AMERICAN PREDATORY LENDING AND THE GLOBAL FINANCIAL CRISIS

ORAL HISTORY PROJECT

Interview with

David Martin

Bass Connections

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PREFACE

The following Oral History is the result of a recorded interview with David Martin conducted by Maria Paz Rios on October 30, 2020. 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.

Transcriber: Darielle Engilman	Session: 1
Interviewee: David Martin	Location: Zoom
Interviewer: Maria Paz Rios	Date: October 30, 2020

Maria Paz Rios: I'm Maria Paz Rios, an undergraduate student and member of the Bass Connections, American Predatory Lending and the Global Financial Crisis team. It is October 30, 2020. I'm currently in Durham for an oral history interview with David Martin, formerly a managing director at UBS, who has joined me via Zoom. Thank you, Mr. Martin, for joining me today.

David Martin: You're welcome.

Maria Paz Rios: I'd like to start by establishing a bit about your background. I believe that you went to college at Carnegie Mellon, right?

David Martin: That's correct.

Maria Paz Rios: After university, when and how did you first get involved in finance and how did that involve the mortgage market?

David Martin: So when I graduated from Carnegie Mellon in 1987, I was a computer science and math graduate and wasn't sure what I wanted to do and looked at everything from consulting to Oracle and software development and finance. And I was offered a job at Salomon Brothers in early 1987 and decided that I would pursue a career in finance at that time. I started working for Salomon, I think it was August 1987, I went through a training program. And then in December 1987, we were supposed to get placed in a department and they came to me and they said, "We're going to put you in mortgages." And I said, "What is that? I understand equities, I understand this... I don't even know what a mortgage is." And so I actually started working in securitized mortgages in December 1987. So that makes me a long time in the industry. For most of my career that was in government sponsored entity backed mortgages, so stuff by Fannie Mae, Freddie Mac, and Ginnie Mae[1]. It started December 1987, and basically I worked in the finance industry all the way through 2015.

Maria Paz Rios: When did you begin to work with mortgage derivatives specifically? And what were the original products like?

David Martin: So when you say mortgage derivatives, are you talking about cash mortgage bonds, or are you talking about CDS [credit default swaps]? Define mortgage derivatives.

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[1] Refers to the government-sponsored enterprises Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac), and the government-owned enterprise The Federal National Mortgage Association (Ginnie Mae). Freddie Mac and Fannie Mae are publicly traded companies that purchase and securitize conventional loans, while Ginnie Mae is a government agency that provides guarantee for federally backed loans.

Maria Paz Rios: No, I'm thinking [more] of CDOs [collateralized debt obligations] and CMOs [collateralized mortgage obligations].

David Martin: So most of my time I actually spent in agency CMOs. So where we would take mortgages, again, guaranteed by Fannie Mae or Freddie Mac or Ginnie Mae, and then cut them up into various parts. Most simply you would take it and put it into two or three different parts, sell up kind of a bond— one bond to a bank, one bond to insurance company, etc. Off of that, there were certain derivatives that were made, as well, which would be like interest-only and principal-only bonds. I started working on them almost immediately in December 1987. In early 1988, I started actually structuring new transactions for Salomon Brothers, where they would be creating these CMOs. It was my job to structure that, and so way back then, I never really worked in CDOs. CDOs was part of the area of time you're talking about the financial crisis. I ran the global mortgage department at UBS and under me was kind of part of the CDO group, but I didn't come up through CDOs. I came up through agency CMOs.

Maria Paz Rios: I believe you joined UBS in the mortgage department in 1991. Is that right?

David Martin: Well, technically I joined PaineWebber in 1991 and then UBS bought PaineWebber. I think it was 2000, I forget the exact year. For purposes, I worked in the same building from 1991 through 2007 and yes, I joined PaineWebber/UBS in the mortgage department.

Maria Paz Rios: When you joined, how did you view the mortgage market and did your view of the market change over time in that decade?

