AMERICAN PREDATORY LENDING AND THE GLOBAL FINANCIAL CRISIS

ORAL HISTORY PROJECT

Interview with

Michael Fratantoni

PREFACE

The following Oral History is the result of a recorded interview with Michael Fratantoni, conducted by Andrew O'Shaughnessy on June 26, 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: Cassidy Bolt
Interviewee: Michael Fratantoni
Interviewer: Andrew O'Shaughnessy

Session: 1
Location: Virtual
Date: June 26, 2020

Andrew O'Shaughnessy: My name is Andrew O'Shaughnessy. I'm a JD candidate at the Duke University School of Law. I'm also a research assistant for the Global Financial Markets Center's, American Predatory Lending project. It is Friday, June 26, 2020. I am speaking remotely with Michael Fratantoni, PhD to conduct an oral history interview. Mr. Fratantoni, thank you for joining me today.

Michael Fratantoni: Thanks for having me.

Andrew O'Shaughnessy: I'd like to start by establishing a little bit about your background. I understand you received your BA from William and Mary, and then you got a PhD in economics from John Hopkins. What led you into a doctoral program?

Michael Fratantoni: I originally intended to enter academia and certainly enjoyed learning about economics as an undergraduate. Obviously, the graduate course of study is an entirely different animal, and through the course of my studies [I] sort of found my way into specializations and macroeconomics and did a dissertation that really touched on some housing market issues. That sort of led my way into the industry. As many careers are, it was by no means planned, but some choices I made early on, even in grad school, sort of opened this door to have a career in the mortgage financial sector. I've continued to maintain my contact with the academic world, doing some publication and doing some adjunct teaching and it's wound up being a nice balance.

Andrew O'Shaughnessy: What was your dissertation about?

Michael Fratantoni: It was looking at what had long been a puzzle in macroeconomics, which is given that stock returns are considerably higher than returns on safer assets like money market accounts, or bank deposits, you would expect that people would put a higher share of their wealth into the stock market because over long periods of time, those returns have been persistently higher. There've been a number of proposed explanations to try to explain this. [It] is what's called this equity premium puzzle. And I suggested that, maybe it's because for many people a large chunk of their income is really committed to a housing expenditure, whether in the form of mortgage or rent. So while it may seem like they have a lot of resources they could allocate into wealth building activities, on the margin where they can make a choice, it's pretty thin in terms of how much they have to allocate. So I built a theoretical model, built a simulation model, and then showed empirically it's true that people that have a larger proportion of their income committed to a housing expenditure are more conservative with what they have left. So it's a very sort of sensible, intuitive – made for a nice, dense dissertation. But then, like I said, [it] sort of opened the door because it forced me to learn a bit about the mortgage industry and the housing market, and that was helpful.

Andrew O'Shaughnessy: So how did you step through that door from Johns Hopkins to Fannie Mae?

Michael Fratantoni: For folks in the academic world, you're probably familiar… you have an annual conference – this is the American Economic Association Conference – and that's where all the hiring gets done. It was in the mid-nineties, and I went to a conference in San Francisco with all intentions of finding an academic job. I did a lot of interviewing…. This was back in the days when late breaking job announcements would literally be put on a physical bulletin board with a thumbtack. And this one said, "Fannie Mae's hiring economists with backgrounds of such and such. If you're interested, slide your resume under door number 5532." And that's pretty much how I started my career in mortgage finance, sliding my resume under a hotel room door.

Andrew O'Shaughnessy: So what were your initial responsibilities at Fannie Mae?

Michael Fratantoni: It's a group that really has a very analytical role, doing the calculations to determine what the guarantee fees should be, that Fannie Mae charges. To get there, you need to have a view on what characteristics of a mortgage are likely to make it more likely to default.

Andrew O'Shaughnessy: Can I interrupt just for a second, Michael? Could you explain what a guarantee fee is?

Michael Fratantoni: Sure. Fannie Mae and Freddie Mac are two Government-Sponsored Enterprises [GSEs]. One of their primary business lines is to provide a guarantee to investors that they're going to get timely payment of principal and interest on mortgage backed securities. In exchange for providing that guarantee, Fannie and Freddie charge a guarantee fee to lenders, which is expressed as a percentage of the payment. Back in the day, it was about 20 basis points, so two tenths of a percentage point of the payment. Today, it's more like 50 basis points, guarantee fees are higher…. It's essentially an insurance function. So in that insurance role, Fannie Mae would have to gauge what's the likelihood the borrower's not going to pay [and the] loan goes into default. You have to go through disposition. What are your losses going to be if that happens?

