AMERICAN PREDATORY LENDING AND THE GLOBAL FINANCIAL CRISIS

ORAL HISTORY PROJECT

Interview with

Susan Wharton Gates

Bass Connections

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PREFACE

The following Oral History is the result of a recorded interview with Susan Wharton Gates conducted by Malena Lopez-Sotelo on April 13, 2021. This interview is part of the Bass Connections American Predatory Lending and the Global Financial Crisis Project.

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

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Malena Lopez-Sotelo: I'm Malena Lopez-Sotelo, a graduate student at the Fuqua School of Business and member of the Bass Connections American Predatory Lending and the Global Financial Crisis team, and today it is April 13, 2021. I'm currently in Durham for an oral history interview with Dr. Susan Wharton Gates, PhD, and owner and principal at Wharton Policy Group, who has joined us via Zoom. Thank you for joining me today, Dr. Gates.

Susan Wharton Gates: You're welcome, nice to be here.

Malena Lopez-Sotelo: I'd like to start by establishing a bit about your background. I believe that you went to University of Delaware for your undergraduate degree, then went on to receive a master's of public and international affairs at the University of Pittsburgh, and finally earned a PhD in public administration and policy from Virginia Tech. Is that correct?

Susan Wharton Gates: That's right. Thank you.

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

Susan Wharton Gates: After graduate school, I was a presidential management intern at the Office of Management and Budget. I worked for two years in international programs, but then my husband's military career took us overseas for several years. When I came back, I went back to OMB [U.S. Office of Management and Budget].[1] This time, I was all in domestic policy, and I was in charge of [the] president's budget and policy for the Veterans Home Loan Mortgage Program -- my first introduction to residential mortgage lending, albeit coming from the entitlement side, from VA [Veteran Affairs]. So that was how it all started. I really didn't know too much about the topic, but did learn a lot through the experience with VA in terms of lending, underwriting and securitization.

Malena Lopez-Sotelo: What attracted you to this particular space at the OMB specifically?

Susan Wharton Gates: Well, I think I really just wanted a job coming back from Italy for two years. As my children would say, "Mom, when did you know you wanted to work in mortgages?" And I said, "I never knew that." I cared about public policy. I cared about how groups and issues come together between [the] private and public sector to kind of advance public policy. It didn't really matter whether I was working on refugee programs or drug interdiction from foreign countries, that sort of thing. Now, I was working on the VA mortgage program, but I became very passionate about veterans. Some of the folks who worked at VA had been veterans and were disabled, and [they were committed] to making sure that this

[1] Dr. Gates worked at the OMB from 1983-1985 and then again from 1988-1990.

entitlement was available to other veterans, and how could we make this a good use of federal money? Because it was and is an entitlement program.

I might add, it was the first program that actually had 100% financing. So, it was even a better deal than FHA [Federal Home Association], and at the time, and I'm dating myself here, in the 1980s when I was doing this, Freddie [Federal Home Loan Mortgage Corporation, i.e. Freddie Mac] and Fannie [Federal National Mortgage Association, i.e. Fannie Mae] were way on my distant horizon and easily always charging a 20% down payment. So we've really moved along. My whole career in mortgages really spans that sort of very safe and sound, heavy down payments, tight underwriting to, as you mentioned earlier, the wild west of subprime lending, and we just sort of opened the barn door. And now, of course, it's tighter. So, it's a very interesting perspective.

Malena Lopez-Sotelo: During this period of time, when you were first starting out your career, what did the mortgage market really look like at the time in terms of lending practices and more broadly in the United States?

Susan Wharton Gates: Well, I'll say that I spent two years working at OMB overseeing the VA program. At that time, I didn't have too much perspective on the broader market. I did, as I said, see some very traditional lending and underwriting, but we were giving out 100% financing. But again, it was seen as a benefit for our nation's veterans. After two and a half years at OMB doing that, I was able to transition to Freddie Mac in 1990, and my title was economist even though, you just read my training, I'm not trained as an economist. So that was the big joke for me, but I got to do very interesting things.

One of the things I got to do in our financial research department was be the editor of a research magazine, and this introduced me to our chief economist. I would interview him and translate him to the broader public because he was so smart, and I was able to translate. I really began to be sort of a writer and a teller of the story of Freddie Mac, but also the broader market. Over that next 20 years, I would be the teller of the story, whether it was through speeches, through articles, through reports that Freddie Mac put out—including reports on underwriting reports, on predatory lending and later CEO testimony to Congress. Through that whole period, we really began to see the shape of the full market. At that point I learned, VA and FHA are pretty small pieces of the market, and what we call the conventional mortgage market, where Freddie and Fannie play, was a much bigger and more dynamic, muscular part of the market.