David Martin: Sure. So, if we go back to the early ‘90s there were really just two kinds of mortgages: there were again, Fannie, Freddie, Ginnie, and then there were mortgages that banks tended to just hold and that was it. Most everything was prime. There wasn't a large subprime arena. Mortgage lending was almost what I would call sleepy. It wasn't an innovative business to speak of. It was, by the mid ‘90s, pretty mature. If you get past 2000, you started to get more of a credit component in the mortgage business. So instead of starting with mortgages that were guaranteed by a government sponsored entity, you had mortgages that were made that had no insurance on them, and then you would take those and put them into different credit buckets, so you'd create a AAA portion, a AA portion, an A portion, all the way down. That became much more active after late ‘90s to 2000. And then by the time you get to 2004, ‘05, ‘06, that's when you're taking mortgages, such as subprime mortgages, and then taking the lower rate of tranches off these securitizations and they're going into CDOs. So that's when things are really starting to become more complex and multilayered. Again, in early mid ‘90s, it was a much simpler business to be honest.

Maria Paz Rios: What do you think led to that innovation within the marketplace?

David Martin: Generally lower investment yields available for investors. You know, one of the big driving forces for investors taking more risk, especially as you start to get to 2002, '03, '04, '05, was the Federal Reserve kept lowering interest rates and it made it harder for investors in fixed income to just buy, for example, Treasury bonds, because the yields were too low. So they were seeking out, "Where do we get additional rates of return?" And so you've got investors coming to you saying, "We want things with higher yields." And then you're an investment bank and you say, "Okay, I got to figure out how to create this product for my investors." So you're going to go back and say to, for example, a mortgage originator, "I know you're making that really pristine mortgage with a 740 FICO[2], and the rate on that mortgage is 4%. If you drop that FICO 50 points and make the LTV [Loan to Value Ratio] a little higher, but give us an additional 0.5% of interest rate, we would buy that as well." So you can think about this kind of push pull, where there's demand for securities, from investors with higher yields, which then flows through to demand for higher yielding mortgages, which are going to be more risky than lower yielding mortgages.

Maria Paz Rios: As investors started getting into these more risky products that gave them a bit more yield, to what extent did they see, or did you and your colleagues in the secondary and tertiary markets, see the changes occurring within local mortgage origination and mortgage markets? So this could include underwriting standards, broker practices, and how the mortgages were making their way into the securitization pools.

David Martin: You got to split this up into kind of two parts. So the first thing, when you're looking at a, let's say a higher risk mortgage, there's actually the statistics that you see about the mortgage: the borrower's credit score, the loan to value ratio, the area of the mortgages, and the loan size, etc. And all of those individual components over time. I don't want to say that the mortgages became riskier. What happened was riskier borrowers were able to borrow where previously they couldn't. So for example, maybe in 1995, you had to put 20% down to get a house. By 2005, you only had to put 10 or 5 or even 0. So you could see the fact that the mortgages themselves were riskier. They came with a higher interest rate, but different pools of borrowers were able to borrow that couldn't have 10 or 15 years ago. I don't remember the exact time, but 2003, 2004, it was obvious that you had mortgages that were riskier than the things that were done 5 or 10 [previously].

What wasn't obvious was what was going on in the broker channel. So you could say, all right, the person bought a house for $200,000. They took out a $190,000 mortgage. What we didn't know is, now we know looking back, that appraisal could have been wildly inflated, right? Instead of the house being worth $200,000, maybe it was only worth $120,000 or $130,000. It was very hard sitting in New York City, in a mortgage department, to see what might be going on with a broker in Iowa with a borrower. All we saw were the statistics

[2] Refers to the credit score system created by the Fair Isaac Corporation (FICO) which lenders use to asses a borrower's credit risk, and which ranges from 300 to 850.

that were reported, and the difference between those statistics in reality. Looking back, it would've been probably, maybe late '07 by the time you recognize that there was this gap between what was being reported and what was actually on the ground.

Maria Paz Rios: What were some of the things that were being reported?

David Martin: Well, Loan to Value is, is a big one, right? Where you'd have a loan and the Loan to Value would be stated as 90 and later on when a new appraisal might be done, you recognize that the house was not worth anywhere near what the original appraisal said. So you thought you were lending on a Loan to Value ratio of 90, and you're actually lending on a loan to value ratio of 120. That's a simple example.