And what types of loan characteristics make that more or less likely? The other thing that you're thinking about is what makes that loan more likely to refinance. Those things tend to be in opposite directions. Borrowers with the strongest credit and the most equity in their house are most likely to refinance most quickly if rates drop. And the alternative is true. Borrowers with weaker credit, with less equity, are less likely to refinance. And then if you look at the default, it's the reverse. Borrowers with a lower down payment [and] weaker credit score [are] much more likely to default if you get an economic downturn. Borrowers with a larger down payment [and] stronger credit are less likely to fall. So these were good lessons to learn and to learn in some fine detail as I entered the industry. [I] also did some modeling around how home prices behave over time.

And the data I was looking at, at that point, really was more regional. So we had seen a decline in home prices in California in the late eighties and early nineties. We had seen a decline in home prices as part of a credit crunch in New England in the mid to early 1990s. We had seen a very sharp decline in home prices in the oil patch in the Southwest during the mid-1980s. So those were the experiences we'd had with home price declines: very regional, very sharp. But we hadn't seen a national home price decline in any data that you had. There were indications that it obviously had happened in the Great Depression back in the 1930s. We were building models of how mortgages were likely to perform…. The most stressful thing you could point to was, "Okay, let's look at that California '91 experience again. And how did high loan-to-value loans perform during that stressful experience?"

Andrew O'Shaughnessy: How would you say that the housing market evolved over your time at Fannie Mae?

Michael Fratantoni: It was a really exciting time to be in the industry because—I mentioned my job market experience of literally the thumbtack on the bulletin board—but the world was changing quickly. When I got to Fannie Mae in 1996, [it was] just the beginnings of automated underwriting systems. So moving from a world where a human underwriter spent days to weeks reviewing a stack of paper and doing good work, but [there were] troubles and concerns about consistency and troubles and concerns about efficiency. And so moving to an automated underwriting system where that full set of information was put into a machine initially, and then over time put out on to… web platforms for lenders to utilize, you could have an underwriting decision in minutes once you enter the information, as opposed to weeks.

Certainly I think whether you were on the Fannie Mae sort of investor side or the lender side, or frankly on the policy side, getting a much more consistent decision framework out of a machine that you could test on the backend was a real improvement. But it really was this push toward, how can we go faster? We used to collect 12 inches of paper, do we really need all that information? So some of the work that the group I was in was trying to say, "Okay, but we know loan-to-value is really important. We know credit history is really important, but what else? What are the factors that are really the most important drivers?" Let's put that into these automated underwriting engine[s] and let's pare away some of the other stuff that might be extraneous, might not necessarily be driving the credit performance of these loans. And so again, it was a really interesting time, moving both on the technology and the analytics.

What has kept me in this industry for 25 years now – it's an incredibly dynamic space. So the leading lender one year might not even make the top 10 the next year. And if it's predominantly all about refinances one year, those may completely evaporate the next…. There may be a new approach to either marketing or gathering information or our new technology that everybody thinks is going to be sort of the big new thing. And… it works or it doesn't, but it is just constantly changing, which makes it a fun place to work.

Andrew O'Shaughnessy: How did those changes in process and the increasing consistency affect the market itself?

Michael Fratantoni: If you look at the numbers from the Home Mortgage Disclosure Act, the US has always been unique – whether in banking or other financial services – [in] that it is a very diverse market in terms of the large, large number of lenders that are playing a role. So, you had [around] 12,000 lenders that were active in [the] late nineties, early two thousands. We're down to about 5,000 now, which is still a lot. If you look at other countries, if you look at Canada, they have six banks that do almost all the financial activity. The US I think it's been a strength that you have this very large number, most of them locally-oriented institutions, that focus specifically on the loan products, the relationships that are important to do business in their community. That sort of aspect of the US market is why we have things like Fannie Mae and Freddie Mac because of wanting to have sort of that flexibility and capability to operate locally and have small institutions that can have these strong relationships.

