had done it for a number of reasons. I mean we didn't always get into the details. I didn't, as someone who was just being asked to collect it, but it was a pretty pro forma format. I mean North Carolina had, wasn't rocket-docket exactly, but it was really pretty quick unless there were substantial defense. It was actually hard for people to raise defenses. And so it was a pretty, I hate to say pro forma, but it was close to that. It was a sad thing. It was awful. You don't forget having people watch you auction off their houses. It's not fun.

Kate Karstens: Moving forward to the next few decades, how would you characterize the key changes you saw in the North Carolina mortgage market from when you were first involved all the way up to 2008?

Joseph A. Smith: I think the difference would have been that, again, as a bank lawyer, I didn't, we didn't have much to do. I didn't have much to do with finance companies or non-bank lenders, mortgage brokers, people who weren't associated with banking. So most of the lending we did was to what you would call conforming loan borrowers. That is to say people with good credit who qualified under Fannie Mae [Federal National Mortgage Association] or Freddie Mac [Federal Home Loan Mortgage Corporation] — were conventional borrowers, had good credit, who put ahead a down payment. The bank I was with, I do not recall that we did a lot of FHA, Federal Housing Administration, lending which would have been lower credit scores except to the extent we did so-called affordable housing loans, which were done to comply with the Consumer Reinvestment Act of 1977.

The design there was to make sure we were reaching out to otherwise underserved communities, particularly communities of color. We did do some stretch lending, I guess I'd call it, during my time in banking, but that was a relatively small part of a relatively large business. When I came back, when I became the Commissioner of Banks, we had 15,000 mortgage originators who did not work in the banking industry, who were employed by private mortgage banks, meaning non-depositories. They were private firms or mortgage brokers who would close loans, make offer loans and close loans on behalf of lenders, but who often didn't have any skin in the game, who would have money advanced to them by a lender and would then close in the lender's name and get paid a fee, a commission. So, the big change was the extent of the non-bank mortgage market. It was much larger than I had thought and it was much less well-trained, much less fastidious.

Kate Karstens: So looking closer to 2008, do you believe that you, as well as the members within your organization and your colleagues at your agency, were seeing the

same changes or was there some disagreement between you and your colleagues?

Joseph A. Smith: There was no disagreement. What we pretty clearly saw — and we saw a number of ways — we saw based on complaints we were getting from consumers in the marketplace and we saw based on discussions we had with the Attorney General's office, who was very keen on consumer issues, and we saw or heard from consumer advocates, Self-Help being one, but only one, there are numerous others, that there were a number of predatory operations in the mortgage market. There were people who were taking advantage of borrowers who they talked into taking loans that the borrowers could not possibly pay, but who got paid a fee, gone onto the next loan and didn't care. And didn't face any consequences. There had been a lot of discussion about this in connection with the passage of the two laws I mentioned earlier, the Predatory Lending Law and the Mortgage Lending Act. So a lot of that discussion had happened before I became commissioner. There was pretty widespread agreement that there was some, and we didn't define it very carefully, amount of bad conduct going on out there that needed to be stopped. And by the way, I got complaints from members of the general assembly of both parties, I might add, about matters involving unfair loans.

Kate Karstens: I'm sure as you can tell from these questions, we're really interested in hearing about your role in state bank regulation. And so continuing on that thread where you are serving as Commissioner of Banks for the state of North Carolina from 2002 to 2012, can you describe a little bit more in depth an example of the type of a complaint that you would hear from a consumer and how you would hear that complaint?

Joseph A. Smith: Okay. You would get a complaint a number of ways. We had a complaints line. We actually had set up a department of people who dealt with complaints. People would call, people who were in desperate straits who could not afford to make their loan mortgage payments, and we felt they were had been threatened — in the sense of, threatened with the loss of the home — would go to any one of a number of places to get relief. So we would get calls from advocates in the area. We get calls from consumer counselors. We'd get calls from consumers themselves. We'd get calls from some people in the industry who were pointing out to us — and this was for good reasons and other reasons — that competitors of theirs were engaged in unfair or questionable conduct. And so we had a lot of sources and we had investigators who would go out and look into it. We had the power to investigate and to do examinations of loan operations, which we did if we got complaints. The outfit who got complained about went way up on the examination — we had limited resources so whoever got complained about got examined sooner than they might have otherwise. And we just did what we could with what we had to try to stop bad conduct, and frankly to put people out of business who we didn't think should be in the business.

Kate Karstens: So both including consumer complaints and anything else you may handle, can you describe some of the official responsibilities that you were in charge of?

Joseph A. Smith: Well, sure. The main one in terms of the mortgage market, if that's what we're talking about. Yes?

Kate Karstens: Yes.