Maria Paz Rios: How would you interact with UBS research? Did they ever give you any sort of announcements on the risk and the increasing risk in the market?

David Martin: Well, they would write articles about what they saw in terms of overall risks in the mortgage market. Laurie Goodman[3], who you mentioned before, had a publication, I believe it was called *The Mortgage Strategist* and it came out weekly, and she was one of the most read research analysts in the industry. So we all read what she put out. She said relatively early on, that there are a lot of layered risks in these mortgages. You're taking lower credit scores, higher LTVs , etc. And therefore, these are riskier mortgages than they were before. So I think we were aware of it, but at the same time, a lot of the disconnect between the statistics that you thought you were buying and what was really going on, that wasn't as obvious then.

Maria Paz Rios: And how would you characterize the key changes in the fixed income marketplace during that time, especially within the high growth areas, such as mortgage-backed securities and structured credit?

David Martin: Which time are you talking about now?

Maria Paz Rios: In the run-up to the financial crisis, maybe 2004 to 2007?

David Martin: A lot of investors were very bullish on home prices. So for example, it wouldn't be common to say, "Well, it's a 90 LTV now, but in a year it'll be an 80 LTV or 75 LTV, so it's only going to look better. " It was pretty easy when a borrower got in trouble and couldn't make the loan payments, but there was such housing price appreciation going into 2007 that frequently a borrower who was delinquent would just sell the house and pay off the loan. So even when a borrower got in trouble, the housing market would be bailing them out. So people became numb to the risk where yes, they saw what the risk was, but they were conditioned, due to experience to say, well, yeah, losses could be this, but

[3] Laurie Goodman's interview, which details her time as the Head of Securitized Products and Global Fixed Income Research Group at UBS, can be found on the American Predatory Lending team's website here.

they're coming in much, much lower because again, housing prices kept moving up.

And in the end, you look back, as long as home prices kept moving up, everything was going to be fine because you could always sell your home to somebody else. And there was enough equity in it that, again, even if you have trouble paying off the mortgage, that wasn't going to become an issue. And so, as it's just very benign and these very risky mortgages are showing extremely low delinquencies and losses that gives investors even more comfort to invest more and more and more. So it's kind of feeding on itself because nothing's happening. You think about it like a hurricane, if you're worried about a hurricane 10 times, and it doesn't come after a while, you're like, "I'm not going to worry about leaving." I mean, the hurricane never comes and then the 11th time comes and the hurricane comes. So I would say, '04, '05, '06, was warning, and even Laurie Goodman would write, "This is bad, this is bad, this is bad." And investors would say, "Yeah, but the performance has been great. So I understand what she's saying, but that's not being matched by what I'm seeing in terms of actual performance of the loans."

Maria Paz Rios: Who were the people that were buying the products, like the mortgage-backed securities that UBS underwrote?

David Martin: Every investor class. Banks would buy generally AAA, floating rate products. Insurance companies that would be buying AA, A, BBB. You had CDOs that would buy. You had hedge funds that would buy. I mean, every investor type was buying. Overseas— it wasn't just domestic US, enormous overseas purchases. Japanese banks, as Japanese interest rates were extraordinarily low during this time period. A couple of very large Japanese institutions were amongst the largest CDO buyers in the world, which was just backed by other mortgages. So, I mean, it wasn't just one, and every client type were enormous buyers because it was the second largest fixed income market behind U.S Treasuries in the United States.

Maria Paz Rios: You mentioned that you knew there was an increased risk, but there was still a lot of investor appetite around the world. So did you all rely on rating agencies for their word, or what did you think about them and what they were saying?

