AMERICAN PREDATORY LENDING AND THE GLOBAL FINANCIAL CRISIS

ORAL HISTORY PROJECT

Interview with

Stanley Middleman

Bass Connections

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PREFACE

The following Oral History is the result of a recorded interview with Stanley Middleman, conducted by Malena Lopez-Sotelo on March 9, 2021. This interview is part of the Bass Connections American Predatory Lending and the Global Financial Crisis Project.

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

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Interviewee: Stanley Middleman
Interviewer: Malena Lopez-Sotelo

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Malena Lopez-Sotelo: I'm Malena Lopez-Sotelo, a graduate student at the Fuqua School of Business and member of the Bass Connections American Predatory Lending and the Global Financial Crisis team, and today it is March 9, 2021. I'm currently in Durham for an oral history interview with Stanley Middleman, founder and CEO of Freedom Mortgage, who has joined us via Zoom. Thank you for joining me today, Mr. Middleman.

Stanley Middleman: Pleasure to be here.

Malena Lopez-Sotelo: I'd like to start by establishing a bit about your background. I believe that you went to Temple University for college and received a B.S. in accounting. Is that correct?

Stanley Middleman: It's true.

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

Stanley Middleman: In the mid-'80s, I started as a mortgage broker and began to refer customers into Savings & Loans, where they would get their mortgages. And then, after some time of doing that, I started Freedom Mortgage in 1990, which was a mortgage banker. And we began originating and funding the loans ourselves.

Malena Lopez-Sotelo: What attracted you to entrepreneurship?

Stanley Middleman: Well, at first, I was only trying to make a living. The first job of anybody when they're trying to go into business is to make sure you're making enough to feed your family and to build a career. And it's a series of steps in which you try and build your career and build a business. It was fun and exciting for me. In 1985, my first son was born. In 1990, my second son was born. So, being in business for myself gave me an opportunity to put food on the table and to help them establish themselves in their life.

Malena Lopez-Sotelo: Did your experience prior to Freedom Mortgage provide insight into you and your work as a founder?

Stanley Middleman: My activities prior—I've been in a lot of businesses. Some of them failed, some of them a little more successful than others. But I had been an insurance broker and had been selling annuities. And mortgages seem like the inverse relationship to annuities. As interest rates began to fall, there was a big demand for mortgages, and it seemed like a good place to be. In hindsight, it worked out to be true.

Malena Lopez-Sotelo: Can you describe what an annuity is?

Stanley Middleman: An annuity is the accumulation and distribution of wealth or savings. You would make a payment in for a period of time or all at once. It would sit there for a while, earn interest, and then be apportioned out. It's very commonly used for retirement funds. It's an insurance product. It's really designed to build wealth.

Malena Lopez-Sotelo: You mentioned a relationship between the annuities and the mortgage market. Can you describe that relationship?

Stanley Middleman: Well, in the early ‘‘80s, interest rates rose significantly. We were in a period of high levels of inflation. We saw the interest rate go up and costs go up in a runaway state. That was a huge issue nationally. Once that started to get under control and interest rates began to fall, there was a relationship: people that want to invest money want to get the highest rate possible, people that want to borrow money want to get the lowest rate possible. So, that inverse relationship became an easy one for me to explain to the general public.

Malena Lopez-Sotelo: At the founding of Freedom Mortgage up to 2008, what geographies did Freedom Mortgage serve?

Stanley Middleman: We were focused in New Jersey where we were founded. Through the mid-‘80s, I had opened offices in Pennsylvania and Maryland. That was one of the things that led me to create Freedom Mortgage. Because as we moved through time, it was easier to have a centralized company to deal with the regulatory responsibilities that varied from state to state rather than individual companies in each of those states dealing with those responsibilities. And that also proved to be correct looking backwards, where the amount of those regulatory responsibilities has done nothing except increase over time.

Malena Lopez-Sotelo: How would you characterize the state of the mortgage market in New Jersey when you began your professional career at Freedom Mortgage in 1990 compared to 2008?

Stanley Middleman: So, it's interesting. At that time in the late ‘80s, the mortgage industry was dominated by what was known as the Savings & Loan. And the Savings & Loan industry had just gone through a big regulatory change. During that change, a lot of the historical Savings & Loans, and ultimately almost all of them, went out of business. There was a fairly large distinction between commercial banks and Savings & Loans. Savings & Loans were primarily designed for local communities—what's now called a community bank—to make their deposits and to get their mortgages or home equity loans. And commercial banks did commercial loans. During this era, there was a movement towards deregulation and that deregulation allowed commercial banks to be involved not only in mortgages but also in insurance.

And in effect, this really ended the reign of the savings and loan in the mortgage space. At that time, the baton was kind of passed from the savings and loan to the commercial banks. That, over the next fifteen or eighteen years leading up to the financial crisis, became the dominant source of mortgage lending in the United States. So, these commercial banks that really became very, very large, and had become referred to as “money center banks,” dominated by five or six very, very large banks: Wells Fargo [Wells Fargo & Company], JPMorgan Chase [JPMorgan Chase & Co.], Citi [Citigroup Inc.], GMAC Bank at the time, Countrywide Bank [Countrywide Financial Services], Bank of America. When you think of Countrywide, you think of Bank of America because they ultimately took over. But as these Savings & Loans ceased to exist and the commercial banks took over, they took on a lot of this responsibility around residential mortgage lending that had previously been the purview of the savings and loan.