But back in the early '90s, everything was locked down, when I started, at 20% down payments, tight underwriting and everything was done manually. It wasn't until the late 1990s that Freddie and Fannie were the first to introduce automated underwriting systems, which attempted to correct for perceived bias in the process, as well as to draw together the new technologies that could better analyze the three C's of underwriting: credit, capacity, and collateral. Those were things that were happening. At the same time, the mortgage research was moving along and [I] really began to see that, Wow, I don't think we really need those 20% down payments anymore. We can lower that. I think that there were big competitive things going on in the marketplace.

But together, between Freddie and Fannie and many of the lenders, we sort of headed in that VA, FHA direction, which was to allow for lower down payments [and] more expansive credit allowances. You didn't have to be a perfect person to get a mortgage. It opened the doors to many other, more diverse sets of borrowers, which is a great thing. That debate continues today. This very day, that debate continues to evolve, but that was the beginning of it in the late 1990s.

Malena Lopez-Sotelo: What kind of institution was Freddie Mac in comparison to all the other players in the mortgage space?

Susan Wharton Gates: Well, coming from OMB, obviously a government agency, [and] VA, a government agency [and a] cabinet agency now, Freddie and Fannie are what they call government-sponsored enterprises or GSEs. Some people call them quasi-governmental. Some people use [unprintable] words to talk about Freddie and Fannie, in that they were in that murky area from a jurisdictional standpoint. So, by the 1990s, we were really a shareholder-owned company.

We had our own board of directors, although a number of the directors were appointed by the president, and we were listed on stock exchanges. And we were starting to grow, and we wanted to feel like we were private companies. But our roots were in federal agencies. Fannie had been part of HUD [U.S. Department of Housing and Urban Development] for a while, part of it was split off to become Ginnie [Government National Mortgage Association, i.e. Ginnie Mae] and Fannie was sent out. We had a little different upbringing in 1970. We were created by the nation's Savings & Loans institutions. So, we existed for them as an entity that would take their mortgages that had been originated out in the nation's Savings & Loans all across the country, and they could sell them to us and we would do their takeout. They would sell us the loan. We relied on the S&Ls to provide us our product, and we packaged the product and made them into securities.

But by like 1989, various things were happening, and the mortgage market was growing. There was a decision—and I think it was bi-partisan at the time, although it's all tangled up in political history—but, in any event, we were set free from the government and off we went, but the problem was we still had this word in our name. We were still called the Federal Home Loan Mortgage Corporation, which has this awful sound of "fhlmc" if you try and make an acronym of it, but the key word in it was "Federal." We were the Federal Home Loan and Fannie was the Federal National. What that conveyed to the listening world, to investors all over the place, was: they're really still part of the government—but we weren't. We were not on budget. And so, we were allowed to grow, and we had massive balance sheet after a time, but no one could ever see it. We really did not have super strong oversight at the time.

Some would say we had very minimal oversight at the time. In another way, I could say that the gripe against us was that we would privatize the profits of our business and socialize the losses, meaning we would keep all the money we'd made, and we made a lot. But, if there was ever a problem, it would go back to the taxpayer, and guess what? That's what happened in 2008.

Malena Lopez-Sotelo: Comparing the early 1990s period to 2008, how did Freddie Mac's services and revenue really change over time, and did its scale and scope of work change over time as well?

Susan Wharton Gates: Yeah, I think that we grew and we grew, just as the mortgage market grew…We were much younger than Fannie Mae. Fannie Mae was way ahead of us in terms of size and networking throughout the country with lenders. Lenders were more likely to sell to Fannie than to Freddie. So, we had a lot of work to do to catch up. But, the main change that happened was, as these new tools came out in the 1990s, Freddie Mac began to feel that we needed to change how we financed our mortgage purchases from lenders. We looked across the river at Fannie Mae, and Fannie Mae didn't do what we were doing. We were packaging loans into securities and selling them to whoever wanted to buy them. By doing that, we were selling off the credit risk. The credit risk means the risk that a borrower is going to default on a mortgage.