But then when it comes to capital markets activities, building [and] pooling mortgage-backed securities, selling them globally, you need large institutions. So if the US was like Canada, and we had six mortgage lenders, there's no need for a Fannie Mae and Freddie Mac. When you have 5,000 or 12,000, there is. That said, if you move from a world where a lot of the power of a lender is in their local knowledge and local expertise and local connections, as wrapped up in that human loan officer and human underwriter, and then you move to a world where a lot of that knowledge is embedded in a machine or a technology process, larger players get advantages. And you see in the industry much more scale, whereas in the nineties and 2000s, the largest lenders in the country might have a percentage point or two of total volume.

Now you're in a place where you have several lenders that have more than 10% of the total volume. So a lot of consolidation. And you see this across industries – this is not unique to mortgage[s] – where, as you add more and more technology, returns to scale generally improve, both on originating mortgages and servicing mortgages. That's the world we live in. But I think, again, it has advantaged larger institutions to the disadvantage of smaller [institutions], for the most part.

Andrew O’Shaughnessy: So how did your responsibilities evolve during your tenure at Fannie Mae?

Michael Fratantoni: I spent much of my first five years in that analytical role with both my graduate studies and just sort of interests. I had spent a year in grad school as an intern at the Joint Economic Committee [of the U.S. Congress]. I'd had some other government roles. I've always had an interest in policy.

So I shifted over into a role in Fannie Mae's regulatory policy group, and the primary topic there that I focused on was looking at capital regulation. And there was a lot of conversation at that point about the capital regulation of Fannie Mae and Freddie Mac compared to the banks. The banking system was going through implementation of Basel II. So there was a lot of action in sort of big picture thinking about how you regulate financial institutions, compared and contrasted with the GSEs. Lots of real interesting topics. I got to learn more about not just the credit guarantee business at Fannie Mae, but the other businesses, including the portfolio business and multifamily business. And so it was broadening my perspective from just a singular focus on single-family pricing.

Andrew O'Shaughnessy: So when, over the course of your experiences, you got that wider view of Fannie Mae's businesses, were you able to synthesize a point of view about the internal culture at Fannie Mae? Could you characterize that?

Michael Fratantoni: Fannie Mae, like many companies, is very much tied to the worldview of the leadership. And so the CEOs, when I was there, were Jim Johnson, who was really sort of a consummate Washington insider. Several times he was on the Vice Presidential Search Committee for the Democratic party, so he was a very connected fellow. He always had this sense of making sure that Fannie Mae was very politically well-positioned. That was very much front of mind for him. The second CEO that I worked for was Frank Raines. He also had some very strong political sensibilities, but he really wanted Fannie Mae to play a larger role in the market. And so he'd had very ambitious growth goals for the company and also had very ambitious goals regarding Fannie Mae's role in the market.

Andrew O'Shaughnessy: And so when was the Frank Raines tenure, just to contextualize this?

Michael Fratantoni: He had been there in the 1990s, left and was OMB director, came back in '98 or '99, and then left in 2005. So some of the history at that point was very complicated accounting rules with respect to derivatives. FAS 133 was one that was really most implicated. First Freddie Mac and then Fannie Mae found themselves on the wrong side of the line with respect to accounting. That was the cause of his leaving. It also led to a fair amount of tumult. That's actually when I left as well, it was a very sharp change and just time for a new job for me.

Andrew O'Shaughnessy: To double back to your analytical role, did your models ever factor in the potential for a nationwide housing price slump? I know you mentioned you had never seen that in the data before.

Michael Fratantoni: Certainly we talked about it, particularly with respect to some of the capital regulation. Because the capital rules under which the GSEs were operating assumed about a 13% decline in national home prices. Our conversation was like, "Well, that's really extreme. That that has never happened in the data we have.

What would be the driver of a decline like that?" Because when you look at regional home price declines, one reason they're so sharp is that if you have an oil patch recession, like you did in the 80s, a lot of those people leave. They go up to work in Michigan or they go out to California. It's not just decline in demand because people are out of jobs, it's a decline in people. And so that's why a regional recession can be so sharp. And it's hard to imagine what would cause that to happen nationally. Again, it's one of those interesting – certainly a critique of any analytics, right? You can only be as good as the data you have and then your imagination. Can you imagine almost 25% national home price declines – that is, twice as big as what I was talking about – that are really the result of overbuilding, weak credit, inconsistent policies and all kinds of factors leading to what was really a horrific home price decline?

Andrew O'Shaughnessy: What led you from Fannie Mae to the Mortgage Bankers Association?