And at that time, independent mortgage banks were just beginning. They were limited to small brokerages or quasi-brokerage operations that really sent all of their loans up, by and large, to an aggregator, which turned out to be one of these banks who typically did most of the securitization through the government agencies, whether it was HUD [United States Department of Housing and Urban Development] and Ginnie Mae [Government National Mortgage Association] for FHA [Federal Housing Administration], VA [Veterans Affairs], USDA [United States Department of Agriculture] loans, or through the GSEs [government-sponsored enterprises], Fannie [Federal National Mortgage Association, i.e. Fannie Mae] and Freddie [Federal Home Loan Mortgage Corporation, i.e. Freddie Mac], which were probably involved in the vast majority of the loans that were done. At that time, there was also a level of loan called a private-label securitization loan, which later became known for subprime loans, but initially was really designed for jumbo loans so that houses that were more expensive could be financed in the same securitized manner as the agency loans or the GSE loans.

So, if you thought back a little further in time, maybe that movie *It's a Wonderful Life,* and you think of Jimmy Stewart in that role. At one time, banks took deposits from the local folks in the community and then lent that money out for people to get mortgages. And that was a really bad idea because these institutions were taking long-term interest rate risk and borrowing the money from depositors on a short-term basis. So, you were subject to extreme, whipsaw-type behavior from changes in the marketplace and that's kind of what *It's a Wonderful Life* hinted at. I think that was one of the problems that ... that really hurt the savings and loan industry and ultimately gave rise to this commercial banking industry.

Clearly, it had a lot to do with federal regulation and changing accounting principles. There was a lot of things that went into this event occurring. But I think, by and large, the transition from local depositors' deposits being reinvested in the community's mortgage became an antiquated notion because you would be limited to the amount of stock on the shelf, so to speak. If you didn't have the money to lend, you couldn't lend more homes, so the community was held back. The advent of the securitization instruments and the aggregation of mortgages and having the value of those mortgages sold to investors really started to come into being, in a large way, in the '70s in Ginnie Mae, and really began to assert itself through Fannie Mae and Freddie Mac, in a large way, as we moved through the '70s into the '80s and ever onward.

So, the way that these mortgages were created through the securitization element took that balance sheet interest rate risk off the banks or the Savings & Loans by using this securitized device. And it allowed to replenish the cash available to make these loans to the institution that was originating the loan through the community. So, that advancement in our industry really allowed for scale and scale combined with innovation allowed companies to get much larger, much faster. And the ability to service those loans and to do it effectively through innovation and through technology played an important factor as we ran up to this crisis.

Malena Lopez-Sotelo: You mentioned technology—how did technology change from 1990 to 2008? How did that impact how Freedom Mortgage was servicing loans?

Stanley Middleman: In 1990, Freedom Mortgage didn't service loans because it really didn't have the capital base. If you recall in my last comments, I talked about how independent mortgage banks sold their loans up to the aggregators of these large commercial banks. What they were able to do is, in 1990, servicing a loan was done on computers, but not on a computer like you and I are looking at today. They were done in computers that lived in huge rooms with elevated floors that had their own cooling system that made a huge hum while they worked. And they took big whirling tapes of data that spun around and fed into them. They accepted, in some cases, conveyor belts filled with cards that were punched out to enter data that got transferred to tapes that became that information.

But the ability to do that rather than out of a filing cabinet, and to turn the data of a mortgage from a physical file into data that went through a machine where that information became retrievable. Storage became something that could be done in a room rather than in a building, and could be maintained by a couple of people rather than an army of people. Today, we don't have too much trouble servicing 1000 loans per person, or maybe even 1500 in some cases. At that time, we were thinking about 200 or 300 loans per person. So, just the scale of that, and then the supporting number of people. And all bills were not electronic. They were all through mail. So, the bills had to be prepared, and they had to be mailed. Then they had to be received. And all of this was manual.

So, the number of people involved in the servicing process really restricted the size and scale of an operation. Today, Wells Fargo services over $1 trillion in loans. There are a couple of companies approaching that. There are many above $500 billion. Freedom Mortgage approaches $400 billion. In 1990, actually I think it was 1993 or 1994, General Electric Corporation [General Electric Company] became the first $100 billion servicer and they were the only $100 billion servicer at that time. So, it's easy to get a sense of what that means. In terms of population, they did it in an entire office park rather than in a single building or a single space like Freedom does today. We certainly do it in a much smaller space with way less people. I think our total servicing population of over $400 billion today is done by under a thousand people.

So, the scale and scope of the personnel required to service loans in 1990 was far different than it is today. The number of servicers was far greater. There were thousands, literally thousands of servicers, versus today where there are not nearly anywhere near that amount, certainly not of magnitude. So, 2008, being twelve or thirteen years ago, was well on the way to the present and fairly distant from that past. By that time, heading into 2007, mortgage delinquency was really fairly low. Our expectations of mortgage delinquency were fairly low. We were thinking 2%, 3% was high. And maybe it would get to 5% or 6%, [that] would be astronomical.