For many years, when I worked at Freddie, we would go out there and say, "We're so safe because we securitized like 99% of everything that we purchased. Nothing is hanging around on our balance sheet creating risk for us." Now, we looked over at Fannie Mae, and they were selling some, but they held onto a huge amount of their own mortgage purchases and held them on their balance sheet. And they made lots more money than we did. Of course, there was a time when interest rates changed and Fannie Mae found itself almost insolvent because of that practice, but they got through that. So by the late 1990s, we were hiring people to come down from Wall Street and work for us in Virginia, and we were really trying to be like Fannie Mae and hold onto more of our mortgages.

By putting things on our balance sheet, we began to grow what we called the retained portfolio, the stuff that we were now responsible for and needed to hold capital against to make sure that we would be solvent in a downturn. So not only did we grow bigger in terms of our reach, we were now marketing ourselves—we didn't call ourselves FHLMC anymore. We were going by Freddie Mac, and it was Fannie Mae. We were growing as a size of company. We were growing our [retained] portfolio, and, most of all, we were growing our risk portfolio.

Malena Lopez-Sotelo: You mentioned that Freddie Mac sold securities to whoever wanted to buy them. What did a typical buyer look like at the time?

Susan Wharton Gates: There's better people who worked on the buy and sell sides than me, but many times, because of capital rules, somebody who sold mortgages to us, by doing that, they reduced how much capital they would have to hold against a whole loan. We gave them back the security, and now they could hold less. It could have been that it went right back to the person who originated the mortgages and basically offloaded the risk to us so they didn't have to hold as much capital going forward. Many called that a regulatory arbitrage. That happened a lot. But there were also a lot of pension funds and others that felt that investing in the United States housing market was a good thing. These were seen as very good investments. They had a AAA rating. Even though that's not the same as a treasury bond rating, but still they were seen as very, very safe. Again, that upset a lot of people who felt like we got a better deal than we deserved, meaning we really weren't the United States government, and we should stop acting like it. We were profiting from all of this, right? So the political debates were just huge. That's more the side I was on at Freddie Mac. When CBO [Congressional Budget Office] and OMB put out reports in the early '90s, there were scathing attacks on us—[we were] too big to fail. We were just getting bigger and bigger and bigger. This retained portfolio was the real boogeyman that many policy makers were really worried about.

Malena Lopez-Sotelo: Was the retained portfolio a common trend seen across several private businesses that functioned similarly to Freddie Mac?

Susan Wharton Gates: Well, Fannie Mae could certainly do it, but it did require you to hold [capital]. If you're going to hold onto these assets, you're going to have to have capital, a cushion. You have to hold money back, money you can't spend or buy mortgages. You'd have to put it in the piggy bank as a backup for all this risk. The only two companies that could really borrow as cheaply as we did were us. Meaning we were almost as cheap as the United States Treasury. It was like we could print our own money in a sense. It is a strategy that companies have to figure out how they're going to make money, right? But because our low cost of capital was so advantageous to us, very few could compete in what we were doing.

Malena Lopez-Sotelo: You mentioned the competition factor, the fact that Freddie Mac was younger than Fannie Mae. How did this all contribute to the firm's culture?

Susan Wharton Gates: You did read my book. Remember the old car dealerships? There was Hertz, which was number one, and Avis was number two, and its tagline was "We try harder." I think that when you're in a duopoly, meaning there's really only two players, there's really one player that you're competing against—up until the financial crisis. We can talk about how that competitive landscape changed. But, it caused us to try and do anything to catch up with Fannie and take away some of their market share. So, pricing wars would take place. But also, we changed our structure of our security right as I arrived in Freddie Mac in 1990, in terms of the payment delay that would go to the owner of the security. We thought that this would be a great way to get around Fannie Mae. But, in fact, it backfired. And for many years we had a security that was not as popular in the marketplace, and that cost us a tiny bit of money on every single security we issued. That was only reversed ten years ago. It was really an albatross on

Freddie Mac. Again, we had done that to try and do it as a competitive play, but it didn't work out so well.

