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Broken

How Greed Brought The Global Subprime Mortgage Industry Tumbling Down
By Charu Gupta



Editor's Note: A former account executive for the nearly bankrupt Novastar Financial Inc. and a former mortgage broker at the now-defunct Equity Consultants, an independent mortgage brokerage firm once in Richfield, spoke to the Free Times on the condition of anonymity. Both continue to work in the lending business. Their names have been changed.

In 2001, business was booming at Novastar Financial, a Missouri-based subprime mortgage lender that had opened shop five years earlier. The company had grown from a 15-person, two-city operation into a nationwide workforce of more than 2,000. Shareholders received a 25 percent return that year and were eager to make even more.

Richard Cayman started as an account executive in late 2004, just as Novastar was about to give back more than 30 percent in returns to investors. The subprime lending spree had shifted into high gear.

Cayman worked out of one of Novastar's Ohio offices. Times were good, he says. There was a pingpong table and an ice cream machine in the employee lounge. The company even bought go-carts to ride through the sales department. (That practice ended, Cayman says, laughing, after a few people got hit.) "But it was a really fun environment," he says. "The whole philosophy was work hard, play hard."

Money flowed freely. The Federal Reserve had already slashed its key interest rate to 1 percent, making it easier than ever before for anyone to get anything on credit, including housing loans. In 2004, almost \$600 billion in consumer spending came from people who had borrowed against their homes. The next year, more than \$620 billion in subprime loans were meted out to American borrowers (including \$2 billion in Cuyahoga County and \$600 million in Cleveland).

At the same time, federal regulatory watchdogs turned a blind eye to the subprime mortgage-only lenders which, through a loose network of independent brokers, drummed up thousands of mortgages with little regard for loan quality or the borrower's ability to repay. Many states' consumer protection laws, especially Ohio's, entirely overlooked the lending industry, letting brokers and subprime bankers operate with impunity.

The bill finally came due in 2007. That year, Novastar posted a \$733 million loss (versus \$66 million in profits the previous year), then closed its loan operations and cut its workforce down to 40. Similar incidents of financial whiplash have been reported by lending companies across the country, involving thousands of loans and workers.

Aftershocks continue throughout the economy. Unemployment is on the rise, new and established businesses struggle for financing, some major financial institutions teeter on the brink of collapse and cities suffocate under the weight of foreclosed, abandoned homes, lost property values and taxes, and rising crime. Last year, more than 1.2 million properties faced foreclosure - a statistic that has been on a steep rise since 2005, with Ohio and Cuyahoga County among the hardest hit in the nation. The fallout will be felt here not for years, but generations.

Cayman, at least, has regrets. Looking back at the heyday of subprime lending, Cayman and others point out red flags that were always there. The inner workings of the industry, however, appear to have provided little incentive to heed them.

"We let the numbers overshadow what we were doing. That's home ownership. That's the American dream," Cayman says. "We basically took that and made it into a money-making tool. It's kind of sobering to take a look back over it now and think about the role we played."

Race to the Bottom: Subprime Lender Novastar Account Executives

As an account executive, Cayman's job was a hustle. He had a list of about 100 independent broker shops he needed to keep up with. The broker shops were dealing with borrowers, and Cayman needed to ensure that Novastar could finance as many of the loan

applications these brokers brought back as possible. Cayman, with a wife and daughter, received a minimum monthly salary. The real money was in commissions on his loan sales.

It wasn't easy - every broker shop had ties to at least a dozen subprime lenders. So Cayman would call shops every day, ask for the manager and go over Novastar's various loan programs. And he had to get individual brokers to like him enough to send him their loan files. Even when that happened, Cayman had to overcome the unique hurdles of a flush and roaring subprime lending industry.

Novastar, he says, was "a bit more conservative than some of the more aggressive subprime lenders. So that reputation followed us and made the account executive position kind of difficult."

At the time, Novastar was known for fully funding loans (that's zero down payment) to borrowers who had credit scores of 620 (the highest possible score is 850). Cayman thought this was a pretty good deal, as a 620 score was already at the low end of the average range, which goes up to 680. But brokers saw it differently. "I was getting hang-ups and people were laughing at me," he says. For 100-percent financing, he learned, the new industry standard was a 580 credit score.

Cayman says many Novastar account executives lost out to competitors from Argent Mortgage Company, New Century Financial Corporation and Countrywide Financial Corporation (also the top subprime lenders in Cleveland and Cuyahoga County through 2006). Credit score cutoffs were getting lower and lower and the array of loan possibilities wider and wider.

Among the most popular was the "2/28" loan, a two-year adjustable rate mortgage (ARM). After an initial teaser rate of two years, the interest rate jumped up and up. The rationale was that it offered a "credit fix": Two years gave borrowers time to make regular payments and resurrect their weak credit profile, then they could refinance into a loan with better terms.