Yet, we managed to get to those places. And we got there through a confluence of events, which I'm sure we'll get the opportunity to talk about. But the reality is, our expectations were: did people pay their mortgage? One of the historical things in this country was property values had gone up, and people invested in their home and built their wealth through their home. That was a general tenet of our economy. During that savings and loan failure that happened in the late '80s, we saw one of our first real events of property values dropping. There was a pretty significant drop in property values that was not dissimilar to what happened in that Great Recession.

That event was called the Savings and Loan Crisis and it resulted in a federal agency called the Resolution Trust Corporation, the RTC. And that was to dispose of the assets of these Savings & Loans that had failed. A lot of the assets were housing assets because there was a lot of excess inventory that was created. Ultimately, if you think about what happened in both of those instances, it was the excess supply that exceeded demand that caused the values of properties to go down. In the latter, there were more credit issues that had taken hold. Most of the credit issues were commercial in the savings and loan disaster because during that same period of deregulation that had commercial banks doing mortgages and insurance, we also saw Savings & Loans try to do commercial properties, which they had previously been kept out of through regulation that was overwritten or done away with. And that led to some of their failure.

So, they were involved in making loans that they were not good at. That was accompanied by an oversupply in housing and diminishing demand and that drop in the value of those homes as the economy turned away. The net result of that was not dissimilar to the net result that happened in that Great Recession. So, we did have a little bit of a playbook to follow in terms of what we thought would happen if property values declined. But as they rose through the '90s, and coming out of that event and coming up on that Great Recession, we found that our memories weren't quite long enough and not everybody remembered that property values could go down. There was a strong sentiment leading up to the recession through the '90s and the 2000s that property values would continue to rise, the population will continue to grow, and the economy will continue to gain, riding the back of innovation that allowed so much more to happen with so many less people, which freed up people to do more in other jobs and to continue to grow the economy. That was the working playbook that we used at the time. So, it's interesting, in retrospect, how very similar those two periods were—maybe interesting for you to contemplate.

Malena Lopez-Sotelo: Leading up to this timeframe to 2008, what were some typical terms that you saw at Freedom Mortgage?

Stanley Middleman: At Freedom Mortgage, we really kind of stuck to our knitting. The use of adjustable-rate mortgages was valuable only at certain points in the economy. There were points in time where a lower introductory rate would allow a larger percentage of the population to own a home. The government was very supportive of homeownership, and had been beginning even earlier than the Clinton administration. But if you only look at the Clinton and two Bushes, as we went through that period of time, I think that one of the tenets of growing the economy was to grow homeownership. Both the GSEs had mandates to grow homeownership. Even the government loans supported by HUD were really aimed at growing homeownership—and for a lot of good reasons.

People that own their homes tend to have more pride in their communities. The neighborhoods are generally kept better. Homes are better kept up. There's less crime where there's a higher level of homeownership. There's less social injustice—I mean, on and on and on. So, the fabric of our communities, our society believed, was bolstered through homeownership. The use of ARM [adjustable-rate] products, adjustable-rate mortgages, was common at different points in the economy based on the relationship of fixed-rate loans to adjustable-rate loans. So, at any point in time, the fixed-rate mortgage would be significantly higher than the adjustable-rate mortgage. Occasionally, we get into what's called an inverted yield spread where the short-term rates eclipse the long-term rates, and that's typically the precursor to a liquidity crisis and a recession. As we approached the crisis, we saw exactly that relationship where the short-term pricing was eclipsing that of the longer-term pricing.

So, when we entered the crisis, Freedom Mortgage did not use short-term loans because the money had to come from somewhere. The way the ARMs with the low introductory rates worked was that they created negative amortization, which I viewed as extremely dangerous to the consumer. We really didn't participate in those. We had to have them on our menu because we compete and live in a world that's inhabited by others, and you can't be too far of an outlier if you want to do business with your competitors and in your industry. You're competing to get business. But we did not push that, and it was a very small percentage of our business relative to some of our competitors. For example, GMAC and Countrywide had these negative amortization loans [that] were the bread and butter of what they did where it really wasn't that way for us. They were strongly promoting them, but we weren't getting as involved in them as they were.

We were primarily fifteen-year fixed [fixed-rate mortgages] and thirty-year fixed. [They] made up probably 85 or 90% of all the loans that we did, with these other fringe products just being something that was on our menu that someone may have chosen rather than [what] we would have promoted. And I think for good reason. The decisions that some companies were making were economic decisions rather than consumer decisions. If you don't make consumer-friendly decisions, it's my basic belief that you're going to be out of business. That also proved to be true. So, one of the things that kept us going was the fact that we were really zeroed in on the benefit to the consumer. With that benefit to the consumer in mind, we were able to stick to the products that were fairly mainstream. Primarily, the thirty-year fixed rate mortgage was what we sold.

Malena Lopez-Sotelo: At Freedom Mortgage, how would you describe the firm's culture?

