AMERICAN PREDATORY LENDING AND THE GLOBAL FINANCIAL CRISIS

ORAL HISTORY PROJECT

Interview with

Ron Cathcart

Bass Connections

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PREFACE

The following Oral History is the result of a recorded interview with Ron Cathcart, conducted by Maria Paz Rios on March 25, 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: Ron Cathcart	Location: By Zoom
Interviewer: Maria Paz Rios	Date: March 25, 2021

Maria Paz Rios: I'm Maria Paz Rios, an undergraduate student and member of the Bass Connections American Predatory Lending and the Global Financial Crisis team, and it is March 25, 2021. I am currently in Durham for an oral history interview with Mr. Ron Cathcart, currently Managing Director and Head of Risk Practice at Promontory Financial Group, who's joined me via Zoom. Thank you, Mr. Cathcart, for joining me today.

Ron Cathcart: Thank you.

Maria Paz Rios: I'd like to start by establishing a bit about your background. I understand you received your Bachelor's Degree from Dartmouth and also received an MBA from the Ivey Business School at Western University. Is that right?

Ron Cathcart: Yes.

Maria Paz Rios: When and how did you first get involved in enterprise risk management?

Ron Cathcart: Well, I started off in banking in 1982 with RBC [Royal Bank of Canada] and after a number of jobs in the first-line working in Paris and in London, I ended up in credit policy in the mid '80s. And after credit policy, I ended up doing more of credit work and then what happened with the banking sector was that credit jobs became kind of the central point that risk management evolved from. And I followed that evolution through my career and stayed in risk management pretty much until now.

Maria Paz Rios: How did your responsibilities evolve over time within the risk management field as you transitioned into more senior roles?

Ron Cathcart: Well I started in credit policy, as I said. That was in 1985, and then I moved into securitization and a number of credit positions. Ultimately, I was the head of credit for western Canada and then became the head of credit and head of risk management for the personal and commercial bank at RBC, which was the bulk of their business— middle market and consumer. I left RBC as the chief risk officer [for] personal and commercial banking in about 2000 and joined Jamie Dimon at Bank One where he had come to take over the bank in about 2000. I was his chief risk officer [for] retail at the time, which obviously had a huge credit component. Subsequent to that, I was the chief risk officer of CIBC [Canadian Imperial Bank of Commerce] in Toronto for a period of about two and a half years, and then assumed the position of chief risk officer of Washington Mutual. Sorry, to correct that, I was the chief risk officer [for] retail at CIBC, and then I took the broader role of chief risk officer for the entire company when I joined Washington Mutual in December 2005.

Maria Paz Rios: … Could you talk to us a bit about how the culture within the company [Bank One] was and what the role of risk management within the company was?

Ron Cathcart: Yes, I was the chief risk officer retail at Bank One, and my responsibility was to review all of the retail business that Bank One was doing, which included a very large credit card portfolio because they had purchased First USA, a very large automotive leasing, automotive financing, some mortgages, middle market lending— that was pretty much the portfolio. It was probably about $150 billion. And my role was to do what risk management does, which was to measure, monitor, and control risk within those portfolios. So what our team did was evaluate the quality of credit management and the quality of the portfolio, determining whether the standards were appropriate, whether they were being properly implemented and monitored, and then to do analysis as to what the trends were in the portfolio to be able to report to senior management and to the board where loss was embedded. We also had responsibility for establishing the credit reserves, or the provision for credit loss and the allowance for loan and lease losses, which was an important activity from a credit perspective.

Maria Paz Rios: What were some of the trends that you were seeing regarding credit extension at that time?

Ron Cathcart: Well, that takes the period of 2000 through to sort of about four years later. And, as you recall, the unemployment rate in the US in 2000 was 3.9%. So it was an incredibly strong economic time, similar actually to 2019, before the crisis. In fact, unemployment was similarly as low as that. The economy was booming and then there was a mini recession, I think 2001, brought on in part or connected maybe with the technology bust which occurred in March 2001. What we were seeing, in many ways, was very specific to Bank One. And in the case of Bank One, risk controls were not properly embedded in the organization and reporting was difficult because of the multiple systems that had resulted from the fact that Bank One, in fact what at the time was called the uncommon partnership, which meant that it was really the amalgam of a number of very small banks that had been serially acquired over the period of 10 years. So it was difficult to get a handle on the risk profile. So a major part of what we did was to try and aggregate risk exposures.