David Martin: Well, at UBS, we were in what we called the moving, not the storage business. So for us, we would take a pool of loans, give it to the rating agency, the agency would come back and say, "You can have this amount of AAA, this amount of AA." They'd give you all the different types, maybe you have a billion-dollar pool, and they'd say, "Given everything, that's in this pool, we'll give you 800 million AAAs, 100 million AAs and go on down." That then gave you an idea based on where similar bonds were trading in the marketplace, what you could get for the whole pool of loans. So was UBS relying upon the rating agencies to tell us how risky an individual piece was? No. UBS was relying upon the rating agencies to tell us "Here's the rating we will give this so that your end investor can easily compare your bond to a bond that someone else has purchased." So

it could say, "I bought a AAA from Nomura on Countrywide collateral, and I got a yield of 4%. So from a AAA from UBS that's backed by Countrywide collateral, and it looks kind of the same. I'll probably pay 4%." So it's almost a way to standardize and give the end investor some way to compare your bond to other bonds. I believe rating agencies had the most important effect on end investors. Investment banks were just sitting in between. It was a way for end investors to feel more comfortable that this security mapped whatever risk parameters they were looking at.

Maria Paz Rios: Did you ever have any conversations with any of the rating agencies regarding the risks that you were seeing within UBS?

David Martin: Oh, I'm sure they did. I never had a conversation with rating agencies directly because at that time I was in a reasonably high management position, so that's just not a conversation I would have had, but yeah, the individual units that would buy mortgage loans and securitize them, they talked to the rating agencies because they wanted to have some idea, "If I buy this pool, what's the range of outcomes in terms of where the ratings would come in?"

Maria Paz Rios: At a higher level within your role, did figures within your organization express concerns about the changing nature of the derivative and securitized products marketplace during the 2000s? And did those concerns lead to any significant internal debates for changes in business practices?

David Martin: I don't remember anything until maybe 2005. You're probably talking 2005, '06. That's when there started to see some cracks here and there. There were more internal conversations about what may be going on, but UBS was barely a top 10 underwriter as well. We were, I don't know, 10, 11, 12, something like that—so I think we had 3% market share. So we were already a kind of relatively conservative. It wasn't like we were out there buying billions and billions and billions of loans every month. So our size was such that we felt like at least we could be nimble, in fact when we get into 2007, we just turned it off. We just stopped buying loans because at that point we thought there was just too much risk because home prices had started to drop. But I would say until probably about the fourth quarter of 2006, there was internal conversations, but they're the same internal conversations you would have about any product that had a large footprint. Again, the mortgage market was and is enormous. And so since we were involved in it, there were always people that had interest in talking about, "What are the problems?" A favorite Wall Street thing is, "We don't know when the bus is going to come around the corner and hit us, but a bus is going to hit us." And proper risk management is always going, "Well, what if this happens? What if that happens?" So there were definitely conversations like that, but I don't remember anything that was rising to the level of, "Oh, this is a serious concern," until you get late '06, early '07.

Maria Paz Rios: So once you started to de-risk, did UBS have a unified view of their subprime exposure across different lines of business?

David Martin: The answer would be no. There was, I think, a public document out that says that they had subprime exposure in a number of different places throughout the bank, and they didn't recognize the sum total of them. So, no.

Maria Paz Rios: Your resume mentioned that you frequently engaged with US regulators on issues regarding the securitized products area. What were the interactions like and were regulators expressing any concern?

David Martin: Most of my interactions were more on the agency mortgage side, talking about the mortgage industry as a whole and the things that would help Fannie and Freddie become more effective, etc. I didn't have very many conversations with regulators and certainly none that I could specifically recall about the higher risk, what we'll call non-agency parts of the market.

Maria Paz Rios: It also mentioned you were part of the investment board, so what were the main priorities that you had during the early 2000s?

David Martin: Before 2003, I ran a small group that was involved in agency mortgages and agency CMOs. I think it was in 2003, I became co-head of the whole global mortgage department. In 2004, I became the sole head. And then in early 2007, I was running the global rates division at UBS, which included mortgages. So the one way I think about it, is until '03, '04, I was a plumber and starting '03, '04, I became kind of an architect where I was looking at the whole house rather than just like, "How am I going to run the pipes through here?" So the job really did change. I went from a very hands-on trading, creating job to a management role. And as part of that management role, eventually, I was on the investment bank board, it sounds better than it actually was. It was about 125 people; we met three times a year and we just discussed. The investment bank had about 25,000 employees, so we were the most senior people discussing what the issues are going to be for the next three or four months, how we could position ourselves, what business lines we should be in, etc.

Maria Paz Rios: Once you moved into a management role, what were some of the priorities you had for your group?

