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At a Mortgage Lender, Rapid Rise, Faster Fall

By James R. Hagerty, Ruth Simon, Michael Corkery and Gregory Zuckerman
From The Wall Street Journal Online

Ruthie Hillery was struggling to make the $952 monthly mortgage payment for her three-bedroom home in Pittsburg, Calif., last summer when a mortgage broker called. The broker persuaded the 70-year-old Ms. Hillery to refinance into a "senior citizen's" loan from New Century Financial Corp. that she thought would eliminate the need to make any payments for several years, according to her lawyer.

Instead, the $336,000 adjustable-rate loan started out with payments of $2,200 a month, more than double her income. In December, Ms. Hillery received notice that New Century intended to foreclose on the property. Then, earlier this month, after a formal demand by the lawyer, New Century agreed to refund all its fees and cancel the loan once Ms. Hillery gets refinancing elsewhere.

The lawyer, Alan Ramos, says the loan never should have been made. "You have a loan application where the income section is blank," Mr. Ramos says. "How does it even get past the first person who looks at it?"

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New Century, an 11-year-old company that billed itself as "a new shade of blue chip," has become a symbol of excess in lending to subprime borrowers, people with weak credit records or high debt in relation to their income. The company has imploded over the past few months as defaults surged and accounting misdeeds surfaced. New Century's share price last week dropped 78% to $3.21 as some traders bet a bankruptcy-court filing is near.

New Century's swift rise and fall illuminates how Wall Street investment banks such as Morgan Stanley and hedge funds awash in cash helped fuel a binge in subprime lending that prolonged the housing boom. The lenders made themselves vulnerable by relying heavily on outside mortgage brokers and gunning for growth even as the boom faded. The Wall Street banks supplied the money to keep them on a roll, readily gobbling up loans and turning them into securities that global investors were avid to put into their portfolios.

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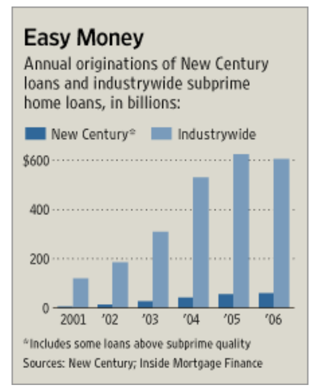

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With a work-hard, party-hard culture, New Century took its employees on a boozy cruise to the Bahamas and threw one bash in a train station in Barcelona, Spain, former employees say. Within a few years, the company, whose head offices are in a black-glass tower in Irvine, Calif., became one of the nation's top subprime lenders, jostling with older rivals like HSBC Holdings PLC and Countrywide Financial Corp.

Last week, New Century announced that it had stopped making loans because too many creditors had cut off funding. The company expects to report a loss for 2006 but can't yet quantify it. It is facing a federal criminal investigation of its accounting and trading in its stock before a negative announcement in February.

A New Century spokeswoman declined to comment on Ms. Hillery's case or any other aspects of the company's business.

While companies like New Century are free to lend through branch offices, Web sites or call centers, their main way of reaching customers has been via independent mortgage-brokerage firms, generally tiny local outfits. Mortgage brokers find customers, advise them on which types of loans are available and collect fees for handling the initial processing. There are more than 50,000 mortgage-brokerage firms and they are involved in 60% of all home loans, up from 40% a decade ago, says Tom LaMalfa, managing director of Wholesale Access, a mortgage research firm in Columbia, Md.

New Century and its rivals competed fiercely for business from brokers, who often favor lenders able to make loans quickly. John Waite, a mortgage broker in Appleton, Wis., says he liked working with New Century because it was "very easy." Until recently, he says, New Century rarely demanded reviews of the appraisals on which loans are based.

Thanks to the brokers, New Century ramped up its business quickly without having to hire a lot of employees or find office space. Brokers "work out of homes and cars and little offices," Mr. LaMalfa says, and they're often willing to go to customers' homes in the evening or on the weekend.

But by outsourcing much of its direct contact with consumers, New Century and other lenders also lost some control over the screening of borrowers and the presenting of loan choices. Some lenders and industry consultants say subprime lenders' dependence on brokers partly explains the industrywide surge in mortgage fraud. In a typical fraud, lenders are duped into making loans based on inflated home appraisals or income data. Some schemes involve organized rings that take the money and run without ever making a loan payment.

Fraud appears to be one reason for a recent rash of defaults occurring within the first few months of subprime loans. One hint that fraud might be a problem at New Century came in the company's disclosure last week that in December, borrowers failed to make even the first payment on 2.5% of New Century's loans. Normally people who borrow in good faith manage to make at least the first few payments.

Lenders loosened standards considerably in the first half of this decade. Home prices were climbing so fast that borrowers who couldn't keep up on payments could almost always sell their homes for a profit or refinance into a loan with easier terms. That emboldened lenders to offer loans with little or

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no down payment. Sometimes they let borrowers skip burdensome paperwork such as digging out tax forms to prove how much money they made.