Michael Fratantoni: I had a colleague, who we shared time at Fannie Mae, and he went to MBA [Mortgage Bankers Association]. Given some of the tumult, I was talking to him, he had a position open, and it was a very interesting opportunity to come in [and], on the one hand, sort of do what, as an undergraduate, what you think economists do, which is talk about GDP and talk about what the Fed does. Most economists who work as economists don't do that. Most economists are working in some very narrow area focused on an analytical job. So I found I enjoyed that. It had links to the teaching that I had done, having 18-year-old students. I had 50-year old CEOs and they were very engaged and interested in what I had to say.

It also had a very strong data component. MBA produces a lot of data, so that was interesting. But once I was there, [I] got involved in what was an absolutely fascinating exercise, and this is something that trade associations can do really well. So the chair of the MBA at the time, Regina Lowery, and this was in 2006, decided that the industry, because of these technology initiatives that I mentioned, because of the consolidation that we were seeing, she thought that MBA needed to have a view about where the industry was headed over the next five years. And so she wanted to get together a group of about 20 CEOs from the industry, some of the thinkers. To just try to not necessarily predict, but do a little bit of a white board exercise. What might the world look like if these trends we are seeing continue?

And I had the absolute pleasure of staffing that group. So that meant once a month, over six or eight months, it was getting this group of people together, planning for some external speakers to come in and give them some context on: What are the demographic changes we're anticipating? What are some of the governmental and sort of fiscal pressures that were built at that time? What are the technologies that we're likely to see over the next five years? And then what [is] the state of the industry? What are we likely to see in terms of further trends? Again, this was 2006. So one of the most interesting findings – and we essentially published a book out of that experience – was in 2006 this group of 20 CEOs from the industry said a major shock is coming.

These trends we were on with respect to where mortgage credit is, and some of the inflated home price values we're seeing in multiple markets – there's going to be a major shock, and this is going to be a shakeout, and the weaker players in the industry are just going to get wiped out. That was a pretty bold prediction in 2006. And I think I told Joe [Smith] and Lee [Reiners] that the one that will always stick with me was in May of 2006, [when we] got the group together in New York and invited as our external speaker for that day – he wasn't part of the group, but he came just for that day – Angelo Mozilo, who was CEO of Countrywide. He had formerly been a chairman of MBA. He was a revered and esteemed figure in the industry because he had built – I don't know if you know his story, but he had started his company in Brooklyn with one office and called it Countrywide, which just speaks to the ambitions of the man. He came in and just talked about what he thought was likely to change for the industry and we got a real good back and forth with that group. And he talked about the consolidation that I mentioned and talked about the importance of increasing sophistication and scale to be successful in the business. At that point, Countrywide and Wells Fargo were the two leading lenders in the industry, and they were battling head-to-head every day. I mentioned this to Joe and Lee that the thing that really stuck with me is one of the CEOs on our group was a CEO of a subprime lender and he asked Angelo, "So what do you think is going to be the future trajectory of the subprime market?" And Angelo said, "I think all subprime-only lenders are going to be out of business within the next 12 months." And that was in May of 2006. That was a remarkable prediction. It wound up being exactly right. He also went out of business 14 months after that. It was quite an experience to live through that.

Andrew O’Shaughnessy: One thing I'm curious about [regarding] the report is [that] you mentioned that there were 20 CEOs involved. What was the makeup of the institutions that they represented and how did that contrast with the institutional membership of the MBA writ large…?

Michael Fratantoni: It was meant to be representative, very deliberately selected. So you had small banks, large banks, you had independent mortgage bankers. You had one-third on the residential side and one-third on the commercial multifamily side. So very much selected to be representative of the MBA membership in the industry at large. You had some folks that were more on the investor side of the business. You have folks that were retail-only, some that had broker or correspondent relationships, so all kinds of different business models represented. The only sort of requirement was, as in every industry, you have some folks that are very much just thinking about the next day and you have some that are more strategic. And so we wanted the more strategic folks to be part of this discussion.

Andrew O’Shaughnessy: So how was the report received when you concluded it?