Joseph A. Smith: [continued] ... Was to determine whether a person who had applied to be a mortgage originator should be licensed. And you couldn't do it in North Carolina. You could offer mortgages in North Carolina in those days, in one of two ways — this changed later — but one step at a time. You could either be employed by a bank or you could be employed by a mortgage broker or mortgage lender. If it was the latter, then you yourself had to be licensed as a loan originator and you had to be employed by a firm that was also licensed as a mortgage banker or a mortgage broker. And so the tool we had to address bad conduct in the marketplace was the threatened or actual withdrawal of licenses.

We'd take licenses away from people who were bad actors or the denial of licenses to people who were obviously unfit. And there were a lot of them to get in the business to begin with. That didn't stop some people from doing it anyway, but that was illegal. Then we turn it over to law enforcement and those people went to jail. It was a coordination. We worked with the NC Justice Department. We worked with the not-for-profits. We worked with the industry, frankly, to which the smarter among whom — I'll stand by that term — knew that their reputation depended on getting rid of the bad folk and bad meant bad and incompetent, and bad meant bad and crooked, and sometimes it meant incompetent and crooked.

Kate Karstens: So did you see controlling licenses, particularly mortgage lending licenses as the primary means for regulating the entire mortgage industry?

Joseph A. Smith: No, but that was what we had. That was the lever we had. There were issues about whether and how — as I'm sure you all know — the Fed [Federal Reserve System] in particular could have under HOEPA [Home Ownership and Equity Protection Act] have exercised broader jurisdiction in the mortgage market to have national standards, which they did not do. There was a lot of other activity, particularly before 9/11, there was a lot of activity at the federal level also about mortgage fraud. A lot of what we dealt with were unscrupulous lenders who had taken good faith borrowers who frankly needed a little more, a lot more financial training, and a lot more advice about how much they could handle, putting gullible people frankly, into loans they couldn't handle.

But around the country there was a lot more than that. There were fake loans, there were loans that have been to made up borrowers. There were terrible other examples of fraud to the point that the FBI's chief agent in charge of these matters had said it was like a pandemic or epidemic of mortgage fraud and it

had gotten to be the FBI's top enforcement priority too. So it wasn't like we were the only people in the world doing these things. I think our view was we can clean up in our neck of the woods with the resources we have. What we can do is clean up the marketplace by getting the bad actors out. We actually thought, I still think, that that was an industry-friendly thing, and by and large, the banking industry and much of the mortgage industry thought the same thing. Some people complained about the cost of it, but relative to the damage that came later, it was cheap.

Kate Karstens: So you've mentioned the FBI and the Fed as agencies that your office worked with. What other agencies, both state and federal did you work most closely with on issues related to the residential mortgage market?

Joseph A. Smith: It was mainly with the North Carolina Department of Justice, the North Carolina AG [Attorney General]. We did some work with the feds, that is to say, the FBI. We didn't do much if anything with the Federal Reserve, we didn't do much with banks. The issue with banks would be that there were some bad actors. Again, if you go back to the presumption that a mortgage originator essentially gets paid on commission as sort of commission-based or at least the big money, the bonuses and stuff, even working for a bank, it would depend on your volume. So there were people in the banking industry, employed by banks I should say, who did not-so-great things. And the problem with them is they go from one to another, in other words, they would, right when you're hot on their trail, they go, they go to another bank, go to another state, go to something else. And so in the early going, the problem we had was keeping track. There were people we knew needed not to be in the industry. So we tried to figure out how to get after them. There wasn't a lot you could do under banking law. Generally speaking, if you saw something that was criminal or near criminal, even bad to the point where you get a civil injunction or civil penalty or fines, generally speaking, that had to go to the Justice Department. Or, it was better to go to the local District Attorneys, there actually were some local DA's who did some work in this area.

Kate Karstens: How would you describe your relationship with the local AGs and the North Carolina Department of Justice?

Joseph A. Smith: I think we had a good relationship. In general, banking supervisors and AGs, it's sort of like the cattle persons and the sheep persons. The AGs don't think we're quite hairy-chested enough in the supervisory world if you, pardon my saying so, and some of us in supervision thought that the prosecutors are like a person with a hammer who thought everything was a nail. But the good news was it was constructive tension, not a bad one. And in the main we worked together a lot. There was a lot out there. There wasn't time to bicker much, but there was a lot of bad stuff.

Kate Karstens: So outside of the government, in your role as commissioner, what other stakeholders did you engage with most?