I also think inside the company people felt unsure about how to get ahead. I think that some people wanted to be as big and bold as Fannie Mae. I might add, at the same time that Fannie was growing its portfolio and making lots of money, they also commanded the public policy space as kind of being the most pro-homeowner company. Freddie Mac was born by a bunch of economists, and one of our early marketing icons was a gnome. You know, like these shriveled up little entities that just had dark eyeshades on and do all the math and calculate the money. We were seen as very risk-averse, which we were. And that was a good thing, except it became a bad thing. It didn't win you any political points to say, "Yeah, but we've never had a crisis, and we don't have any risk." And the retort to that was, "Yeah, but you're not helping enough people. You're just purchasing the mortgages that are safe and easy; the white bread mortgages, if you will, the vanilla product, you're not taking any risks." Over there across the river was Fannie Mae: big, huge, very powerful. From all the books that have been written, you learn about how powerful they were, how powerful they were politically, how they would twist arms and play real dirty pool, politically. But they were making money, and they were seen as being really good and really progressive and out there and expanding the envelope. So we would, at Freddie, [think] it seemed impossible to try and catch up. And so the basic market share was 60/40 for the 20 years that I was there.

Malena Lopez-Sotelo: I understand you started your role as the director of public policy at Freddie Mac and then moved on as VP of public policy. What were a couple of the key policies you oversaw during that timeframe?

Susan Wharton Gates: Well, that's probably what my LinkedIn profile says, but I really did start as an economist. Then a few years later [I] ended up in a kind of a new world of public policy. But, in between that, I did board reporting on credit risk oversight. I managed a magazine. I was a speech writer. I did a variety of different kinds of things. But once I got into public policy, that first position was located in DC in our government affairs office, which really is the lobbying shop. I was not a lobbyist, not a registered lobbyist, but I worked for the top lobbyists, and I was the person who did the research.

One of the first things I did was on minority homeownership. I was asked to research, not just kind of empirically where the differences in homeownership rates, which are stark. I might say that this, again, this debate—I'm working on some research related to this right now, in underwriting and collateral assessment, particularly. But if we scroll back to the year 1999, when North Carolina put its first anti-predatory law in place, where there was great concern about this growing disparity between homeownership rates, particularly African American to white and as well as Hispanic, I was tasked to go learn about that and not just deal with, say, the Joint Center [Joint Center for Housing Studies] up in Harvard and understand the data and the numbers, but also how did we get here? What have been the policies? How did the legacy of discrimination that came through FHA, particularly, impact where we are today? Even going back to early debates, 19th century sort of stuff, trying to kind of unpack where we were and then how major pieces of housing legislation had attempted to deal with that. Fannie Mae had come out with this huge announcement. They called it the trillion dollar initiative, that they were going to expand homeownership. And we thought, "Oh my goodness, this is just hyperbole." But we wanted to come up with something that we felt was credible.

One of the big projects I did there was focused on what were twenty-five initiatives that Freddie could do to take down barriers? These would seem incredibly quaint by today's standard, but it was a start. But it was public policy that had a real political angle too. And that is sort of where I began to sour once I saw under the hood how the politics were done in the mortgage world. You need a strong fiber constitution to kind of look at that and understand that a lot of it is tied into political vote-winning, by demographic, by racial and ethnic group, [and] that homeownership is up there with apple pie, baseball and hotdogs. I mean, it is the icon of America, and it was for sale. How that was playing out politically is really why I ended up writing a book about it.

Malena Lopez-Sotelo: Can you describe a couple of the policies that came into play to address these disparities between minorities and their homeownership rights that you were discussing?

Susan Wharton Gates: Yeah, I mean, just on the technology front, I wrote a piece. I think it's in *Housing Policy Debate*. I don't remember what year it came out, but we did a study of our automated underwriting systems, which were also getting people really worried, and they still are, about what they called a black box. Let's feed this model all this personal data, and then we'll spit out an answer whether we're going to buy your mortgage or not. The idea was, well, if everybody had the same data, then we could kind of evaluate this without any fear of discrimination coming in. But just like you know about data—SAT [the Standardized Aptitude Test] scores and other things—there are implicit biases in the basic data, whether it's FICO [Fair Isaac Corporation] score, credit. We're now looking at collateral and how that is evaluated. We did an experiment at Freddie Mac where it was like, let's run through all of our loans and see what's coming out as being rejected. And then let's run the rejections back through. And through other different adjustments that were made, we actually were able to boost the acceptance rate by what we call the second level approach.