The other thing that happened during that time that was particular and specific to that era was that used car prices declined significantly because the economy was so strong. The preference was to buy new cars, and there was also a big shift to big SUV's. So at the same time as used car prices declined, more expensive cars became less valuable and it had a big impact on Bank One's automotive portfolio. So it fell on my group to quantify the amount of reserves necessary to underpin that loss. That's sort of an example of the type of work that we did, but obviously it would take a lot longer for me to explain all of the functions that our group fulfilled while I was at Bank One.

Maria Paz Rios: How would you describe the change in lending practices in the overall market, regarding retail, mortgages, in the early 2000s? I would also be interested to know how automated underwriting impacted this as well.

Ron Cathcart: We submitted our report every quarter to the Fed and, as you know, the Federal Reserve does a report on lending appetite or lending trends among banks, and whether credit is being pulled back or whether it's being extended. During that period, the reporting was that credit was being increasingly made available. This was a period of time when client relationship management was a big buzz word, CRM, and banks were working very hard to try and mine the data that they had to find opportunities of particular segments of their borrowers or their depositors who would be credit worthy. As I recall, we even had a product for a cohort of people, called "credit seekers", which was actually designed to try and identify people who needed credit. Fair Isaac[1] was very involved in developing a number of new models at the time.

So this was an era when statistical modeling became more and more important and significant in making lending decisions for individuals. At the same time, regulators started being concerned about things like fair lending and red lining and other issues on the compliance side that had to do with disparate treatment, and discriminatory lending. So it was a very interesting period of credit expansion. And if you look at the credit card balances, they started trending towards a trillion dollars for the first time in history. And as I said, in terms of car lending, the car lease was a big business. It eventually blew up for the very reasons that I described, because used car prices were unpredictable and that was the way banks got repaid. When people stopped paying, they didn't get repaid by the customer, they got repaid by the car. And so increasingly, banks started leaving that area and leaving car leasing to the automotive companies who had an incentive to actually grant the credit beyond just the credit spread. But there were a lot of trends that were emerging during that period that increased availability, along with government policy which had as an objective increasing homeownership.

Maria Paz Rios: How did risk management practices adapt to this extension of credit?

Ron Cathcart: Well, risk management was a voracious user of data. So a huge amount of effort was put into capturing the right data and then building models to try and understand the underlying trends that were embedded in the portfolio. So we would look at what came in the door in terms of the credit profile, risk credit ratings. And then we would look at trends in the portfolio. We started trying to match behaviors within the checking account to behaviors in the loan account, behaviors in mortgages as compared to lines of credit or credit cards. The biggest challenge that we faced at Bank One, and I think this was universal across the banking industry, is that a lot of the loan systems had been established on different platforms to support different businesses or even different banks whose systems were never consolidated. And as a result, it was

[1] Fair, Isaac, and Co

very difficult to develop a customer centric view. So you could know what was happening in the mortgage portfolio and you would know what was happening in the credit card portfolio, but you wouldn't necessarily know if one individual was having a problem in both at the same time, because those databases didn't speak to one another. There were a whole lot of issues that you could get me going for a number of hours, but I would say increased analytics, credit expansion, increased government scrutiny.

Maria Paz Rios: What led you to move to CIBC?

Ron Cathcart: I was headhunted by a recruitment firm and they had an undeveloped risk management function for their retail portfolio. They had a very small team and the risk management was highly decentralized. And I was brought in to centralize it and to create some credit and risk management discipline.

Maria Paz Rios: What were some of the challenges of going into a smaller risk management group and trying to incorporate all these data analytics and even in getting the data? How did you navigate these challenges?

Ron Cathcart: Well, first of all, the role of any risk officer who's successful is to be relevant. And so even with a small team, you're able to distill information and provide analysis, which gives management and the board insight into trends that are not being brought forward necessarily by the business. The business may be focused on market share, revenue growth, customer penetration, things like that, but that may drive the business, for example, to go through certain channels, like indirect, where it's buying loan portfolios from third parties, as opposed to direct where it's lending money directly itself to customers. Those sorts of dynamics within a portfolio were not always evident to senior management or to the board. They aren't necessarily called out or reported on, or even analyzed that closely by the business.