- Joseph A. Smith: Mainly with NGOs, non-governmental organizations, or not-for-profit advocates as they were generally called. Self-Help was the big one around here. I did a lot of back and forth with them — and I mean in a good sense. They would say we never quite did enough, which was fine. There was constructive criticism and coming from them all the time and a lot of referrals. That was it primarily. Somewhat to a certain extent — again, the members of the General Assembly get complained to like members of Congress — members of local or state legislatures get complained to constantly by constituents. And so we'd have a lot of coordination there. It was important to do this because it was good relations with the General Assembly was an important part of my job.
- Kate Karstens: And how did your office respond to those complaints that, for example, Self-Help would process?
- Joseph A. Smith: What we could do — and we would talk with them about it — if there was an urgent need to stop something — I mean, what we couldn't do was intervene in foreclosures or in mortgage lending, and in particular, in the operation of the mortgage market. What we could do was investigate immediately and maybe open up a file and begin to talk about taking somebody's license away. I mean, we had — talk about a hammer — what we had wasn't very nuanced. It was kind of binary. You were either in the business or not in the business. And so the threat of not being in the business helped sometimes. If something was really bad or they just didn't listen or they were fly by night or you just didn't trust them, them being the lenders, mortgage lenders or brokers, you got with [the Department of] Justice immediately and try to see if there was a civil action that can be started or even criminal and depending on the facts, right. I mean it depends on how bad it was, whether there was actual fraud and if there was fraud, whether there was criminal fraud, which is somewhat different. It depends.
- Kate Karstens: And as you and your office began addressing these complaints, at any point, did you and your colleagues believe that policy changes were in order?
- Joseph A. Smith: I think what we mainly believed — what we couldn't understand, and when I looking back on it, what I wish I would have done, what I couldn't believe was — I couldn't understand why people were buying some of the paper they were buying. I mean, I just — and it wasn't all banks. It was others ... Mainly, what we wanted them to do was stay out of our way. We were having a big fight with them over preemption, which is an entirely, it's another topic perhaps for another day or perhaps for never. But I mean the, the biggest problem we had was that some of the federal agencies in charge of federally regulated banking organizations were trying to preempt all the laws we had.
- Kate Karstens: So did you believe that policy changes needed to be had or did you believe that that just simply wasn't in your office's day-to-day issues to handle?
- Joseph A. Smith: ... Frankly, we were so busy doing what we were doing. We weren't thinking policy... We thought what needed to be done was what we were doing, which

was cleaning up the market, enforcing the market. I wish we'd had a little more cooperation from the people who were buying the paper, but as it turned out, apparently it was being bought by much of securities firms who would themselves just pass it along, pass along the good and the bad, mainly the bad.

Kate Karstens: So over the last decade we've seen a number of different narratives emerge to explain the financial crisis and particularly the role of residential mortgages within that narrative.

Joseph A. Smith: Right.

Kate Karstens: How do you understand the role of residential mortgages within the broader financial crisis?

Joseph A. Smith: ... The bad mortgage paper — and the derivatives — I thought there was going to be, to answer your question, I thought that something bad was going to happen as a result of what I was seeing. What I thought was going to happen was to be something like the S&L crisis, which would be a serious but not life-threatening downturn in the economy. A lot of red ink and a lot of institutions fail. Some failures, a few guys go to jail. And that's going to be it. What we didn't understand, what I didn't understand, was the role that derivative securities were making in the leverage that the magnification of the risk of the mortgage market in the secondary, in the capital markets by the use of derivative securities, so that the same bad loan could support 10 times the loss that you thought it would. So I think that was the piece I missed.

To get back to your prior question, by the way, now that I've thought about it, there was an argument particularly with regard to Georgia's attempt to amend its predatory lending law to allow liability for fraud to go along to someone who purchased a loan. In other words, if you buy it from a not-so-great mortgage broker or through one, or if you buy it from somebody else who bought from them and there's fraud, the liability still attaches to you. Right. In other words, you still are obligated. You're still — there's an issue there about your own conduct. And so you have to do due diligence, fundamentally. You have to know what you're buying. That never ... happened. It was in the Georgia law for a while and then it wasn't. It got taken out. The industry said no, the rating agencies, God bless them, said no. They couldn't rate securities where there was this risk that, you know, heaven forbid, you'd have to take responsibility for what you were financing. And so, in retrospect, I guess the question is whether, assignee liability, as it was called, whether the addition of that to the policy arsenal would've made a difference.

Kate Karstens: So looking back, do you believe that had you had other tools — and perhaps you can give any examples — had you had other tools besides regulating mortgage licenses, things would have been different, at least in the state of North Carolina?