Stanley Middleman: Autocratically benevolent dictatorship. It was fairly closely controlled by me. I had a lot of influence over our day-to-day activities. I managed the company fairly closely. We weren't nearly the size that we are today. They say the meek shall inherit the earth. One of the things that helped us survive that crisis was the reality that we weren't that large and we weren't subject to as a significant amount of exposure as some of our peers. I would say our culture was one in which we were very focused on our customers. We were very focused on building our customer base and being kind of consumer-oriented. I think that that's been a hallmark of the way we have approached this. We wanted people to buy things that would be good for them.

Our mission has been to foster homeownership and help people leverage the homes they live in. One of the greatest places to build personal wealth is through your home. It's how my parents built whatever wealth that they had in their lives, and millions of other people have built whatever personal wealth that they have through their homes. Unfortunately, in that crisis, a lot of people came in at the wrong time and had the opposite effect. But as we've seen since then, we've returned to the norm, and a lot of people have continued to build wealth through their home. I think it's probably more apparent in the last couple of years than it's been in the number of years leading up to today, but I would urge everyone to keep in mind that it's not always that way and property values can go down.

One of the things that we tried to do was be somewhat risk adverse. One of the things that we built our culture around was trying to make loans that were not only salable but defensible. That became a big part of how we went about this business. One of the reasons that we fared relatively well—one, we didn't go out of business, so that means we fared pretty well. But one of the reasons that we did fare pretty well was because we stayed away from non-owner-occupied loans. The degree of speculation that was taking place by ordinary citizens that shouldn't have been speculating in housing was extraordinary at that time. There was a lot of people that were buying fix-and-flip homes, buying houses that they thought they would make the arbitrage between the current value and the expected value as property values rose, and they could get levered returns and in that.

It's kind of like buying stocks on margin and then having the value of that stock go down. So, not only do you lose the amount that you had to put in, but you multiply the amount that you put in and then you get a margin call that may be for perhaps more than you have. That's what happens in these fix-and-flip loans. There are a lot of people that lost enormous personal fortunes doing that because they were speculating in housing when they shouldn't have been. It's interesting that it's an easy comparison to make to the end of the '20s, when the Great Depression occurred, to this Great Recession—the number of people that got hurt speculating in real estate. The people that had a home that they could afford and make their payments and were oblivious to all the things basically went on with their lives unchanged, right? They had a mortgage payment before, they made their mortgage payment now, and they were fine.

It was the people that tried to get too much house for too little money and were leveraged into their home. They couldn't handle their margin calls or had products that allowed them to have negative amortization so that the value of their house went down in addition to their loan going up. So, all of these things kind of collided together with the fact that property values turned down as a result of a basic supply and demand environment that really caused the turndown. It's the fallout that was sad. The fallout was a combination of a rip in the social contract where people didn't feel obligated to pay their mortgages, which was kind of a problem, and an inability to pay their mortgages, which was also a problem.

But there were different problems. Some people chose not to pay their mortgages, and some people couldn't pay their mortgages. The ones that couldn't pay their mortgages were sad. The ones that chose not to pay their mortgage shame on them. That's kind of just not right. But there was the combination of the two. And it really was an outgrowth of the same problem of supply and demand. There was more supply than there was demand. Value had gone up, inappropriately so. People were trying to cash in on the increase in the value. The net result was [that] there was a lot of fallout when the bubble burst.

Malena Lopez-Sotelo: You mentioned negative amortization. Can you describe what that is and who that impacted the most, whether that's geographically, or any other way to identify groups of people?

Stanley Middleman: So, [the] negative amortization loan, the concept was to give more people the opportunity to own their home that were sophisticated enough. When the program was originally rolled out, I guess in the '80s, it was to give a more sophisticated borrower the opportunity to better manage his finances and to leverage into his home and to build his wealth stronger. It came out in the context of rising property values, not falling property values. It was really promulgated out west in California, Washington, Oregon. It was a California savings and loan that were the first couple of big neg-am [negative amortization] providers with these option ARMs [option adjustable-rate mortgages], which gave people a variety of down payment choices in return for having their debt go up rather than amortized down. They amortized up. So, as they were in the loan and making the payments, they were getting a discounted payment that essentially got added onto the balance of their loan, thus the term negative amortization.

As time went by, one, three, five, seven years, their loans would get larger and their payments would rise over time until the negative amortization stopped, and the real amortization of the new balance began. The theory was, by that time, someone would have refinanced out of their original loan and gotten a fixed-rate loan, and there would be more value in the house. The house would have gone up in value, or the person's circumstances would have changed. They'd be making more money because there was a basic tenet of American belief for a very long time [that] you knew two things were going to happen. When I was in college, you expected that every year you're going to make more money than you made the year before, and every year your house was going to be worth more than it was the year before that.

So, if that's the way you think and your base belief system, which so many people in this country really believed. That was just the way everybody thought. We all thought the same thing. In the ‘60s and in the ‘70s, as we ran up to the savings and loan crisis, we really thought that, and it had been true, probably since the end of World War II. So, there were multiple generations that have gone through this kind of line of reasoning and thought this. That thought proved to be wrong, as other tenets that we believed in proved to be wrong. What was morally acceptable then wouldn't be morally acceptable now. What was socially acceptable then wouldn't be socially accepted now. When I was in college, we thought that 6% was an acceptable unemployment rate, that full employment was 6% unemployment.