Risk management has a role to play in dis-aggregating trends, looking at underlying dynamics, and then coming up with observations that add value to the decision-making. So that yes, we may want to grow market share by two percentage points, but if the way we're doing it is buying loans in the secondary market, they have a loss rate that's four times the loss rate of direct loans. So in fact, we're buying a lot of credit costs that weren't built into the forecast because we were using a forecast based on the "before the change" data. So that's an example. But, in addition to that, a certain amount of regulatory oversight, in that case, was brought to bear. The regulators wanted to see the emergence of what we would now call second line, whose role it was to provide independent assessment and a challenge to the business. And clearly it was very difficult to do that with a very small team. So what ended up happening was that most of the risk of the credit resources that were within the businesses were transferred into my group. And so I ended up having a group of about a thousand people instead of a dozen or so.

Maria Paz Rios: Looking back on your years, both at Bank One and CIBC, how would you characterize the role of regulators in relation to your risk management team?

Ron Cathcart: Up until 2008, and I think we have to draw a sharp line after that because there was a very dramatic change, I would say that regulators were very enabling of banks generally. This was the period of time when economic capital was the preferred way of measuring risk. And as all of you well know, economic capital is statistically based on history and based on some assumption about confidence intervals and so on. It turns out it didn't work. It was a big failure. It resulted in banks having a great deal less capital than they needed for the crisis. It was also an era of hybrid capital, where there were all these newly developed ideas of pseudo capital, like perpetual prefers [perpetual preferred stock] and convertibles [convertible debt], and so on that counted towards capital to an extent, which turned out not to be capital when the risks emerged in the portfolio. So the regulators were starting to use a lot of analytics, that it turned out really were not the best representation of risk. And probably, as I said, because the philosophy was very much towards consumer growth and especially homeownership, there was a certain permissiveness I would say? to the regulators that was evident up until 2008.

Maria Paz Rios: Could you describe how you think these policies [of homeownership] affected the change in lending practices and the mortgage space in the 2000s?

Ron Cathcart: Well, in terms of mortgages, I would say that most people thought they were risk-free. The bulk of our mortgages were being originated at 80% [down payment]. And then above that, then there'd be mortgage insurance that could take you as high as 90%, but the traditional 30 year mortgage was 80%. And the feeling was that at 80%, the bank was pretty much unable to lose money. A little known fact, and this fluctuates quite a bit, is that in the cases where banks actually do take possession of homes, they end up getting about 83% value. The rest of it goes to costs associated with collections and foreclosure and delays in time value of money and so on. So at 80% really at the moment that a bank advances its funds, it's pretty much in a break-even position, it would have to take possession the following day.

So there's a certain assumption that prices would continue to rise, as they have, you know, for the last 100 years so to speak, more or less. And aside from some regional fluctuations, from a national perspective, it was sort of seen to be a safe bet. So I don't think that the regulators paid a lot of attention to that risk. They focused a lot more on credit card [risk]. Credit card was an area where the math that I described earlier was being very, very much [brought?] to bear. And financial institutions were getting very smug in their ability to predict how people would behave and which client selection— remember, every day in the mail, there was a request— well, you probably don't remember, but there was an offer for credit card every day in the mail. And they were like, guaranteed, you can have a line of credit of $15,000.

And then the government had this whole idea of, "How is it okay to say to everyone, you're going to get $15,000, when in fact the average lines end up being like $8,000" Well then the government actually had a soft guideline where it had this "up to %". And it said, "You had to have a certain number of people, a percentage of people who get this 15% in order to advertise that you could have up to 15%", in order for that statement to be true. A lot of this "angels on the head of a pin twisting" to try and make this incredibly aggressive credit growth, business world, something which banks could do within reasonable guidelines. And I would say that, as I said, the regulators were on their back foot a lot of this time. You probably also know this, with the time of Gramm-Leach-Bliley. Just earlier on in that period, that was when the barrier between investment banks and banks were brought down as a result of a number of things like Sandy Weill and pressure and so on. This was the era of [Alan] Greenspan, which was, for lack of a better word, a fairly laissez-fair Federal Reserve. There was the OTS, if you remember the Office of Thrift Supervision, which was eliminated under Dodd-Frank. It oversaw the thrifts— the thrifts were mortgage banks, and the Office of Thrift Supervision was very unsophisticated and very permissive of the organizations it oversaw. You had the Federal Home Loan System, which was considered to be a zero-risk system, which actually, as we know, in 2009 had its own fair share of problems and had shared equity among the home loan banks and a shortage of equity. So it was all building to where 2008 in retrospect became kind of an inevitable outcome.