David Martin: A lot of it's good old fashioned human resources. It's talent acquisition, making sure that the people that you wanted to keep you kept. On top of it, business lines, where did you think growth is going to be in the next five years, then you would want to invest your human and economic capital in those business lines that you thought would expand. In particular, in that time, we invested a lot of money in foreign businesses. We thought that there were a lot of non-US mortgage markets that were not as developed. So for example, I spent a lot of time in London because the European mortgage market became quite active over time. So there were ways to take the technology and the things that we'd learned in the US and move that elsewhere.

Within the US, there was definitely an investment into CDOs because, again, we had investors that wanted to buy the higher yielding CDOs, and then we had clients that wanted to issue CDOs. So we had both sides of that. So it became a natural thing, again, us being in the moving, not storage business, to be involved in the middle of that. When you're in a management role, again, you're looking at all your business lines, what looks good, what doesn't look good, and put the resources in the right place.

Maria Paz Rios: To what extent did you benchmark your team's performance to other institutions?

David Martin: On the stuff that you could, you did. So for example, issuance was easy because it was public. Financial performance was hard because it wasn't like I could call up Goldman Sachs and go, "Hey, how'd you guys do last quarter?" Everybody knows how Goldman Sachs overall did, but I don't know how Goldman Sachs' mortgage department did or Goldman Sachs agency CMO group did. So how do you compare? You don't have that visibility in terms of the date. You looked at things like market share; you talk to clients which is another good thing. I used to like was to talk to clients and go, "Do you like the service that you're receiving from our traders and our salesmen?" You would look at surveys from your clients about what your market share was with clients, that was important as well to see how you're doing. It's also how you're trying to identify opportunities, right? So in a sense, you may be, as I go back with 3% of the market in something you say, "Well, we can do better than 3% of the market." There was another business, we were 20% of the market. Well, we're not going to do much, we're not doing much better than 20, so why am I putting additional resources towards that?

Maria Paz Rios: How did you react when housing prices started to go down?

David Martin: Well, here's the funny thing. So when housing prices started to go down, of course, you don't know they're going down, because the first month they drop, it's not like it's obvious, right? In retrospect, the fourth quarter of 2006 is when home prices peaked and started to come down. But you started to see the effects of that in the first and second quarter of '07. Because, as I said before, all of a sudden now people that became delinquent on their mortgage, they couldn't sell their house. So before, they sold, and actually looked like a prepayment, now they just went delinquent, and it became 30, 60, 90 days delinquent. And then you had to go through the loss mitigation and a foreclosure, etc. So in retrospect, again, home prices peaked. I remember a guy I worked with said he thought they peaked September 2006, but I don't think we really saw it until the first or second quarter of '07. And by that point, it was late in the game. I mean, it was kind of the whole market at the same time, woke up and said, "Oh, we've made some mistaken assumptions about home prices." And as time went on, you started to see some of the problems I talked about before about, "Oh, I thought that house had a $200,000 appraisal that was inflated because this, that, and the other thing." A lot of the problems started to come out as 2007 moved along.

Maria Paz Rios: Over the last decade, we have seen a number of different narratives emerge to explain the financial crisis. How do you understand what caused the crisis?

David Martin: Yeah, it's a funny question. My cousin, once we were on the beach and she turned to me and she said, "I kind of knew where we were on Monday. What happened on Tuesday?" It's kind of saying the same thing as, "How did this happen?" It's interesting when you read about the Federal Reserve, because one of the things they'll say is when they lower interest rates, they worry about creating what they call "asset bubbles." It's one of the things that economists will talk a lot about. We don't want to artificially inflate the value of an asset because interest rates are low, because that means when interest rates go up, you can prick the bubble, right? So I view what happened as a combination of very low rates, and then the Fed said they were going to keep them low for an extended period of time at that time, forcing investors into higher and higher risk items. The intermediaries like UBS were responding to investors wanting to buy higher yield, and mortgage originators, at the same time, trying to create more product, right? Because one thing about a mortgage origination platform, they got to create product.