When I graduated college in 1976, we didn't count women in the workforce. So, obviously things changed, and they changed pretty dramatically, and in hindsight, reasonably quickly. There were obviously more jobs, more employment, more money being earned, more value in the assets that were being bought with those dollars. And it was a part and parcel of our daily lives, but a lot of those base tenets changed. When I talk about that social contract being torn, that fabric was built over a long stretch of time. It's just what we believed. We thought people would make their mortgage payment. I mean, I believed that. I was very surprised when people made the choice not to pay their mortgage. Previously in hard times, people would make the choice not to pay their credit cards because they were unsecured, and they would take that credit hit. But this time, they paid their credit cards because that credit kept them going through this period of downturn in their hard assets. So, it was a real departure from historical norms that we witnessed in so many different ways....

Malena Lopez-Sotelo: Did the change in the base belief that you mentioned change the goals of Freedom Mortgage at all during the boom and right after?

Stanley Middleman: I think it made us more conservative. It's an interesting thing. When you think about how we behaved and what I was thinking about at the time, the decisions that I made were based on my social beliefs, the way I thought it should be, not necessarily the way I probably should have behaved in certain instances. Like I got us in a little bit of trouble because I probably pulled into credit too tight relative to my peers. So, I was exposed, relative to my peers, by certain scrutiny by outsiders because my relative performance got out of whack. My delinquencies were higher on a percentage to origination. It's not because my delinquencies were going up so dramatically to what I had originated, as much as my delinquencies went up to what I was currently originating because I chose to originate less.

In certain periods, it makes more sense to lend less than lend more because of the problem society has making their payments. So, if you make less new loans, less of those new loans will go bad. However, that makes your existing loan portfolio get out of whack because if you have a fixed group of new loans and more delinquency occurs and you don't have new loans going in, a higher percentage of the loans that you have become delinquent. So, that was a difficult balance for me to strike. It took me several years to get it right and to bring that out. I had to really learn how to make more good loans to offset the delinquent loans, and more good loans were harder to find than more loans that would become delinquent. It became a little circular, and it was challenging for several years. It really forced us to shrink and reduce our labor force dramatically in order to handle that current environment. Basically, you can either grow into a problem and outrun it, or you can turtle up and let the storm pass.

At that point in time, we took the choice to turtle up and let the storm pass, but that doesn't mean that we didn't have scratches on our shell. So, conservatism ruled the day. Pulling in the credit parameters—it's probably a choice I would make again. I think that in uncertain times when you can't really understand the value of the collateral, the three basic functions of decision-making criteria that we use in credit are cash, collateral, and character, which means credit. Substitute the character today for FICO score, or a way to analyze credit, which in the ‘80s was more manual than the ‘90s. But it's really cashflow—do the people have enough income to make their payments relative to their debt? Is their credit history one that says they're likely to pay their bills on time?

And then the third criteria is collateral. I think that that is the underlying criteria for people's success, and I think that that's the piece that got lost. I think that we felt, as an industry and as a society, that the value of the property is going to continue to go up, and we can be more lenient in credit and income evaluation because the value of the property is so great. The value to society of having people own their home was so great that the risks were small relative to the collateral, as long as the value of the homes go up. And I think that that's true. The problem is that the homes didn't go up during that recession. The fallout of being overly aggressive in the other two criteria compounded with a deterioration in the collateral. So, you ended up upside down in all three phases of the credit picture.

So, what we call credit is those three things brought together: cashflow, collateral, and character. That creates a credit picture, or compensating factors is a term that's been used in the past. I think that the industry, goaded on by these quasi-government institutions called GSEs, which ultimately failed, were goaded on at the behest of the government and society to drive homeownership up to improve the fabric of the quality of our society—which I think was noble in its goal, ill-applied in its practice. There's just some times [when] it's not a good idea. The economic cycles don't call for properties to go up in value all the time and that was the flaw, the ultimate Achilles heel, of the societal trend to really encourage homeownership that gave up the importance of good, strong collateral and skin in the game.

Now, I will tell you that if you go back into the 60s and 70s, when you needed to have 20% down to buy a home, that was probably too stringent in the other direction. So, I think that all things considered, homeownership is a positive event for people. And I think that the government and government agencies have to play a bigger role in managing the credit cycle and access to credit when the overvaluation of properties in a cycle are more at risk. I know that nobody in any of those places are taking any blame for this. But truth is that the wisdom of Congress and the pressure that they put on these GSEs was inappropriate to continue to drive the demand for homeownership to rise in adverse cycles.

And we knew, well ahead of the cycle, and the GSEs knew, that by lending to people at high LTVs [loan-to-value ratios], the performance of those loans would be worse. In fact, I recall being at an advisory group session of Fannie Mae, I think as early as 2005, that we had some understanding that certain credit levels at certain LTVs performed poorly and had as much as an 18% delinquency while property values were rising. That was enough of a warning that they should have rolled back the LTV requirements. In other words, the amount that you would lend against the collateral. If those LTV requirements had been restricted—and there were a lot of forces demanding that they get looser, not stricter, including housing advocates and on and on. But if they had been stricter, they could have headed off a great deal of the frothiness. And ultimately, the bubble breaking that occurred could have been mitigated significantly if different choices were made in 2005 as interest rates began to rise.