Maria Paz Rios: What were some of the primary lessons and management practices that you learned in your previous CRO [chief risk officer] positions and you brought into Washington Mutual?

Ron Cathcart: I think that in order for risk to be successful as a second line function and to have the ability to provide independent risk management to bear on any company, that it's necessary for risk to have control over risk resources. And so one of the philosophies, or principles, that I arrived in, was the belief that in order to provide the board with robust risk management, I needed to have risk management resources which reported solely to risk management. And Washington Mutual had a bit of a soft and an indistinct management structure where that became not so clear. And that was always a challenge while I was there. But then, you know, other principles— I mean, after many years, as you imagined, I had a whole lot of kind of predispositions. One of them was that analysis was the center of risk, that it wasn't appropriate just to have a suspicion or a feeling or a sense of things. That it needed to be backed up by an analysis, looking at underlying trends, which required a lot of data. So focusing on gathering [the] right data. Some portfolios in Washington Mutual had great infrastructure and a really good control of data. Some had very little, if any at all. And in fact, I think you could probably predict what they were— the ones that had very weak analytics associated with them, with the mortgage portfolio, as compared to say the credit card portfolio.

And the reason the credit card portfolio was very well-disciplined was because Washington Mutual had purchased it at the end of 2005 and it was previously

Providian. And Providian was the firm that almost failed because of its over-aggressive subprime lending. And Providian was overseen very aggressively by the OCC [Office of the Comptroller of the Currency] for a period of maybe even eight years or so. And as a result of it, it had very robust risk management, and it had a great infrastructure. And at the time that Washington Mutual purchased it, it was pretty much state of the art in terms of risk management. So you can imagine that as chief risk officer you are overseeing a very broad range of portfolios and businesses, commercial mortgages and mortgages, a small business, credit card. They're all going to behave differently and they're all going to have various strengths.

Maria Paz Rios: Could you talk us through how you restructured enterprise risk management and divisional oversight within Washington Mutual when you first joined?

Ron Cathcart: Yes. There were four essential divisions, I pretty much just named them. Retail, which was the retail clients and the branches, the commercial mortgage business, which was mostly multi-family, the credit card business, and the mortgage business, which was called Home Loans [Group]. And what I did was I appointed a chief risk officer over each of those businesses. And I also had a specialized risk skills [team], and so there were another five people that reported to me. One was the head of credit risk, market risk, operational risk, and a chief of staff. And as time went on, laterally, I also appointed a head of, of liquidity risk. So the primary risks had risk heads and the primary businesses had dedicated risk heads. Each of these people had their own team. So we ended up becoming a hybrid of both business specific, which were generalists risk roles, and the highly disciplined— if I didn't mention credit, I should've mentioned chief credit officer as well— operational, market, liquidity, credit, and then a chief of staff.

One of the challenges of Washington Mutual was that I was never successful in getting the chief risk officers to report wholly to me. Those responsibilities were always a shared resource between risk management and the businesses themselves. So they were double reporting relationships, which nowadays wouldn't be allowed, but having lived through it, I would tell you that it's not an optimal organizational design in any case. It should have been direct to risk. I'm not saying the outcome would have been different, I'm just saying from a risk management perspective, from a good governance perspective, three lines of defense, the arrangement that existed at Washington Mutual would not be allowed today by the regulators.

Maria Paz Rios: Did having the CROs report to the business unit leader and also to you cause any disagreements between you and the business unit heads?

Ron Cathcart: Of course it did. Depending on the business, some businesses were more prepared to cooperate with risk than others. But yes, absolutely, it resulted in disagreements.

Maria Paz Rios: How did you come to terms with that, especially with the business units that they did not want to collaborate with you as much? What were those conversations like?

Ron Cathcart: Well, I don't want to get into too much specifics, but it would be that like, let's say risk management would want to limit on some kind of behavior, and the business wouldn't want that limit because it would interfere with some aspect of the growth plan. The kind of classic push and shove between revenue and and risk. Or they could be about data, where risk management would have some analysis which concludes something, and then the business would come up with another alternative set of financials or analysis that would argue a different version. I mean, it's not unusual in any organization to have a certain amount of political maneuvering back and forth. Sometimes, it would be solved by simply trying to make sure that risk management wasn't in the room when the decision was made, which is a classic organizational response to a risk management function where there's either not seeming to be any value add, or where there's a desire not to have full transparency. Both of those have the same symptom. But it can ultimately result in the marginalization of the function.