Subprime lenders took cues from Wall Street. Investment banks and hedge funds were ravenous for the riskiest types of loans, whose higher yields made them vital ingredients in investment packages offered to investors globally. New subprime loans made in 2006 totaled about $605 billion, or about 20% of the total mortgage market, up from $120 billion, or 5%, in 2001, according to Inside Mortgage Finance, an industry newsletter.

Wall Street is deeply entrenched in the entire mortgage market, including loans to more creditworthy borrowers, on which defaults so far have remained low. Last year, banks and brokerage firms pocketed $2.6 billion in fees from underwriting bonds that use mortgages as their collateral, nearly double 2001's figure. Wall Street banks also extended billions of dollars of short-term credit, called warehouse lines, that allowed lenders like New Century to fund mortgage loans.

New Century, whose loan originations jumped to $59.8 billion in 2006 from $6.3 billion five years before, proved an especially valuable client. It has spent about $38 million in fees just for stock and bond sales since 1998. The company is structured as a real-estate investment trust and, under rules governing REITs, must pay out the vast majority of its earnings as dividends. That meant it needed to return frequently to Wall Street to raise money and keep its operations going.

Morgan Stanley has helped underwrite $9.8 billion of stock and bonds for New Century since 1998, pocketing about $17.4 million in fees, according to data-tracker Thomson Financial. Last week, Morgan Stanley helped New Century with an emergency loan even as other Wall Street banks said no. Morgan Stanley declined to comment.

Wall Street firms such as Morgan Stanley and Bear Stearns also compete with subprime lenders by offering their own mortgage loans via brokers. On an online forum for mortgage brokers last week, Christopher Logan, an account executive for Morgan Stanley's recently acquired Saxon Mortgage subprime-lending arm, said his company is still eager to lend as others bow out. "With Morgan Stanley as our parent, we have the stability & strength -- which is what it takes to survive in today's subprime!" Mr. Logan wrote.

The shakeout in the subprime area is the latest of the mortgage industry's periodic purges of dubious practices and weak lenders. In the mid- to late-1980s, savings-and-loan institutions moved into risky lending, sometimes to cover losses after interest rates turned against them. Courts found that some executives looted dying S&Ls. A 1989 government bailout ultimately cost hundreds of billions of dollars.

The collapse of many S&Ls, once the dominant force in home mortgages, opened the way for specialist mortgage-banking firms and commercial banks to take more of the business. Today, Countrywide and Wells Fargo & Co. have a combined share of around 30% of all home loans originated each year, but the rest of the market is splintered among more than 8,000 lenders. Regulation is a patchwork. Five federal agencies oversee mortgage lenders affiliated with banks, thrifts or credit unions, while New Century and others that don't take deposits are regulated by state agencies.

New Century's founders -- Edward Gotschall, Brad Morrice and Robert K. Cole -- worked together at a California mortgage lender in the early 1990s and formed New Century in 1995 with about $3 million of venture capital. It went public in 1997 and survived a scare the next year when Russian loan defaults caused investors to flee risky businesses and some subprime lenders went out of business. U.S. Bancorp of Minneapolis helped out by acquiring $20 million in New Century preferred stock.

At the height of the housing boom in 2003 and 2004, New Century executives grumbled that the stock market was undervaluing their company. They and several other subprime lenders responded by turning their companies into REITs, hoping to attract investors interested in high dividends. The move didn't have much of an effect, as investors continued to worry that earnings and dividends in the mortgage industry couldn't be sustained at boom levels. The REIT structure also made it harder for New Century to put aside earnings for a rainy day.

Despite disappointment over the share price, former New Century employees say the company was a fun and rewarding place to work. One former executive says the company made a priority of promoting from within. A former secretary to Mr. Cole took charge of investor relations.

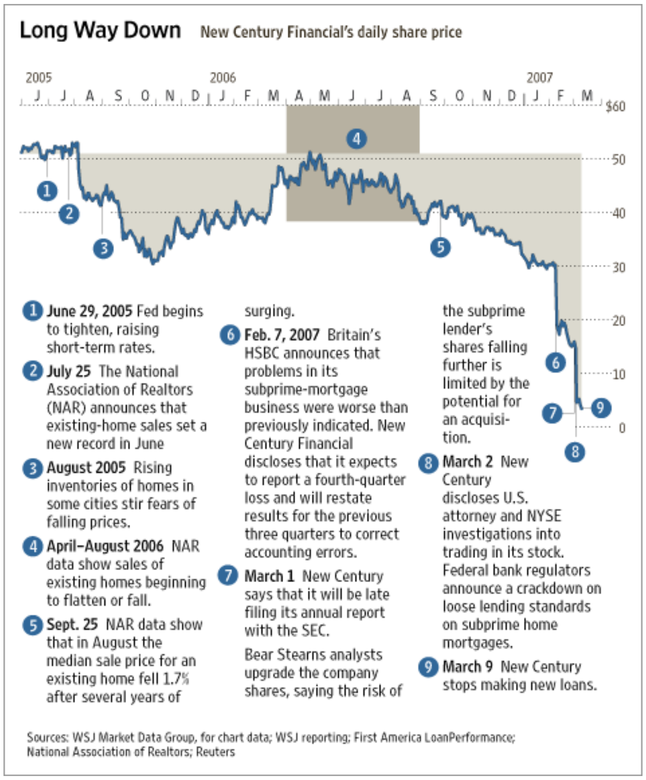
Partying and heavy drinking were common on company outings, former employees say. David Pace, a former New Century account executive who dealt with loans in southeast Michigan, says the theme of one cruise in the Bahamas was "The Best Damn Mortgage Company. Period."