That was just the tip of the iceberg of trying to figure out how to use technology [and] how to use the empirics. Our old understanding of what created risk—like low down payments, we always felt was associated with higher risks and it is—but are there what they used to call compensating factors that would make up for that? And you could do all of that mathematically. I am not a mathematician, but I would sit in these people's office who were way smarter than me and I would understand what they're doing and then I would write about it. That was what was happening kind of empirically with the financial economists. Then, on the marketing side they were starting to finally publish mortgage documents in

Spanish and other languages. There was more of an attempt to work with banks and lending institutions that had pulled back from urban areas to expand opportunities in those spaces where there was not a lot of buying and of houses going on. …And we were alerting people to the problems with predatory lending…. Because what was happening at the time, in the early 2000s, [even] 1999, was that Freddie and Fannie began to lose a grip on the whole market. Meaning we were seen before that as like “Mother, may I?” To get anything done, it had to be approved by Freddie and Fannie. We just commanded such a big space. There was no other source of money to go to if a lender wanted to make a loan. Our underwriting standard was the gold standard. And if we purchased a loan, that was like a good housekeeping seal of approval. But what began to be happening was it seemed like things were, I used to say, "The sun was out in the mortgage market. Nobody worried about risk anymore."

We have this amnesia every ten years, [and] we completely forget about everything that just happened. Because there had been some real calamities with low documentation loans and other types of lending that were niche products that sort of escaped like nanobots into the mortgage environment, like viruses, and then contaminated everything. In the late 1990s, people were getting a little irritated having to do what Freddie and Fannie said, and Wall Street came along and goes, “Hey, you don't have to deal with Freddie and Fannie anymore. We'll give you the money.” There was a runaround us. “And you know what? We have figured out how to securitize things without those two monsters, [without] needing…that seal of approval.” And Wall Street, in financial structuring terms, was brilliant and dastardly all at the same time. They came up with this cascade of securitization structures that was very mathematically based, and it would allow an entity to purchase mortgages with this senior subordinated structure and not have to get a guarantee from Freddie Mac.

What that led to was the rise of very small entities that later became associated with predatory lending, or subprime lending, I should say. I don't want to at all imply that everybody who was in a subprime space was a predator, but that is where primarily the problem was—AmeriQuest, New Century [New Century Financial Corporation], I think was another one. But when these small standalone entities started to do a lot of business being financed through Wall Street investment banks, primarily, the more stable well-known household term names of banks you would know, [such as] Bank of America, Countrywide, mortgage originators, [and] Wells Fargo created their own shops, so to speak—little subsidiaries that would deal directly in the subprime space. I think I'll pause here just to say subprime still doesn't have a good definition. In legal documents that go way, way back, the idea was, well, you know it when you see it. It's sort of like pornography, and that is part of the problem. And these mortgages, this type of lending was done at the state level or it was regulated at the state level. There weren't really national standards to deal with it.

Malena Lopez-Sotelo: You mentioned that Wall Street came in and started providing this securitization service. What kind of market share loss reactions from Freddie Mac did you start to see during that time?

Susan Wharton Gates: Well, as I said, we had a comfortable 60/40 with Fannie and that began to erode as both of us lost share to Wall Street. I can't give you the full numbers, it's [been] decades since. …[I]t was a significant hit to the bottom line. The term at Freddie Mac that we used politically was, we're becoming irrelevant. And irrelevant meant that people were not selling us as many mortgages as they used to. So, there wasn't just a loss of market share, but what was happening, because many of our traditional customers were running after the pied piper of Wall Street, is that in order for us to compete they would say, "Well, we'll bring our mortgages back to you, but you have to allow no income, no asset documentation loans. You have to allow really low FICO loans. You have to allow loans without documentation." What really happened was we were not used to that, anybody talking back to us. It was our way or the highway. Now, there was another highway and they were beginning to press on us.

I'll end on Fannie and, I think, the famous account of Angelo Mozilo, from Countrywide, basically going, "It's a stickup. No, you're irrelevant. We're commanding. You have to bend to us now." This was significant both from a financial perspective and from a policy perspective in terms of who were we really as a company, but we had never been tested like this before. It's fine to go out there and say we're up there with mom, apple pie and baseball, and we care about the American homeowner. But, are we going to now finance loans that we and our smart researchers know are going to have a higher risk of default and are not good for people? Are we going to finance that just so we can stay competitive and not lose too much money? And that, in my book, is what I call the battle for credit leadership. Are we going to be leaders? [Or] are we going to be followers? Are we going to lower our standards to keep making money? Or are we going to take the high road and take the hit? That really was the debate at Freddie for at least five years leading up to the financial crisis. If you don't know how the story ends, we did not take the high road. We did invest in very risky things. When things fell apart, so did we.