Maria Paz Rios: How would you describe the general company culture when you joined Washington Mutual?

Ron Cathcart: Extremely humane. Washington Mutual had as its standards: fair, caring, human, dynamic, and driven. These were five principles that were openly discussed all the time by the CEO. I think they were his brainchild that he was very proud of that. And it resulted in people being treated very humanely and I think the culture was quite cooperative. I would say during the time I was there that that changed pretty dramatically. New leadership came in, which I think assessed that that resulted in some cases in a certain lack of discipline that needed to be instilled. So there was always this little conflict between dynamic and driven, and fair, caring, and human, which started to morph when the problems came. And when it became very clear that the whole organization was under stress, then you got more aggressive behavior, as you might expect in an organization that was effectively on the way to failure.

Maria Paz Rios: At what point did Washington Mutual decide to increase their exposure to the subprime market?

Ron Cathcart: I believe that might've been a decision made in 2003. It preceded me, the chairman and the board recognized that the margins on high credit content business, subprime business, that the margins were really high. They believed that mortgages in particular required less capital, not more capital, so if you put those two beliefs together— that mortgages don't need as much capital as they are really holding and high risk credit has a very high margin, then you can see the scenario where you got a great return on equity by going into subprime. So I think that decision was made in '03.

Maria Paz Rios: Did any figures within Washington Mutual express concerns when this plan was adopted, the "Higher Risk Strategy"?

Ron Cathcart: I was not there at the time, but I understand that the prior chief risk officer had raised concerns at the time but he wasn't successful in changing the strategy. There was a saying at Washington Mutual at the time. It was "the power of yes". Meaning we as an organization are going to try and find a way to finance you, to help you buy your house. The power of yes. It's a very compelling public statement of your position in the market. And this chief risk officer said, "Yes, the power of yes needs to be balanced by the wisdom of no." And I think in the case of the strategy, the wisdom of no did not get adopted.

Maria Paz Rios: What was the relationship between Long Beach's leadership and Washington Mutual's leadership? Did this relationship change as market conditions deteriorated?

Ron Cathcart: I don't really, I can't tell you. I know that the head of the business reported to the head of home loans [group], who reported to the president, but I can't tell you what that relationship was like.

Maria Paz Rios: What strategies did you use to evaluate Washington Mutual's risk profile, especially as Long Beach mortgages were on the rise?

Ron Cathcart: Yeah, that's a really interesting question actually because that goes to the core of one corner of the crisis. And when I say one corner of the crisis, I'm sure that, in your work, you're touching on the origination process with the agencies, and then the bundling of mortgages, and the securitizations, and the ratings of them, and the purchases of them. So there's a whole chain where there was just so much money on the table that everybody's standards got warped. And every one of those chains, every link in that chain was broken in one way or another. And broken in ways that in many cases still haven't been fixed in the mortgage market. But I'm going to focus very specifically on the underwriting origination piece, which is the piece that Washington Mutual owned.

There were a few phenomen[a]— there was the macroeconomic phenomenon, and then there was the specific to Washington Mutual operational phenomenon. On the economic side, because the banks assumed that prices were going to keep rising and that no matter what happened to the borrower, the house would repay the bank. The bank started caring less about the quality of the borrower and more about the price of the house. And because capital became so available to homeowners, house prices were increasing enormously. This wasn't demographics. We did research at the time and we showed that there was out migration from California at the time, there was no housing shortage. What there was, is an enormous surplus of capital. So if you could walk into the bank and you could put down 20% and buy yourself a million dollar house, because it appraised that way, that's what was happening.

And that involved the appraisers as well, who were following the price up. So as banks got more aggressive and— Washington Mutual was one of the largest ones in California, along with Countrywide, Golden West— there was this craziness in California where the availability of debt for borrowers was resulting in prices that were extraordinarily high and increasing quickly, which resulted in more provision of capital into the system, which resulted in more loans. And it was literally a spiral, or a bubble. So in the minds of originators it was impossible to lose money lending to the mortgages because you're going to buy a $300,000 house, and in another year it was going to be worth $330,000, and so why worry about some meager 80% rule. That was caused by the banks. The banks caused that problem. Because if the capital hadn't been available, people don't have $300,000 in their pockets to spend the money and prices of houses won't go up. That applies by the way to car prices, the same thing. Availability of capital, or availability of debt, is what causes car prices to be what they are. Pretty much any big-ticket items like that, including commercial real estate.