Michael Fratantoni: We shared it with MBA leadership, and I think people took it as a warning that this shock was coming. Well, that's a good heads up. We shared it with several regulators around DC and on the Hill. We did not do a broad public release. And if you have regrets in life, that would be one, right? Because you wonder whether that could have helped change some of it. I think it just speaks to often what happens for heads of businesses. They would nod their head and said, “Yeah, I know. Bob down the street, that is not a well-run organization. He's in bad shape when that shock comes.” It’s much easier to see the flaws in another organization than to see the exposures and potential weaknesses in your own.

Andrew O’Shaughnessy: So what do you think was the basis of the decision not to circulate the report more widely?

Michael Fratantoni: I think because initially the objective of the project was to make sure that the trade association had sort of the capabilities and the mindset for where the industry was likely to go. A lot of the thought was if there was going to be more consolidation, so you have to think about who were larger members. Particularly, I think with that warning, we didn’t come out with a cure. And so there’s a lot of business mindset of “Don’t bring a problem unless you also have a solution.” I think retrospectively [I] probably would have argued that it would have been a public service to talk more about what some of these findings were.

Andrew O'Shaughnessy: I was looking over the report and there was one reference to "fraud against the industry." During your research, how did you find industry leaders were thinking about fraud in origination?

Michael Fratantoni: Fraud is always a problem in this industry. You talk about a distinction between fraud for housing versus fraud for profit. Both are problems, but as someone misrepresenting their income or their employment stability, or they received down payment funds that they say is a gift when it's actually a second loan of some sort, those kinds of things happen all the time. So that raises the risk of individual loans. I think that's dealt with within the credit policy and underwriting framework to try to minimize that. Fraud for profit, if you have a ring where you have a realtor and a mortgage broker and perhaps a settlement agent working together to steal the funds from closing, that can kill a company quickly. 20 years ago that was a concern and [there were] increasing incidents of that.

Georgia was really a hotspot, Florida's always been a challenge. That's not really credit, that's law enforcement. You have folks that are ex-FBI that are leading fraud investigations at every major lender in the country. Just to sort of snap forward to today, that's even a bigger worry given cybersecurity risks and given that you have nation-states breaking down the walls virtually to intercept wires and using phishing attacks to have last minute changes to wire instructions. It's got people on edge. Whereas before it had the ability to bankrupt a company, now I can do so extremely quickly. And everybody's just on guard.

Andrew O'Shaughnessy: So you mentioned that the report captured a few prescient predictions. The report's pretty exhaustive. You covered a lot of ground. What were some areas where you thought the reports predictions didn't hold up as well?

Michael Fratantoni: 2006 was a time when the private label securitization market was the majority of securitized originations, and Fannie Mae and Freddie Mac were playing the smallest role they'd played in a number of years. And from an industry standpoint, there was this sense that people had sort of figured out that they could do and perform a lot of the functions that Fannie and Freddie had been performing. So there was a sense that over time, Fannie and Freddie's footprint in the market would get smaller and smaller. That if you had a crisis, their share would increase because that's their natural countercyclical role but then over time it would grow smaller. That's definitely been wrong. Their share did jump during the crisis with the support that they had.

But looking back on it, 12, 13 years later, there's no indication that their footprint in the market is going to shrink.

And I think people have come around to the view that, particularly given the experience of the crisis, there just is a level of catastrophic risk out there that really only the government can take on and the GSEs acting as agents of the government. It's a sensible way to deal with that risk. And we've now seen the private label market fail multiple times when you get a sufficient stress. It's always going to have a role, but I think most industry folks believe it's going to be a small role. Whereas in that 2006 paper, we thought it would be persistently a larger role.

Now with respect to the consolidation that report was forecasting, I think that's held up well. Like I said, the more and more technology that's being applied, the table stakes to be in this game have continually risen. And there is some ability to outsource to technology providers some of that capital expenditure and research and development expenditure, but when you do that you've lost some control of your own course. I think that has held up well.

The other finding or discussion point was the role of banks versus non-bank lenders. To your point of the makeup of the group, that was such an interesting discussion. Because I think the folks from the banks always had the view that they have some natural advantages in this marketplace. They have a lower cost of funds. They have access to liquidity. They have the ability to offer multiple products to a borrower. And particularly for some of the larger banks, they have so much information about their customers that they will be able to really craft individualized solutions and marketing approaches that you think would just be the dominant.

