

How Wall St. Helped Ignite the Subprime Mortgage Binge

*by
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The Wall Street Journal (12/03, "At a Mortgage Lender, Rapid Rise, Faster Fall" by James R. Hagerty, Ruth Simon, Michael Corkery and Gregory Zuckerman) sums it up: "A look at 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 gunning for growth as the boom faded and relying heavily on outside mortgage brokers. The Wall Street banks readily gobbled up the loans, turning them into securities that global investors were avid to put in their portfolios.

"They fitted perfectly in the swaths of higher risk with correspondingly high nominal returns that the banks could quickly unload onto hedge funds and others intending to pass on to unsuspecting investors. Nobody at any point of the career of these mortgages assessed the risk of the borrower or had the slightest intention of monitoring the payments if they actually came in.

"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 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. It is facing a federal criminal investigation of its accounting and trading in its stock before a negative announcement in February. The mortgage industry is undergoing one of the periodic purges of dubious practices and weak lenders. In the late 1980s, savings and loan institutions moved into risky lending, sometimes to recover losses after interest rates turned against them. Courts found that some executives looted dying S&Ls. A 1989 government bailout cost hundreds of billion 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 30% of all home mortgages 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 overlook the mortgage lenders affiliated with banks, thrifts or credit unions, while New Century and others that don't take deposits are regulated by state agencies."

The Collapse of a Savings & Loan Creates Space for a New Breed of Mortgage Magician

"While companies like New Century are free to lend through branch offices, 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 suitable 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. 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 upon which loans are

based.

"But by outsourcing much of its contacts with the consumers, New Century and other lenders lost some control over its screening of borrowers and the presenting of loan choices. Some industry leaders and consultants say this partly explains the surge of mortgage fraud. In a typical fraud lenders are duped into making loans based on inflated home appraisals or income data. Some schemes involve rings that take the money and run without ever making a loan payment. Normally people who borrow in good faith manage to make 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 the payments could almost always sell their homes at a profit or refinance into a loan with easier terms. That emboldened lenders to offer loans with little or 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 parcels offered to investors globally. New subprime loans made in 2006 totalled about \$605 billion, or about 20% of the total mortgage market, up from \$129 billion, or 5% in 2001."

"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 extended billions of dollars of short-term credit, called warehouse lines, that allowed lenders to fund mortgage loans. New Century, whose loan originations jumped to \$59.8 billion in 2006 from 46.3 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.

"In short high finance in this deregulated globalized age joins deregulated banking at the hip with the sordid business of preying on helpless aged lost in the carnivorous modern mortgage refinancing jungle.

"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 and strength — what it takes to survive in today's subprime!' Mr. Logan wrote.

"New Century's founders — Edward Gotschall, Brad Morrice, and Robert K. Cole — worked together in the early 1990s at a California mortgage lender 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 risk business and some subprime lenders went out of business. U.S. Bancorp of Minneapolis helped out by acquiring \$20 million in New Century

preferred stock."

Its REIT Structure Made It Hard Putting Aside Earnings for a Rainy Day

"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. 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 hard 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. Partying and heavy drinking were common on company outings, they say.

"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.

"New Century's implosion has big investors such as David Einhorn of Greenlight Capital Inc., a New York hedge fund that holds a 6.3% stake in the lender. 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, Mrs. Robertson found that 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's County Superior Court against New Century and the mortgage broker. The complaint alleges that Mrs. Robertson's income was never sufficient to meet the expected payments and that the information in her application was falsified.

"Early this year, another mortgage broker, California Loan Co., arranged for Mrs. Robertson to refinance into a new mortgage with New Century that boosted her balance to \$450,000 and cut her monthly payments slightly, to \$3,139. 'New Century didn't know they had the earlier loan or even care,' said Melissa Huelsman, a lawyer representing Mrs. Robertson.

"'I just wanted to be able to eat and sleep in my house and have a roof over my head,' says Mrs. Robertson, who continues to work even though she will soon turn 90."

Elsewhere in the same issue of *The Wall Street Journal* Andy Laperrière ("Mortgage Meltdown") makes an important point: "Far from being limited to the subprime market, the data show that the risky loan features have become widespread. According to Credit Suisse, the number of no or low documentation loans — the so-called 'liar loans' — has increased to 49% last year from 18% of purchase loans in 2001. The investment bank also found that borrowers put up less than 5% down payment in 46% of all home purchases last year. Inside Mortgage Finance estimates that

nontraditional mortgages — mostly interest only and payment ARMs that allow the borrower to defer paying back principal or even increase the loan balance each month — which hardly existed five years ago, grew to a third of all mortgages last year.

"Common sense suggests that the boom-time mania that led banks and investors in mortgage-backed securities to offer dangerous loans to individuals with poor credit histories also led them to offer the same kinds of risky loans (no income verification, no down payment, high payments as an income share, low teaser rates) to individuals with good credit scores.

"The Alt-A market — a middle-ground between subprime and prime has increased seven-fold since 2001 and accounted for 20% of home purchase loans last year. Fully 81% of Alt-A loans last year were no or low-documentation loans, according to First American Loan Performance. It should come as no surprise that delinquencies on these unconventional loans have increased sharply. Investors were shaken last week by a Mortgage Bankers Association report which found that mortgage delinquencies hit nearly 5% at the end of last year and that prime adjustable rate loans deteriorated at a faster rate than subprime ARMs. A recent UBS report finds the 2006 Alt-A loans 'on tracks to be one of the worst vintages ever.' This is no subprime niche problem."

"Foreclosure losses as a share of the economy will be small and most home owners have a comfortable amount of equity in their homes. But home prices — like all prices — are set at the margin. It was the marginal buyer, especially the subprime borrowers and speculator, who drove prices higher. The easing of lending terms increased the demand for homes and quickly translated into higher prices. It's not the size of the foreclosure losses as a share of the economy that matters. It is the effect of those losses on the availability of credit. When banks and investors in mortgage-backed securities start suffering losses, they inevitably pull back. This is so why so many subprime companies have gone bankrupt.

"What is more, the bank regulators are only now beginning to tighten lending standards, and will be under increasing pressure from Congress to do more. The concern that tighter lending standards could reduce access to financing is the reason a widely watched survey of house builders conducted by the National Association of Homebuilders dropped earlier this week.

"The report by Credit Suisse estimates mortgage originations could drop 21% during the next year or two because of the tighter credit standards. Coupled with high inventories of unsold homes and the additional supply likely from distressed sellers could produce an unprecedented nationwide decline in home prices."