Malena Lopez-Sotelo: In this timeframe leading up to 2008, what would be considered a high LTV?

Stanley Middleman: 100%, 102%, 103% of the property value. If you don't have any money in the game, you're going to make a different set of choices than if you had 10% in the house of your own money, or 20% or 15% or even 5%. The higher the LTV, the more likely the house was to default.

Malena Lopez-Sotelo: Did that look different in New Jersey versus the rest of the country?

Stanley Middleman: It was national. And that's an interesting question because if we look back at the savings and loan crisis, the reason it wasn't as deep and probably as noticeable in your history books as the Great Recession was because it happened in waves. The savings and loan crisis didn't all happen at the same time everywhere. We witnessed it on the East Coast pretty significantly and didn't see it on the West Coast until two years later. And then in between, in the middle of the country. So, it didn't have the broad-based impact. By the time the problem of the savings and loan crisis occurred on the West Coast, it was almost over on the East Coast and the fallout was already being dealt with, and the tragedy had already been mitigated to a certain extent. The fact that it didn't all happen at once was significant, but by the time we got to 2008, the geographic risk was national, not regional.

That was one of the big changes. We started using the term "world village" in the mid-2000s. Prior to that, we were very, very sensitive to regional changes and economic changes in a region. For example, in the early '80s, we had seen some property value devaluation in Texas when they had problems with oil and there was a tremendous amount of employment that was really a regional economic change. That was very significant, but it didn't happen everywhere. We've seen that happen through disasters: hurricanes and floods and that type of thing. But we really didn't see that in the crisis in 2008. Everything happened everywhere all at once, and that was something we really weren't used to or as prepared to deal with systemically. Remember the volumes that were being dealt with were so different than what we're used to. Instead of having thousands of servicers, we had relatively few servicers. The number of institutions that had to deal with the impact of this and the aggregation of this activity was small, and that reverberated throughout the industry, and therefore society.

So, it was something that was really different in that regard. This was a negative impact that was unforeseen that was engendered through the use of technology to build the scale that no one had really dealt with previously. So, being able to cope with a foreclosure is a fairly labor-intensive process. When you multiply it by the scale and the number of units per person that had been in place, we went from a highly automated process—one person can handle 1500 current loans, but 1500 people have trouble handling 100 delinquent loans, right? So, the percentage of delinquency as it goes up, the amount of work that goes into loss mitigation and trying to help people resolve their financial woes and ultimately foreclose on a property, is much more labor intensive and much less automated at that time in particular than handling current loans.

There was a dearth of automation around loss mitigation and foreclosure. The industry, the economy, and the society were not built to handle it. The legal jurisdiction, the court systems couldn't handle it. There are two types of foreclosures: judicial states and nonjudicial states. Judicial states include places like New York, New Jersey, and Florida. In those places, it took up to seven, eight, ten years. We just finished cleaning up the last of those crisis loans where a lot of people lived in those homes for free for five, six, seven, eight, and ten years and didn't maintain them. We couldn't foreclose on them because of the backup in the judicial system to clean up those loans. In the nonjudicial states where it's more by law than by court appearance, we were able to clean most of those up in a couple of years. So, the problem was solved in places like California and Arizona and Nevada much faster than it was solved in places like New York, New Jersey, Florida. They're kind of the three extreme cases that really come to mind.

Malena Lopez-Sotelo: … Did Freedom Mortgage ever interact with regulators leading up to 2008?

Stanley Middleman: Well of course we did, but it was a different regulatory environment. At the time, an independent mortgage bank is regulated by the states it does business in. Those states are overseen by the agencies. I would say they were augmented in their oversight of the independent participants by other companies that they regulate. So, if you think of it as an ecosystem, one company feeds into another company feeds into another company. For example, we sold many of our loans to Chase [JPMorgan Chase], who in many ways oversaw our operation. We also sold loans into Fannie and Freddie, who also had oversight responsibility of our business. So, not only did we have oversight from a regulatory standpoint from a particular state, which kind of dealt with the exceptions at that time rather than proactively like an institution like the CFPB, the Consumer Financial Protection Bureau, would today in all the Dodd-Frank [Dodd-Frank Wall Street Reform and Consumer Protection Act] era regulation that came out of that, we also had a great deal of oversight by these GSEs and Ginnie Mae at that time.

[They] really became the true oversight of our day-to-day operations, and ultimately, they played a very proactive role in helping us deal with our new regulatory environment because they were getting more direct feedback from the new set of regulators as to what the new rules of the road would be because they were so much larger. They had the capacity to really help us understand and implement the rules to help us get back on the road of the new view of what was acceptable in society versus what's not accepted.

Malena Lopez-Sotelo: … How did banks like Chase either provide incentives or interact with Freedom Mortgage leading up to 2008 in addition to those regulatory factors?