On the other hand, there is just something about bank culture, which is not really comfortable with the mortgage industry. I actually had this conversation with someone from the UK in the post-crisis environment where they were saying, "I just don't understand why banks aren't dominant in the US mortgage market." And my colleague at the time said what a bank wants is a business head to come and say, "Okay, we're going to grow 4% this year, and we're going to grow 5% next year. And then if things go really well, we'll grow 6%." And the mortgage guy comes in and says, "Well, we're going to grow 150% this year," and then comes in later and says, "We're going to drop 75%. And by the way, the mortgage loan officer who is accountable for much of that growth is going to get paid more than you, Mr.

Bank CEO, because of the amount of business he brought in." And it just runs counter to the whole bank culture. So I think we're still sort of seeing that tension between some of the promise and potential that a lot of particularly large banks have in terms of what they could do, but then execution is really challenging. And so what we've seen over decades is banks moving in and out of the mortgage market, depending upon the regulatory environment, depending upon the economic environment. This has been a time period where they've generally been moving back, certainly from government lending but even in conventional conforming, many of the banks have focused to a much greater extent on jumbo lending to wealthy borrowers.

Andrew O'Shaughnessy: Can you explain a little bit more [about] why mortgage lending is so volatile relative to other products banks offer?

Michael Fratantoni: [There are] two general types of lending. There's lending to buy a home, and that's a function of many different factors, [like] demographics. Now, we have a large millennial cohort that are entering prime, first-time homebuyer age. That's a huge tailwind for the purchase market. It's a factor of level of unemployment, other economic factors, and [interest] rates play a role, not a particularly powerful role, but it does matter in terms of affordability and purchasing power for the purchase decision. So that portion of the market, is relatively easy to predict over time, relatively smooth growth.

The refinance market is an entirely different story. In 2003, we had the largest refinance wave that we've had to date. This year we might come close, but in 2003 we had two and a half trillion dollars in refinances in a $4 trillion market. Just a few years later, we had a $1 trillion market.

Most of that difference was in refinances, entirely driven by the level of rates. Rates have been on a downward slope since 1980, we're setting record low mortgage rates again. Now, even though it's my job as chief economist to try to predict what rates are going to do, it is extraordinarily difficult. And that's the main uncertainty. If rates drop half a percentage point, refinance volume can easily jump 50%. For a mortgage lender, that means you go from being overstaffed to being woefully understaffed, and it is just a crazy environment.

Andrew O'Shaughnessy: Interesting. So one thing you mentioned was that the Mortgage Bankers Association has access to a lot of data from its members. How is that data collected and what is that data?

What types of datasets informed this report and seemed particularly salient to you at the time?

Michael Fratantoni: We do a weekly application survey, just looking at the volume of purchase and refi[nance] applications and the level of mortgage rates. We do a quarterly delinquency survey… looking at delinquency and foreclosure rates by type of loan and by state. That’s just been a nice sort of benchmark for the industry because we’ve been doing it in a very similar way since the 1950s. So for people looking for a long time series on delinquencies and foreclosure, that's the one to look at.

We also do some benchmarking exercises, so much more detail looking at measures of productivity and profitability and how those change over time in both the origination and servicing businesses. It’s all very informative. The broad-based surveys just sort of capture the environment in which lenders are operating and the detailed surveys really can show which types of business models fare better or worse in which types of environment.

A regular finding that we’ve had is the large banks with large servicing portfolios tend to perform at their best during these largest refinance waves. That's where they really shine both in terms of market share and profitability and small, independent mortgage banks, non-bank lenders, tend to perform best when the purchase market is the dominant portion of the market. And talking to lenders about that through the years, it’s just this very, very repeatable finding that in a purchase market, what you really need are relationships with realtors and builders and having that local presence and sponsoring the softball - It’s that sort of activity that's going to get you business because the realtor will suggest that a customer work with a lender they know who is going to meet a closing date. They’re not going to say, “Go out there and find the absolute lowest mortgage rate you can find,” but “I know a guy or a gal who will absolutely execute for me and make sure that your loan is ready by this closing date.” So that aspect of the market is really important to sort of focus on execution and the types of loan officers that work for the smaller organizations. That is just the way they think about the world, that they are going to do whatever they have to do to meet those expectations of their realtor and build relationships because that relationship has a lot of value over time.

Andrew O’Shaughnessy: So who has access to this data?