- Joseph A. Smith: No. I actually don't. I mean, I think the basic infrastructure that we now know that was there — which was people buying the stuff no matter what passing along no matter what, taking a fee and going on about their business and pretending nothing had happened and the rating agencies rating bad stuff as good. No policy we could have in our hands could have made any difference to that at all. So no, I don't think so, actually. I think the best we could do was try to get the real jerks out of the market and that was helpful. But in retrospect, I mean, we didn't, we didn't win the war. I mean, we did what we could and I think it would have been worse if we hadn't done what we did. But no, I think the changes had to come from Washington and from New York and from London and from all kinds of places where people had to take responsibility for this stuff.
- Kate Karstens: To what extent do you see your personal experience as adding up to something important to our understanding of what happened in the run up to 2007, 2008?
- Joseph A. Smith: Oh, I think it's crucial, don't you?
- Kate Karstens: Of course. [Laughs.]
- Joseph A. Smith: [Laughs.] My experience I hope will tell you that from the ... what you could learn from what happened to me is that I saw — and I'm, no, I wasn't that much of a consumer advocate guy, I mean I was sort of an industry person, but you didn't have to be an advocate to see that there are bad thoughts, stuff going on. What was interesting to me is we, from the local level, would tell people in Washington and tell people in the financial markets, if allowed to — and I did. I actually went to an investor conference once, that was an experience, that something bad was going on. And then you get a pat on the head and they'd say, "Oh, well it's, you know, you're conflating them. You're taking your local experience, conflating it, you're making a mountain out of a molehill. You don't know what you're talking about. The data we have says otherwise." And so it was — the frustrating part was not to be listened to. And so I guess the lesson would be that policymakers and industry people all over need to talk to each other more and listen to each other more.
- Kate Karstens: And speaking of, you know, comradery, talking to people in similar positions, do you believe that you were the only state that was experiencing that?
- Joseph A. Smith: Oh no. No, no, no, no, no. And then during this period, the states formed a licensing system nationally with a common database that allowed us to track bad actors across state lines and across the like. And so we — it was at first — only, it was a state owned and operated activity. We've ultimately — and the national mortgage licensing system still exists. And, no, so the states worked together on this and it was made part of the federal infrastructure surrounding mortgage in the HERA Act, Housing and Economic Recovery Act of 2008. I should have studied up before I came here. It was adopted as an appropriate licensing mechanism. And so first with HUD [Housing and Urban Development] and now with the CFPB [Consumer Financial Protection Bureau], the states still

operate a licensing system. HERA, by the way, also included bank employees, not as licensees but as registrants under that, so that if you go to a bank and you see someone give you — somebody gives you a card, it undoubtedly will have an N M L S number on it. And that's because in order for that person to use the word “mortgage” in a sentence directed to you, they have to be registered. And that was a big state accomplishment. But I will tell you... — at an event at Harvard University, at the joint center, the then General Counsel of the Office of Control of the Currency sniffed and called this the pharmacy approach, the pharmacy licensure approach to financial regulation.

Kate Karstens: And can you explain that a little bit?

Joseph A. Smith: Well, yeah, it was put-down. It was sort of like, “Okay, well they've, they've got this system now. They think they have —” It was sort of — everything we did was — it wasn't even, we didn't even want an “attaboy,” we just wanted people to pay attention. Now, understand that there were things going on that needed to be worked on. Anyway, but I'm over that. It hurt at the time, but I'm over it.

Kate Karstens: And looking back on the crisis over a decade later, what do you see as the most important lessons for mortgage originators and state-level policy makers as well as state-level regulators like yourself?

Joseph A. Smith: I think you've got to be really careful about a product like this being sold by people on commission. I mean I do. I think actually it is — I think in the name of efficiency, generally the whole mortgage system, mortgage lending system has run out lawyers. By the way, in North Carolina it used to be you had to have a lawyer to close a mortgage. Now you — the FTC [Federal Trade Commission], by the way, ruled that that was an antitrust violation. ... You can have one, but you don't have to. And so the lawyers got run out. So you had situations, you have situations, particularly where if you have a national home builder who shall remain nameless who also has a captive finance arm, who's about to close a loan with somebody, I mean, everybody at the table has an interest in closing the loan, right? And getting it done no matter what. And they don't get paid until it does. And you have on the other hand, the borrower who's going to be left holding the loan — and well not the loan, but holding the bag — owing on it and paying for the rest of his or her or their — well, for the foreseeable future. And there's nobody there looking out for the, for the borrower.

There's nobody there to say, “No. Stop. Think.” There are no, there are no brakes. Efficiency has overcome everything else. And in fairness, I mean, most loans pay off. Most people pay their loans. The default rates, even in the worst times in the crisis weren't above 10% maybe, but that means 90%. And in some parts of the — in the conforming parts, it's way over that it's 98 or 99% pay. So there's the people — the advocates for efficiency are right to that extent — ... for people who understand what they're doing or at least have enough money to get through it all ... efficiency works better. It's lower costs, more convenient, quicker. For people who — of lower, of lesser economic means with less education, less understanding of financial — less financially literate, it can be a

problem. And it's one that stays with them, right? I mean, it's a foreclosure. It's not the end of the life, but it's on their record, then it affects every other bit of credit they have for a long time. So I just think we've, we've gone a little overboard in terms of efficiency. It would be nice to come back a little bit in terms of prudence and fairness.

[END OF SESSION]