The company also sent top-producing employees to a Porsche-driving school, says James Fuller, a former project manager in New Century's information-technology department. "It was a culture of excess," says Mr. Fuller, who left in 2005.

Racing is a passion for one former top executive, Patrick J. Flanagan. While he was at New Century, a division under his control sponsored a Nascar race car. In late 2005, the company granted Mr. Flanagan a six-month leave of absence with pay of $76,445 a month (he had made nearly $4 million the year before), while he looked for new horizons. He then left the company and says he has spent part of his time competing in car races. He declined to comment on New Century.

Company executives made a splash with charitable giving. Mr. Flanagan last year pledged $500,000 to a private school attended by four of his children in Aliso Viejo, Calif. Co-founder Mr. Gotschall and his wife, Susan, gave $3 million to a hospital in Mission Viejo, Calif. In the 2006 election cycle, New Century's political action committee contributed $202,634 to political campaigns, according to the Center for Responsive Politics.

Some analysts warned of trouble long before this month. An August 2005 report from Gradient Analytics Inc., a research firm in Scottsdale, Ariz., highlighted heavy selling of shares by the company's three founders as a sign that prospects for the company were clouding.



In November 2006, the Center for Financial Research and Analysis, an accounting research firm in Rockville, Md., flagged concerns about New Century's third-quarter earnings release. CFRA analyst Zach Gast noted that the company for the first time had lumped together two categories of reserves, one for losses on defaulted loans and a second for losses on real estate that had been acquired through foreclosure. Combining those two categories allowed the company to show a small increase in reserves from a quarter earlier, he wrote. But that masked a decline of 8.7% in the reserve for losses on soured loans, to $191.6 million, he calculated.

Mr. Gast found it curious that New Century was lowering reserves at a time when defaults on subprime loans generally were surging. Had New Century maintained reserves at levels comparable with the second quarter, he estimated, earnings per share would have been at least 50% lower than the $1.12 reported.

At an investor conference on Nov. 28, New Century's co-founder and chief executive, Mr. Morrice, said that despite the subprime area's problems, New Century was "well-positioned to compete and continue to profitably grow market share." Patti Dodge, an executive vice president, added that the company would continue to enjoy adequate liquidity thanks to "strong relationships with...Wall Street lenders."

In fact, when the chips were down last week, some of those Wall Street firms refused to extend New Century more credit, the company disclosed last week.

In a securities filing March 2, New Century said the audit committee of its board has hired independent lawyers and forensic accountants to look into the company's methods for valuing certain risky mortgage securities known as "residuals" that it kept on its books. The company also has said it will need to correct errors in its accounting for losses on defaulted loans it has been forced to buy back from investors. That will significantly reduce earnings for the first nine months of 2006, it said.

New Century's implosion has hit big investors such as David Einhorn of Greenlight Capital Inc., a New York hedge fund that holds a 6.3% stake in the lender. After tangling with New Century's management, Mr. Einhorn won a board seat a year ago, which he gave up last week without explanation. The value of Greenlight's stake in New Century has fallen to about $11 million from $160 million in mid-2006. Mr. Einhorn declined to comment.

It isn't only investors who are smarting. In 2004, a mortgage broker at the Seattle firm Washington Loan Network Inc. offered to refinance Gertrude Robertson's mortgage into a New Century loan with lower monthly payments. The 89-year-old health aide agreed to take out a new $414,000 loan that carried a fixed rate for two years and then was set to adjust every six months.

Last year, Ms. Robertson found she couldn't meet the payments, which had climbed to about $3,300 a month, leaving her without enough money to pay her other expenses. In October, she filed a lawsuit in King County Superior Court against New Century and the mortgage broker. The complaint alleges that Ms. Robertson's income was never sufficient to meet the expected payments and that information in her application was falsified.

Early this year, another mortgage broker, California Loan Co., arranged for Ms. Robertson to refinance into a new mortgage with New Century that boosted her loan balance to $450,000 and cut her monthly payments slightly, to $3,129. "New Century didn't know they had the [earlier] loan or even care," says Melissa Huelsman, a lawyer representing Ms. Robertson.

The phone number for Washington Loan Network was disconnected. Washington state's regulator says it is investigating the broker. Alex Torres, who described himself as the office manager for California Loan Co., which handled the second loan, declined to comment.

"I just wanted to be able to eat and sleep in my house and have a roof over my head," says Ms. Robertson, who continues to work even though she will soon turn 90. "Every day at midnight when I go to sleep, I think maybe when I wake in the morning, they'll tell me to get out."

-- Jonathan Karp and Lingling Wei contributed to this article.

Email your comments to rjeditor@dowjones.com.

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