Michael Fratantoni: [For] the broad-based surveys, we put out a press release and they're available for subscription to both members and nonmembers. The benchmarking data for the most part just goes back to the participants, but we do show some highlights. MBA puts on 20 large conferences a year when we're not in a pandemic. We do it virtually when we are. We share some of the highlights there. When talking with various regulators we will give them periodic briefings on what we're seeing in the market. It's a good way to keep them informed in that they may not have access to the same data that we do.

Andrew O'Shaughnessy: What led you from MBA to Washington Mutual?

Michael Fratantoni: It really was connected to that Council to Shape Change group that I mentioned. Hearing the CEOs talk about the strategy behind running their business was just really exciting. I just fortuitously got a call asking me to go be [an] economic strategist [at] Washington Mutual [WaMu]. And they called at the right time. I'd had that appetite developed. And so it was a good opportunity to go out to the fifth largest bank in the country, working at the corporate level in the risk management group. So going a bit back to my analytical duties, but also it was an internal chief economist role, so I was regularly briefing the executive committee and the board with respect to what I was seeing on the horizon.

Andrew O'Shaughnessy: Could you elaborate a little bit on your responsibilities in that role?

Michael Fratantoni: Sure. I was reporting to first, the Chief Credit Officer, and then ultimately to the Enterprise Risk Officer, providing forecasts for the economy and for the different industries that WaMu was touching. The mortgage market was predominant, but also multifamily and commercial. We had a credit card business and then a banking business. Probably the most important part of my role was in three or four executive-level meetings each month providing those forecasts and data inputs. Then my forecast would be incorporated into financial statements in various ways, whether that was valuations of some of the holdings, the mortgage servicing rights, the loan loss reserve. One of the things I was forecasting was the future cost of home prices. Obviously that was critical given their concentration in mortgage lending.

Andrew O'Shaughnessy: So you start there, [and] what are your initial impressions of the risks on Washington Mutual's balance sheet at that point?

Michael Fratantoni: It was a very concentrated risk in mortgage for a large bank like that. Not only that, but the geographic concentration was unbelievable, and that was something I did not know going in: that of the $300 billion portfolio, the majority of that was in three counties in Southern California. And the majority of that was in either subprime loans or home equity loans. And with a home equity, any decline in prices eliminates the value. So extremely concentrated risk. And some of that came from just the historical development of the organization through a range of acquisitions, it had picked up a lot of California thrifts, and just hadn't done the cleanup work to reposition the company from being a Washington state-based community bank to being a nationwide institution and needing to geographically diversify, given the capability to do so.

Beyond that, I think the operational risk [was] a bigger concern. I mentioned the acquisitions. When I started working there in 2007, they were using more than 20 different loan origination systems across the company, and these are sort of the platforms that you use to take a loan from application to closing. And that's no way to run a railroad. By the end of my time there, they had whittled it down to one, I believe maybe it was down to two. But that’s just the kind of management of the operational risk that wasn’t occurring. I had built my analytical skills at Fannie Mae on 20-plus years of very rich, high-quality data. [At Washington Mutual,] they had barely two years of not very high-quality data.

My bosses at Washington Mutual, on the risk management side, were very consistent in terms of their messaging, which was, “Look, if you're going to go rollerblading, that's fine, but you have to wear a helmet and you’ve got to wear elbow pads. If you're going to be making high-risk loans, you’ve got to know what you're doing. You’ve got to have good technology, good data and good analytics. We don't have those, so we should be pulling in our horns with respect to the amount of risk we are taking.” And so then there was this mismatch between the decisions being made to pump up market share and volume by taking more risks versus the capabilities of the institution, which given the size, it was really a mismatch.

Andrew O’Shaughnessy: So you're finding this concentration of risk, you're talking about it with your immediate superiors in the risk management chain, it sounds like they received those. How were their concerns received by senior management?

Michael Fratantoni: There’s a challenge with being in a risk management organization. You’re working for the corporation. That vision of, "Let's equip the organization to take the amount of risk that you want to take, but put the safeguards in place first and then roll" – that is a challenging message. Several heads of risk management, prior to the folks I worked for, had tried to communicate that. You can either dig your heels in and say, "No, you can't do that." Or you can just say, "Well, okay, maybe we'll get to it later," and get rolled over. And neither one of those work, because the ones who dig their heels in get fired. The ones who get rolled over, they feel bad about it, but they're not changing the direction of the organization.