Malena Lopez-Sotelo: Did regulators ever come into play while these changes were going on?

Susan Wharton Gates: There was a law in 1994 called HOEPA, the Home Ownership and Equity Protection Act of 1994, and this gave authority to the chairman of the Federal Reserve to set standards as to what was a good loan. Basically, the idea was if a loan either had too high of an interest rate or it charged too much in terms of points and fees, that it would be flagged as a HOEPA loan. It wasn't illegal, but the idea was [to] make it a pariah. And so any lender that was coming to Freddie said, "Well, here's this loan." We looked at it and we would go, "That's a HOEPA loan, we don't want it." The problem was that it wasn't enforced. It wasn't illegal. After a while, lenders learned how to just duck right under the requirements and bring us stuff to buy that was just about as bad, if not just the same. So the big rap against Chairman Greenspan, head of the Federal Reserve at the time, was that he failed to put out implementing regulations that had any teeth into them on HOEPA standards.

So, one of the very early [instances], when we didn't even know what predatory lending was, we didn't really know we were testing the subprime market, everybody was new at this game. But it was when Martin Eakes from North Carolina, from the Center for Responsible Lending, came to Freddie Mac in 1999, [he] said, "We just passed this law, and if you buy this stuff, you're participating. You're aiding and abetting predatory lenders." We didn't even know what that word meant. Moreover, the loans that were being made were legal loans. You can see the dilemma, both for Freddie and Fannie or any major bank. It's like, okay, they're legal. Who are we to say that people can't have those loans? The states have determined they're legal loans. There's no federal standard. It could be a good loan for some people. It may be a bad loan for others. It was a very difficult conversation to have.

One of the first responses to that conversation was, "Okay, fine. We won't buy any HOEPA loans." But that was a very minimum standard at the time, and we eventually ramped up the things we wouldn't buy. But, again, it was a whole new brave world. There was a lot of pushback inside Freddie… about being told what to do by a consumer advocate as not something that a Fortune 500 company did really easily at the time. We just thought, "Well, if a consumer wants this mortgage, who are we to say they can't have it?" There was also this sense of freedom, consumer choice, and there weren't a lot of data on how these things would perform. Again, if everything went well and house prices kept rising, it was like musical chairs. The music would play on and on and on, and it would work. But unfortunately house prices began to tumble, fears came into the market, and then the whole thing collapsed.

Malena Lopez-Sotelo: In terms of where Freddie Mac plays in the mortgage field, can you define what the secondary market is, and what you define its purpose as being?

Susan Wharton Gates: …In the mortgage world, there's two levels, or two markets. The primary market—that's the part of the market that touches the consumer directly. That would be your bank, your real estate agent, the title insurer. That market where you want to sell your house or you want to buy a house. [It] would be the people you interact with and you see them. You know them. You deal with them. You pay them money, et cetera. What happens next is behind the scenes and most consumers don't even know that it's happening. But, after it's all done with you at the closing table, you have the keys. You go off and enjoy your house. At that moment, that mortgage, that debt that you promise to repay, it's a promissory note, that got sold to a Freddie or Fannie. Now, the plan to sell that had happened before when you were negotiating for a rate and they said, "Okay, we'll give you 5% and we'll lock you in as of September 1. And even if rates go up you can still have that rate." And you went, "Great". You had no idea how that magic would happen. You didn't care. But, behind the scenes, a contract had been set up with your loan and many, many others to say a delivery from Bank of America to Freddie Mac, with mortgages originated around this time could have a rate-lock sixty days earlier of September first.

That financing mechanism is what we call the secondary market, where the lender now is turning to sell your mortgage to Freddie Mac or Fannie Mae. Maybe it's a big lender and they're bundling together their mortgages and selling them in a big bunch. Or maybe it's a small lender and they're just selling onesy twosy. They go up to Freddie and Fannie, at which point we bundle them together into larger securities with different characteristics based on interest rate, location, [and] type of mortgage. Then, these are either sold back to the originator or they're sold to other entities looking for a good investment—a safe investment that paid a little bit more than a treasury bond. That secondary marketplace is the secondary financing of the mortgage. It involves Freddie and Fannie [and], when we were in subprime, that was the investment banks of Wall Street. Then, it involves all these other players overseas who are buying these securities.