The thing that was happening in the bank though, I find even more interesting. What was happening was that the borrowers were using mortgage reps. And mortgage reps are agents who worked for the borrower. They don't work for the bank. They have no obligation to the bank except to provide the bank with all it needs to make a decision. And there was a huge amount of coaching going on that was causing loan applications to be inaccurate, especially with respect to income, which was not being verified. And that income figure goes into a debt service coverage ratio, which determines how much of your income goes to pay the debt and how much you can afford to borrow. Well, incomes were being exaggerated dramatically, and there was no consequence to that because nobody was verifying the accuracy of the income.

So incomes, debt service coverage, looked fine. It looked as if I can afford to buy that half a million-dollar house because I make enough, because my debt service coverage is below the threshold, and there's no red alarms going on. Plus I have a $300,000 house, I'm making an offer on it, the appraisers come in and say it's worth $350,000 because appraisers are following the price up. So I have a $350,000 house and I make $80,000. But the truth is, the house isn't worth $350,000. It never will be. And I don't make $80,000, I make $40,000. And so what happens is that information went into the infrastructure of a bank and you understand the way it works. It goes into a loans system, and they have these big systems that are run by Freddie and Fannie that do statistical analysis and they say, "Well, $80,000, $350,000 appraisal has like a .0001% probability of default.”

If the system had known that the real income was $40,000 and the real value of the house was $290,000 or $300,000 the system would have given a far different probability, the loan would have been priced very differently. So what became clear when things completely unraveled was that the basis the banks had lent on was inaccurate. In many cases, it wasn’t outright fraudulent, but it was certainly exaggerated. And everyone was making so much money that nobody wanted to stop the parade and take product off the table, because

there was this huge thirst on Wall Street for product. They just wanted product. So Washington Mutual would put $10 billion of these mortgages, it would sell them at a spread— I don't remember what this spread was, let's say it's half a percent— and they'd make tens of millions of dollars for doing that. And I could do that, and they could do that until the cows come home, and hold nothing on their balance sheet.

And if you remember, this was the area of, in California especially, the non-traditional mortgage products, which were things like Option ARMs [adjustable-rate mortgages] and other types of loans. Option ARMs were loans that allowed the borrower to sort of manage their interest rate and their repayment schedule. And in some cases, the structure resulted in no mortgage payment being made at all, or even in some cases, the principal amount going up. Sort of weird to have a mortgage where the principal goes up every month, but not really, when you think house prices are catapulting ahead every year, then why would you worry, considering you'll still be under your 80% loan to value because the house, or the price, goes up.

And the non-traditional side was that things like income wasn't being verified. In fact, very little was being verified. It was all kind of done on a wink and a nod. So the fundamental building block, if you will, behind the mortgages, which resulted in a CDO, or a AAA tranche being sold to a Chinese investor, or a French investor, that whole chain which all went through capital markets, went through Wall Street, went through the rating agencies, went through distribution, went through the currency swaps and the whole thing. The building block, the foundational brick at the bottom of the whole thing, was not what people thought it was.

Maria Paz Rios: How did Long Beach monitor and carry out quality control to ensure that underwriting standards were being followed?

Ron Cathcart: My impression was that Long Beach didn't have much of a quality control capability. I think there was one, but it wasn't very effective at picking up weaknesses. There were really two groups that independently did that. There was one called credit review, and credit review reported to the chief credit officer. There is a new guidance that just came out from the OCC and the Fed and the FDIC [Federal Deposit Insurance Corporation] on credit review just a few months ago— there is a recognition that that should be an extremely independent function. It reported to the chief credit officer at the time, who reported to me. Now that position would have a more close relationship with the board of directors. So it seemed to be in the same view as audit. And the second group would have been the audit group itself. Both of those groups would provide independent confirmation and testing of the quality of Long Beach's mortgages.

Maria Paz Rios: When did questions about the quality of Long Beach's underwriting begin showing up?

Ron Cathcart: As soon as I got there.

Maria Paz Rios: And what was the response from management?

Ron Cathcart: I would tell you I didn't think management took it seriously enough.

Maria Paz Rios: When did you fully become concerned about the housing market and the soundness of Washington Mutual?