Stanley Middleman: If you thought about people like Chase and Wells [Wells Fargo] and BofA/Countrywide [Bank of America]—and I think you have to throw GMAC into that mix as well, and maybe Citi—they managed our relationship by giving us rules that the loan had to conform to their guidelines. GSEs had certain guidelines, and then this particular bank institution, whoever that may be, layered in their guidelines, which went beyond the agency guidelines. Then, the individual company had the right to layer on their own guidelines that could be stricter. But the lowest common denominator that we used was the strictest set of guidelines that apply to us by these aggregating banks. They published guidelines regularly, and they updated them regularly. As rules changed, they updated these rules regularly. We really relied on their guidance on managing our risk because they had direct pipelines to the agencies who use them to manage their risk.

And to a large degree, they did the counterparty reviews. For example, we have a counterparty group that reviews the quality of the people that we buy loans from. But at that time, those counterparty groups were a significant regulator of the smaller companies like Freedom would have been at the time. We really looked to them for guidance on the rules to follow that made a loan eligible to sell to them. And then, if we were going to use several of them and not just one of them, we had to make sure that the nuances of the particular loans that we were going to sell to this aggregator met their guidelines versus the nuances of another lender and their guidelines.

Malena Lopez-Sotelo: After these loans were sold, did these institutions keep them on their balance sheet or did they sell them to another entity or securitize them, for example?

Stanley Middleman: By and large, almost all loans were securitized. I'm sure there were some portfolio loans, but that wasn't generally done out of choice. That was really the result of a flaw of some type.

Malena Lopez-Sotelo: In this ecosystem of different players, did you ever interact with brokers as well as a part of Freedom Mortgage?

Stanley Middleman: We did. We had a small broker division that was part of our business, and we bought loans from the broker community. However, we didn't really do it on a very large scale until 2006 at which time we had acquired Irwin Mortgage, which was a little larger than Freedom was running up to the recession. They had a larger broker base than we did. They also had stronger systems, stronger counterparty risk management [that] ended up better overall job of managing that community.

We did that acquisition for [three] primary purposes. One was for the systems and technology. They had an outstanding technology system at the time, and the platform that they ran their business on really served us well through the recession because it made our data readily available. The access to information improved significantly over where we had been in 2005. Also, we wanted to have a larger representation of Ginnie Mae or government loans and 20% of their production was government. Even though government loans only made up 2% of the total population of loans done at that time, having 20% share of that market was pretty significant. In my view, government lending was going to be the future in this housing collapse that I saw coming in 2006. I recognized that there were going to be significant issues and we had to convert from being primarily a GSE lender to being a primarily government lender, which we did at that time. The technical expertise and staffing and scale that was available in that acquisition was critical to us at that time. The third reason, which was really important, was it gave us a vast technical expertise in general and an infrastructure to run a larger business that was far more effective than the business we had been in. So, the size, scale, and technology, and the entrance to the Ginnie Mae space was really important to us.

Malena Lopez-Sotelo: Can you describe some of the incentives in place for the brokers that were acquired?

Stanley Middleman: So, there was no incentive. We gave them a price, and they chose to do business with us, or they didn't. By and large, the banks that we sold to generally gave us a price and we sold our loans to them or didn't. We didn't get too caught up. Our industry was a little funky at that time. People had boondoggles, and people went on golf trips, or they did this. I never really got too stuck in that silliness. I had a business to run, and I was busy running it. So, I didn't really have a lot of time to fool around with extravagant dinners and parties and trips. That wasn't who we were. We didn't really get too involved. We probably weren't large enough to draw anybody's attention for that stuff. So, there were no particularly significant side deals or incentives or stuff flowing our way, and nor did we pass any on. We bought it for X and sold it for Y, and that's the way we conducted business. When we did business with a broker, we bought it for X and sold it for Y. We assumed that brokers did pretty much the same thing.

Malena Lopez-Sotelo: … As mortgage loans were sold or moved around, who did you think carried the risk in each one and how did that change?

Stanley Middleman: So, the risk of the loans was an interesting question. In my view, [that] takes me back to a period of time in the early 2000s, or around 2000, or maybe late '90s, where the agencies actually asked for repurchase of certain loans—and this happened in the early '90s as well—of loans that were made: non-income loans, and we didn't verify incomes. I talked about the credit standards a little bit. Then, the agencies asked for repurchase of these loans. And typically, the reason they asked for the repurchase was not because they were non-income but typically because of the appraisal. So, I was very sensitive of the fact that there would be repurchased demands based on the value of the collateral because that was the universal link that tied how a loan performed.

It's not typically the ability to pay or the credit character. The underlying delinquency-producing event is the value of the home. So, if the value goes down and the customer's underwater, they're less likely to perform. The less they have in the game, the less likely they are to perform. One of the things that we tried to do and really worked hard at was to get out of the risky loans. We eliminated doing any alternate document loans [Alt-A loans] in '06, which was way ahead of the curve. We eliminated investment properties in '06, which were the loans with the greatest losses that were most exposed. We did accept credit character loans that were probably too low because if you're going to be in the loan making business, you have to make loans to somebody, right?