So they were always looking to push the envelope, the investors are looking to push the envelope, the investment banks are in between moving the product between one and the other. And again, because home prices kept going up through that time, it encouraged all of us to continually push the envelope, create higher and higher yield, create more and more leveraged mortgage products, and then when home prices stopped going up and started going down, the music stopped. I think the narrative that has come out is there are a lot of greedy people at various parts of the chain that knew what was going on was wrong, and knew that there was fraud, and certainly Bernie Sanders would say, "No one went to jail," which is not true, one Countrywide woman went to jail. The reality is a little bit more complex.

It was an asset bubble. US housing was the asset bubble, right? And when rates were low, it spurned all this activity on financial products, which ended up inflating housing, because you could just continually create more and more mortgages. So people were more and more comfortable buying houses. So I would say the Fed bears some risk, investors bear some risk, investment banks certainly bear risk, mortgage originators bear risk. And I hate to say it, but the one narrative that always gets left out is the U.S homeowner, because in a lot of cases, they knew they were buying a house with no money down. And a lot of them lied as well. They lied about their income; they lied about other sources of funding. I mean, there's a lot of blame that could go around through the whole system. I would love to tell you that I don't think it can happen again, but it absolutely could happen again.

It won't happen again in mortgages per se, but it'll happen in something else because at its core, it was an asset bubble, and then once you have an asset bubble, there was lending on it and then it just kept going. And honestly, at the beginning it was a victimless crime if you think about it. So I always remember, I

went to Vegas with my wife, I think it was 2005, and we're in a casino and we're having dinner, and the waiter comes over and there's nobody in this restaurant. And we started talking to him when I said, "Oh, I see you're a waiter." He goes, "Really, I'm a house flipper." I said, "Oh, are you?" And he goes, "Yeah, right now I own four houses. I just keep buying them and selling them and buying them and selling them." That was it. Everybody became a home investor, right. "And I'm going to buy this $200,000 and I can take a loan out and I'm going to sell it at 240 in three months I'm going to make $40,000. I'll put no money down, and it's a great business." So there were an awful lot of people surfing an asset bubble wave, and when it burst, it hurt.

Maria Paz Rios: To what extent do you see your personal experience as having something important to our understanding of what happened in the run up to 2007 and 2008?

David Martin: I don't think I have any unique perspective on the whole thing. I think everything I said is pretty well-known and pretty well out there. I'd love to tell you that I had something brilliant to add, but it's pretty much the common narrative, common wisdom.

Maria Paz Rios: Looking back on the crisis over a decade later, what do you see as its most important lessons for Wall Street?

David Martin: It's really hard to be early and right. So we'll use Laurie Goodman again. She was right for a long period of time on the facts, but market prices didn't move the way she thought they would move. And therefore, investors who have very short time horizons kept saying, "Yeah, I know she'll eventually be right, but I'm going to keep surfing this wave and I'll get out before it crashes on me." I think it's really to be a patient investor. It's very hard to be a patient company today. Everyone's measured on quarterly earnings. Everyone's measured on short term performance, but the reality is a lot of these big trends take years to play out and they don't become fully evident until something precipitates a crisis. And I think that's the biggest thing that we all should learn is, if your time horizon is too short, it doesn't matter if you're investing in stocks, bonds, real estate, whatever it is, you're going to make bad decisions because you're going to ignore fundamentals and you're just going to basically go, "If home prices are going to go up for the next three months, I just want to own it, even though they're too expensive, but I'm going to be in, I'm going to be out." So I think the lesson really is don't get caught up in a mania. Don't try to surf an asset wave because it can end badly.

By the way, it's happening right now in an odd way. I don't know if you've followed, but everybody gets home because of COVID, and if you look at something like Robinhood, which is a retail investors paradise, they have a huge number of accounts they've opened up. You have people day trading stocks now because they're home. Well, that's kind of scary. Last year you were doing something. You're a student, now you're in a dorm room. You got a little extra money and you're day trading stocks on Robinhood. That's not really

fundamental investing. So I think that the lesson for me is again, be patient and recognize if there's an asset bubble. Don't assume that you're going to be smart enough or good enough to get in and get out before the whole thing crashes.

Maria Paz Rios: Thank you, Mr. Martin, for joining me today.

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