There's one last piece I haven't mentioned, but you might say, "How do you hold all this? How do you buy all these mortgages, Freddie Mac, if you're holding them on your balance sheet?" Meaning you're not selling them to somebody to get the money back. That's when we began issuing debt securities. That's where we really began to look like the United States Treasury issuing debt, not in the name of the United States government, but in the name of Freddie and Fannie. Every piece of paper we put out said, "Buyer beware, these are not backed by the federal government—wink, wink!" But, in fact, they traded almost as if they were. That was what we called the implicit guarantee. That confusion about the GSE status led to some unfortunate outcomes. That's the purpose of the secondary market. [Despite what happened in 2008] I'll just say that it's a beautiful thing. We need the market because it allows the money to keep circulating, and Freddie would be able to get money from all over the world and bring it into the US housing market, and that's a really good thing.

Malena Lopez-Sotelo: It sounds like as mortgages made their way across the securitization process, perhaps the further down you go, the less transparency there is around the original homeowner, home buyer. Do you think that more transparency or connection to the original root homeowner, home buyer would have changed any of the processes or risks along the way?

Susan Wharton Gates: Well, it'd be great if we could all live in the world of *It's a Wonderful Life* where Jimmy Stewart knew every single person who wanted to borrow money from the bank, and he could lend knowing what he was doing, and people had that relationship. We just don't live in a world like that. There will never be a way that a GSE can know and have this touch factor with the original homeowner. That's why we rely on the banks to protect the interests of the homeowner. Regulations are put in place by Freddie and Fannie that say, "We don't want any mortgages that are hurtful to borrowers. And lender, it's your job to figure that out. Here's a bunch of guidelines." Then regulators come in and FHA or CFPB [Consumer Financial Protection Bureau] are out saying, "This is bad. This is bad.

Don't do that." Then we have to check and make sure they're not sending that in. It's really what they would call a system of representation and warrant. There has to be trust between the GSE, or the final purchaser, the investor, and the lender who made the mortgage in the first place.

In my book, one of my colleagues had said, "Try to explain this to the consumer advocates." We can't tell that every loan is perfect. If you remember Pinocchio, we're like the whale in Pinocchio. We open our mouth—we're Monstro—half the sea comes into our mouth, and we swallow it. It's only later we're able to figure out if we bought something we shouldn't have bought. So we use regulation, we use requirements, and contract language with our lenders, to say, "Don't bring us anything that's not good for homeowners." Of course, those standards all fell apart when the subprime place really got taken advantage of. Many people were hurt and got mortgages that they could not afford to repay, and they ended up losing their homes.

Malena Lopez-Sotelo: Pivoting to post-2008 in your role at Freddie Mac, how did your role change in scope and responsibility from VP of public policy to VP of corporate strategy?

Susan Wharton Gates: Well, that was mostly after 2008. I guess this was before the failure of the company. But things were just very difficult, and I felt like I could no longer really—no one trusted anything Freddie said. I felt that the role had sort of atrophied. And I thought that given the crisis that was beginning to unfold, moving into a strategic place where we could finally deal with our existential crisis of, "Are we a Fortune 500 company? Fortune 100 company?" Or do we have some responsibility [of] submission to the public by virtue of our founding, by virtue of all the corporate benefits that we enjoy? Can we thread the needle? Can we triangulate that tension? Of course, I had no idea that the dice had already been rolled. I think I came in in January and we were in conservatorship nine months later, meaning that so many of the decisions had already played out, and there was really no guiding the ship. It was just about to hit the iceberg when I moved into strategy.

So, it was a sad ending for me to kind of go, "You know what? I think I'm done here." Because I'm a writer and a communicator. Once Freddie was taken over by the government, you couldn't say a word. There was really no point of it. We couldn't communicate at all. I want to say, because I know your guys are interested in North Carolina. But I'd just like to roll back, if I could, one minute here and mention, from 1999 to 2003, North Carolina put out the first-in-the-nation anti-predatory lending strategy or legislation at a state-level. I have to give great credit to CRL [Center for Responsible Lending] and the other lawmakers down there that did that, and then they came and gave us a hard time. While that was unpleasant at the time, it was a good thing to do.