I think it was a little bit too late, but they had the right set of people there who could say, "Here's the ultimate goal. We're going to get 60% of the way there over the next six months by doing A, B and C." And you're not saying no to everything, you're recognizing the company has to make money to perform for its shareholders [and] its employees. But that takes some real diplomatic skills to reign in an organization that had been running a bit wild for a number of years and say, "Okay, we need to impose some discipline on this and some sophistication." My sense from the seat I was [in], and I was involved in a lot of the conversations, is [that] it was headed in the right direction when the shock hit. And it was just too much, too soon for the capabilities that the organization had.

Andrew O'Shaughnessy: So at that point you had been a longtime observer of the industry. What surprised you about working on the inside?

Michael Fratantoni: For me, it was just the intensity of the competition. And the intensity of the expectations from your investors. On the same hand, there's the intensity of the oversight from the regulatory world. You were getting pulled in so many different directions – and this was even before the crisis – you could see that and hear that in the conversations in the executive committee. If you do this, you shut down earnings, but you've reduced risk. If you've done this, you've increased earnings, but you've made an exposure over here. You do this, you've opened yourself up to a regulatory action, and it's this constant balancing. It's a really challenging exercise. I guess the other finding I had was having spent considerable amount of time at Fannie Mae and knowing a number of folks at Freddie Mac, [I] had always had the sense that we were competing. It was competing, but having had the Washington Mutual experience, I think is very different.

With Fannie Mae and Freddie Mac, it's like a good tennis match, and you can get a little sweat on and you have an iced tea afterwards. But in the primary market, it's like NFL football.

You're just going to get clobbered if you are not on top of your game at any point. And there was this sense all along that if the company didn't perform up to investor expectations, some of the leading investors would force a sale of the company, which would then mean that the entire management group lost their jobs, essentially. That was ever-present. You hear in many industries the chorus of how difficult it is to live in a quarterly earnings environment. Really feeling that for a couple of years, coupled with a crisis where the world exploded, it really is an experience.

Andrew O'Shaughnessy: We've had a number of these interviews and a number of different narratives have been expressed about the origins of the financial crisis. How would you say you understand what caused it?

Michael Fratantoni: I'd say it's a confluence of events. I definitely think there was an impact from monetary policy being too loose for too long. In the wake of 9/11 and the recession that followed, the Fed brought rates extremely low. When rates are too low for too long, you have investors reaching for yield. We saw that in tighter spreads on private label securities. That led to private label securities taking the majority share of the market away from the GSEs. As I mentioned, without all the safeguards in place yet, that this was a private industry that didn't have the experience and expertise that the GSEs did in managing credit risk. So they didn't put the right safeguards in place. So mortgage credit got too loose, and I think driven by that, investor demand for securities [that] were delivering more yield than the Fed was allowing the market to yield. So credit spreads came in, so the macro environment was conducive to that.

You also had signals being misread. That increased demand for mortgage credit and the ability to really stretch mortgage credit led to purchases that really were unsustainable in many parts of the market, led to overbuilding, which then potentially built up this home price bubble because you had supply running well in excess of what [were] sustainable demand levels.

I do think that there were regulatory gaps. You had some [players] operating under federal banking regulators. You had some operating under state regulatory authority. You had some that would have subsidiaries trying to dance across and arbitrage costs, [you had] different regulatory differences. I do think that with the question that you've asked there were unrealistic expectations about, certainly, how home prices would behave nationally. And those unrealistic expectations were held by global investors, Fannie Mae and Freddie Mac, the

Federal Reserve, the entire mortgage lender industry, and everybody that bought a house during that time period. It was a mass misunderstanding of how home prices could really behave in the midst of a home price bubble.

What we found ourselves, in 2007, as subprime lenders were going out of business, was that this level of uncertainty – Chairman Bernanke at the time said that the crisis was contained because if you look just at the amount of subprime losses, it sure looked like it was. But my visual for it was the pig working its way through the snake over time. First you had subprime lenders and then it worked its way more into the prime sector. And then it got into the banking system and the GSEs, and then it was the entire global financial system as these losses worked through. So the approach by the accountants and the regulators in terms of – I don't think that the losses were recognized as quickly, probably, as they should have been. I think the U.S. did better than many other countries. So Europe didn't really fully recognize those losses until 2011, 2012. The U.S. took the hit relatively early, but I think that’s another aspect of it. Extraordinarily complex, but that's the way I think about it.

[END OF SESSION]