"Brokers flocked to it," Cayman says. "So [Novastar] offered it too because brokers were demanding it." It quickly became the most lucrative product in Cayman's portfolio.

Wall Street also fed the beast: Investors around the world loved American mortgage-backed securities with high rates of return - something that 2/28 ARMs seemed to promise. As insurance against borrowers refinancing after the teaser period (and reducing investors' cash flow), lenders demanded exorbitant prepayment penalties and paid bonuses to brokers who tacked them on. These penalties became more common in 2004 and '05, as subprime mortgages flourished.

With the 2/28 ARM doing so well, subprime lenders looked for still more creative ways with which to sign up even more borrowers. Credit score requirements dropped further; traditional lending guidelines fell to the wayside. Subprime lenders like Novastar, Argent

and New Century didn't put money into accounts for clients and so were considered "non-depository" institutions - a sector of the financial world that at the time received little regulatory oversight from federal agencies. So riskier and more profitable loans multiplied. In 2005, 80 percent of all subprime loans were ARM variations.

Soon there were interest-only mortgages, where borrowers bore no responsibility for the principal loan amount for years. "Stated-income" (or "liar") loans, in which homeowners simply wrote in what they made and were never asked for proof like W-2 forms, spread like wildfire.

The logic behind stated-income loans was that poor people working a second under-the-table job, or the self-employed, for example, could qualify for a home loan. In fact, the practice was rife with fraud. A 2006 study that compared applications to IRS records found that out of 100, at least 60 borrowers had claimed to make more than twice what they really did.



Risk-layering - the piling on of problematic loan features, like stated-income and interest-only payments - made these loans more perilous, increasing the probability of default or foreclosure.

Richard Cayman remembers some of these strange deals. Brokers would submit loans with incomes that didn't add up. "I'd tell 'em, look, when this goes down to underwriting, they're going to kill it," Cayman says. "They'd say, okay, I'll try it elsewhere." And they were usually successful, he adds. "It would amaze me some of the stuff we would turn down and brokers would get processed elsewhere."

With lenders like New Century. In 2004, as New Century became the nation's second largest subprime lender, more than 40 percent of its loans were stated-income loans; more than 70 percent were two-year ARMs. The company has since gone bankrupt.

A court-mandated investigation completed in March found New Century's tactics especially egregious. There were frequent exceptions to underwriting limits on monthly income levels required to pay down debt and loan amounts compared to home values. Instead, loan quality standards depended on whether loans could be sold off to Wall

Street. And though independent brokers were supposed to abide by a best-practices handbook, there was little evidence of any action taken against those who violated policies.

Throughout 2004 and 2005, internal company audits highlighted incomplete documentation, missing files required by state law and other problems. An e-mail in the fall of 2004, from New Century's general counsel, noted the potential "sticker shock" of 2/28 ARMs. While it was reasonable for a lender or broker to tell a borrower they could refinance after two years, the e-mail continued, "we should not be making loans where the inability to refinance after two years leaves the borrower at very high risk of default even under modest interest rate increases."

That's because loans were being underwritten based on a borrower's ability to pay the teaser payments, not payments at the adjusted interest rates after two or three years. A series of subprime refinancing would begin, where a borrower, after dishing out likely prepayment penalty fees, rolled into a second 2/28 ARM to buy another two years of lower payments. This, New Century employees wrote to higher-ups in early 2005, was "essentially perpetuating a cycle of repeated refinance and loss of equity to greedy lenders."

With each refinance, while homeowners cashed in on savings, they also gave fees to hungry brokers, account executives and lenders, not to mention additional sums for appraisals, credit reports, flood and tax certifications, document preparation, and sometimes charges for e-mailing paperwork or sending it through expensive couriers. (When the same broker and subprime lender refinance the same borrower multiple times it's called "flipping" and it never benefits the borrower.)

But refinances were only possible as long as borrowers retained equity in their homes. By 2005, home values had plateaued after years of astonishing appreciations, and in some markets were even beginning to fall.

Eventually, New Century employees pointed out, borrowers would have no equity with which to refinance when yet another ARM reset came due. At that point the only choice would be to sell or face foreclosure. These and other warnings were ignored by top executives, the court investigation found. One senior manager declared that the revenue generated by New Century's loan production departments rendered internal audit findings moot.

Pumping for Profits: Mortgage Brokers

The speed and intensity with which the subprime mortgage industry expanded between 2002 and 2006 - originating more than \$1.75 billion in subprime loans in Cleveland alone - wouldn't have been possible without mortgage brokers.

For lenders, dealing with brokers made sense. It meant less office space and less investment in direct consumer marketing, as brokers did much of that legwork through

cold calls, neighborhood flyers and door-to-door house calls. Brokers were paid when deals were closed; they did not draw salaries or benefits from the lender. And until recently, most states, including Ohio, only lightly regulated brokers, focusing on just licensing rather than best consumer and business practices. So broker operations ran the gamut, from professional, hundred-employee firms to rag-tag individuals, sometimes with criminal histories, looking to make a quick buck.