But their law didn't have any teeth in it. It was sort of like HOEPA. It was the right thing to do, but in a competitive marketplace, if things don't have bite, sometimes they don't make any change. It was Georgia that came along in 2003 with their GAFLA [Georgia Fair Lending Act] that actually had teeth. And it had a provision called assignee liability that said, even if you're Monstro, and you're buying these, and they're coming into your mouth, and there's no way you can check every loan that you better have the policies in place to show that you are not supporting predatory lending. Because, if you do, you'll be open to class action lawsuits on a big scale, meaning they were going to now hold people accountable up the chain—people in Wall Street, high rise skyscrapers. The suits would now be accountable for what lenders in Georgia were doing. This was huge.

This was Bunker Hill. This was a real attack on the secondary market. As I explained, we were separate entities, and now they were saying, "All the practices and the primary market, they're not just staying in the primary market. You are now responsible for them even though you weren't there at the closing table." And that led to some really ugly political things happening in the state of Georgia. Freddie and Fannie and many other entities said, "We don't like this law, and we're going to pull out of the state." There were a lot of showdown things that happened that were pretty ugly. Georgia, even after the crisis ten years later was pretty sore about those things. I don't blame them. That, again, is a chapter in my book. It was called "The Night the Lights Went Out in Georgia," because it was pretty ugly. But the point was we didn't know how to deal with that as a secondary market. We just didn't know how to deal with it. I might add, later, if you've talked to your banking people that they came up with this national preemption that said, even if Georgia's law says that, we're going to allow our federally chartered banks to disregard that. And that hurt Georgia too. There is a federal issue.

Now I'm speaking in terms of my academic role, there is a federalism issue that is, what is the federal government's role? What are the states allowed to do? Can they go out ahead of the federal government, in terms of putting out more stringent standards? This could happen in everything from environmental policy or anything else, but it really hasn't been resolved because the crisis happened. Freddie and Fannie were put on the sidelines. We were now backed with full faith and credit. We were essentially government agencies, but nobody's really solved the real problem. Dodd-Frank [Dodd-Frank Wall Street Reform and Consumer Protection Act] did put in place a number of stringent rules, and some of those may be getting to be undone. Again, it's a trade-off. The looser the requirements are, the more people that will come into the market. Is that a good thing? It's a good thing as long as they can hold onto those mortgages. If things get rough, like you have a pandemic, anybody who came in that wasn't as strongly financially ready for that would be more at risk of losing their home. That's the job of the policy maker is to find that balance.

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

Susan Wharton Gates: That's another book. I've been on the sidelines of the mortgage market. I do research on the side, and I teach, and I am a small business owner. But I keep an eye on the market. I think that one problem is that we really haven't learned what we needed to learn, and we sort of put everybody in a freeze frame, and we really haven't solved things. So Freddie and Fannie used to be vibrant companies. They're just sort of stuck. I know the regulator is trying to move them forward, but it requires political consensus and bi-partisanship to move them to a stable future. I don't see that happening. So, we're stuck. Secondly, I think we continue to see homeownership as the be-all end-all. I understand that. Right now, house prices have risen through the roof and guess what? It's really good for people who own their homes, but it's a huge barrier for people who don't. This wealth differential we worried about twenty years ago is only going to expand. People have to have a place to live, but it doesn't always have to require a thirty-year mortgage. To place that kind of debt on people, if they're ready and want to do it and the world is great and the house prices don't fall out of the pandemic, it's awesome.

But it is a huge asset, and there are risks to it. Expanding the other assets that people could invest in and grow well would be nice so that it's not all about trading up and being the most over-housed nation in the world, as we are. Yet, we have terrible homelessness [rates], too. The mortgage interest tax deduction that we give people encourages home building, bigger homes, and it disproportionately benefits the wealthy people. The IMF [International Monetary Fund] might look at the United States and go, "You guys are nuts. You spend way more than you should on homeownership, in terms of subsidy and who's benefiting. Maybe you should've built some more great rental communities or more affordable housing and change your tax code and get Freddie and Fannie into a position where they're competing with other [companies] and figure it out. Solve the problem. Flush the toilet." I hate to use that term, but let's just move on. Lastly, the debates I hear that we need to expand underwriting—I've been there, done that. I'm telling people that risk is risk, and the whole system relies on stable underwriting. Does that mean that some people are not going to get mortgages? It does. Let's make sure that's a fair process, but that's what makes the system work ultimately. I guess that's all I have to say on that subject.

Malena Lopez-Sotelo: Thank you so much for joining us, Dr. Gates, that concludes our interview.

[END OF SESSION]