Ron Cathcart: Well, the soundness of Washington Mutual meaning did I think that it was going to go bankrupt? That would be a lot later. I think that the first thing was the soundness of the mortgage market was what I observed, not so much the soundness of Washington Mutual's origination. And there were early signs in the fall— well, there were early signs-, everyone will tell you they saw it coming— I would say the mortgage market for me was HSBC's problems in the fall of 2006. It became clear something was wrong. Everybody thought it was idiosyncratic. They had these huge portfolios that suddenly were defaulting. That was the beginning. Most people said that HSBC didn't know what it was doing, that it was a bad acquisition of Household Financial. [But] no. It was a fundamental mortgage problem. And that was the beginning of it, as I saw it.

In terms of origination problems at Washington Mutual, I saw that literally my first board meeting the month I arrived, because what was happening in Long Beach Mortgage was something called first payment defaults and early payment defaults. But the first payment defaults are just horrifically scary because it means the mortgage gets advanced and no payment gets made. None. Not a first payment, not a second payment. It's clearly a fraudulent transaction. I won't go into the specifics, but early payment defaults, I'm not pretending this was something that risk management discovered. That is not what I was saying. That was a subject of a board discussion that was brought to the board at the time. But that for me was an insight into the fact that all was not as advertised, because if you looked at the loan files, you couldn't understand why there would have been a default because the loan looked fine. It gets back to my discussion about the [first] brick, the reality is it was fraud.

Maria Paz Rios: How much of Long Beaches business strategy was set independently, internally, or by the larger Washington Mutual executive team?

Ron Cathcart: The board would have signed off on the strategy to increase Long Beach's portfolio, so that would have been approved by the board.

Maria Paz Rios: What actions did you take to express these concerns you just mentioned to the leadership?

Ron Cathcart: I did frequent risk reports to the board, which showed the trends within the portfolio. For transparency, we used a lot of the credit criteria in conjunction with the business very, very aggressively, but the problem is if the loan is

fraudulent in the first place and you start changing things like score cutoffs so that you don't let a person with a FICO score of 630 buy the loan, it's going to have to be 680, and if you increase your loan to value requirements from like 80[%] down to 78[%], it actually doesn't matter because fundamentally it's all not as represented anyway. And so what increasing a FICO threshold might have done to the history and your data, won't relate to the new loans coming in the door because they don't have the same criteria.

So I would say that, during this period, certainly as a risk officer, I was becoming more and more alarmed. And I was reporting loan deficiencies to management on an ongoing basis. And management was not receptive to hearing of it, either from loan review, which that group was marginalized, credit review, and internal audit, whose findings were not given the kind of profile that I would have expected. So, I ended up leaving Washington Mutual in April of 2008, having reached the point where I didn't believe that I could add value as a risk officer, because the management wasn't receptive to hearing a risk perspective. And then of course, Washington Mutual failed in the fall.

Maria Paz Rios: As credit conditions deteriorated and the housing market started to spiral, how did the leadership culture within Washington Mutual change?

Ron Cathcart: Well, I'll give you an anecdote. We had a tradition of Halloween that the executives all dressed up and the kids came in and they saw the executives dressed as various characters. And it had been a longstanding tradition. It was that kind of a family friendly type of place. And when Halloween 2007 came along, almost none of the executives showed up. And kids sort of came, but not very many. That goodwill and that feeling of "we're a winning place", it changed. And it became a place very much turned in on itself, and everyone was extremely concerned. We all knew what was happening in the market—liquidity was getting drained, deposits were fleeing, the liquidity was drying up for the bank. The losses were phenomenal. I mean, it changed the whole atmosphere we were in. We were in crisis mode.

Maria Paz Rios: In hindsight, is there anything you would have done different within this time period?

Ron Cathcart: No, there's nothing I would have done differently. There were major forces in play externally outside the bank, and also internally in the bank. The board was very optimistic about the future and about how things were going to turn out. They were very much supportive of the chairman's vision. The chairman's vision was to be a subprime bank, I think he referred to it as being the Walmart of banking, and the risk officer doesn't set the strategy. What the risk officer does is provide transparency, quantifies the impact of the strategy, articulates what the consequences of various actions are. I think as a risk manager, I did that. I think that our function did that to the extent it could. The one that I wonder about, the piece that I want to understand better, is— how is it that we didn't know quite how bad it was in the frontline at the originations? And I think that's all about testing. And I would tell you that if I learned anything from the

experience, it was the need to do more rigorous testing at the frontline to try and establish what's happening at the coalface. What's so far down in the organization that it's invisible, and then you build all these models on top of it, and they don't mean anything.

[END OF SESSION]