So, we took on more character risk loans in exchange for harder valuations and better documentations of income, controlling the value of the collateral and keeping some skin in the game. We did that by going to government loans and forsaking the GSEs because the GSE loans have a peculiar institution called mortgage insurance. Private mortgage insurance is an insurance company that insures essentially the first loss. So, they insure the highest LTV portion of the loan. The problem is that, first of all, they didn't pay losses because that's not what insurance companies do. And when these private mortgage insurance companies denied these claims, which they universally did across the board, because they couldn't have been our fault. We did our job. We underwrote the loan. We're not paying that claim. It must be some kind of failure on the lender's part, which was the common theme.

We knew that was going to come. We knew that insurance companies don't pay claims, and we knew that they would deny the claims. And when they did, that triggered a charter repurchase through the GSE that now made repurchase demands on the originators. These repurchase demands, in many cases, put the originators out of business. The same thing happened on the private-label securitization side. And again, the same MI [mortgage insurance] companies wouldn't cover the claims, which put the loans in default, which created a repurchase. Many of the larger companies that were doing these private-label securitizations defaulted and had liquidity crises, [which] caused them to declare bankruptcy. And again, triggered from the same issues around lack of private mortgage insurance or default that triggered a repurchase demand.

However, you didn't have that problem in government loans. And we moved. Our production was primarily GSE-oriented in '06. By the end of '07, we were 90% government-loan-oriented. We remained that way today. We're still probably 70, 60% government-oriented rather than the 2% that the industry was at the time. That's because the insurance on a government loan is by statute and has to stay in place, and they have to cover that insurance. That gave me great comfort. That was the way I mitigated the risk that I was exposed to. We ended up having some issues with the government that we had to settle because there was a dispute, because nobody likes taking a loss, right? Whether it's the government, whether it's us, whether it's a mortgage insurer, GSE—nobody wants to take that loss.

So, you're passing that hot potato around. But we came to a settlement with the government that I think, ultimately, was fair, that we were happy to pay and resolve. That helped us all gain a perspective on new rules of credit evaluation. But the one thing that they didn't do was dissolve the insurance because of the change in the property value. That didn't happen on non-government loans: in the private sector, whether it's private label securitizations or GSE loans. And that's why so many of my contemporaries went out of business. They were just caught in a liquidity crisis based on repurchase demands that they couldn't meet because the loans that they made were eligible to repurchase. We had our fair share, but it was more manageable.

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

Stanley Middleman: The ultimate crisis was the result. I know I've talked a lot about that through our discussion here. And obviously I don't want to repeat everything that I said, but if you wanted to summarize it, I think [it was] the hope for a higher percentage of homeownership, the rising value of properties that was probably exacerbated by the profitability being made by people trying to build homeownership and make profits, combined with that change in property value. I think that the underlying thing that caused the crisis was the deterioration of property value—fundamental supply and demand. I think the degree was exacerbated by all the stuff everybody knows about: the credit, the underwriting, the greed, the selling pieces, Wall Street financially engineering those pieces. But the underlying issue was a supply-demand issue. There was too much supply, not enough demand, property values fell, and the fallout was significant.

And I think it wasn't very different from the same fallout that occurred in the late '80s and into the early '90s from the savings and loan crisis. I don't think it's going to be very different from the same fallout we'll see when we see a supply-demand shift at the end of this decade. As we start to enter the 30s, the end of the 20s, we'll see a very similar situation arise where there will be more supply than demand. The property values will decrease coming off a previously large increase. I think supply and demand is a natural force that was, for whatever reasons, and there were many, was not prepared to be dealt with. People made bad decisions ignoring the reality that demand would not constantly rise and prices would not consistently rise, and that at some point demand would fall.

Malena Lopez-Sotelo: To what extent do you see your personal experience as adding something important to our academic project's understanding of what happened in the run-up to 2007-08?

Stanley Middleman: Hopefully you found me to be an articulate witness to help you better understand the events that proceeded the run-up to the issue as well as to help you see some of the things that could happen again. So, hopefully, taking the time to listen to people bear witness to events that occurred can mitigate their recurrence. I don't think you can stop them from reoccurring, but I think you can mitigate the recurrence by managing the cycle run-up in value. I think limiting LTVs on new homes based on preceding years' housing property appreciation is probably a good practice that should be implemented by people that aggregate loans. Since Fannie and Freddie and Ginnie aggregate probably 75% or 80% of all the loans, I would hold them responsible for managing the LTV as we move into the future over the next several years.

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

Stanley Middleman: The way we approached it then, and the way that we've approached this business since, is we make every loan like any loan that goes bad, we're responsible for anyway. That was the lesson learned. If you make a bad loan, that's your problem. I think the secret is to not make bad loans. If we see that the agencies don't manage the LTV bands, as time goes by, we'll do that as a company. We'll mitigate our risk and exposure by managing our exposure to the higher LTV loans ourselves. Because as I've described as convincingly as I am able, I believe the value of the loan to the value of the property is the number one determinant in whether a loan will perform and that the value of the collateral is the deciding element in making good credit decisions.

Malena Lopez-Sotelo: Thank you, Mr. Middlemen, that concludes our interview.

[END OF SESSION]