By 2005, New Century had relationships with over 50,000 brokers nationwide, submitting loans via an in-house network of 1,000 account executives. That year, brokers accounted for 84 percent of New Century's loan volume; 75 percent of Novastar's loans came through these channels.

In theory, broker shops are one-stop shops where borrowers get guided through the process of selecting the best loan from the wide variety available. What few customers realized was that brokers have absolutely no fiduciary responsibility to borrowers. Rather, broker compensation is tied only to the number of loans they close and the corresponding interest rates. Nowhere is loan performance - avoiding default or foreclosure - a benchmark against which loan officers get paid.

Carl Rodriguez joined Equity Consultants, a since-closed mortgage brokerage in Richfield, in April 2005. He insists that Equity was among the more upstanding firms around, but that by the time he left, in mid-2007, he'd seen enough of how some of the less scrupulous brokers did business. Rodriguez described the variety of ways in which brokers convinced borrowers into signing high-interest subprime loan papers - with the primary goal of garnering larger commissions.

"You're a commission-only business," Rodriguez explains. "You're paid to get loans."

In most broker shops, new employees get an advance for the first three months. After that it's sink or swim. Commissions must then be enough not only to pay back the advance but also make a living. Both Rodriguez and Novastar's Cayman say this arrangement fueled many brokers' aggressive drive to close loans fast, regardless of quality. A high volume of loans ensured steady employment and heftier paychecks.

So corners were cut.

For example: Debt-to-income ratio (DTI) is the percent of monthly earnings spent on bills. To lenders, a lower DTI equals a better credit risk. An ideal debt-to-income ratio is 33 percent, according to most financial counselors, leaving more disposable income for food, clothing and other living expenses. Subprime lenders were often less conservative, Rodriguez says, sometimes green-lighting DTIs of 50 or 55 percent.

Borrowers' income also became less important; the ability to make payments was increasingly pegged solely on credit scores. "It was all just based off credit," Rodriguez says. "If you had a good credit score, they didn't care what kind of job you did. They were saying if you have good credit there has to be some form of, I guess, responsibility

... tied to that credit." (Recall that, by 2004, a "good" credit score had dropped to at least 580.)

Loan terms were often misrepresented, Rodriguez says, to drum up sales. One reason Rodriguez suggests the 2/28 ARM was so popular was because of the way it was explained. Brokers would emphasize that this type of ARM was a two-year fixed-rate loan, Rodriguez says, "and the customer would hear 'fixed rate' and they wouldn't hear anything else.

"People sign so many pages they don't pay attention to it. So a lot of times, [brokers] said, "Well you know what, let's see what the customer does. If they sign the paperwork then great, if they don't then no loss. I'm no worse off than where I was."

When the loan reset in two years, customers would come back to ask, "What happened to my payment? Where's the guy who worked on my loan?" That broker was long gone by then. "The customers got their paperwork and they never read it," Rodriguez says.



Brokers found borrowers with weaker and weaker credit histories, even some with recent bankruptcies. Getting these borrowers into loans proved trickier - they had little equity in their homes and their debt-to-income ratios were already stretched. More creative ways to fund such applications were needed.

This, Rodriguez says, explains why appraisals were often jacked up. For example, a home value would come in at \$100,000, Rodriguez says. But with the loan itself \$100,000, plus \$2,000 in broker fees, the final bill was \$102,000 - a number the home's value alone couldn't support because the borrower didn't have the additional \$2,000 in pocket. In order for that application to work, the home's value needed to go up. "What you would see is lenders calling the appraisers saying, "Hey, I need it at 103,000'," Rodriguez says. (When the housing market collapsed and actual home values came in, that \$103,000 home was in fact worth, say, only \$91,000, leaving the borrower owing \$12,000 instead of just \$3,000.)

The informal agreement between some brokers and appraisers was, "Give me the values I need and I'll keep sending you business," Rodriguez says. "So that appraiser counted on Company A to keep sending them loans, and they would give [the brokers] the values they needed" to close the deal and turn a profit.

At New Century, when loans soured, more often than not it was because of faulty appraisals, the court investigation found. In a series of 10 lawsuits filed last year, former Ohio Attorney General Marc Dann accused mortgage brokers and lenders of trying to improperly influence appraisers. In one case, against First Ohio Banc, a mortgage brokerage in Independence, Dann claimed that the company used preprinted forms to solicit specific home values. A "Request for Appraisal" read: "Estimated Value between \$165,000-181,000 (...) Please contact Dianne ASAP if you feel the value can't be obtained."

Also common was debt consolidation, a tactic that allowed brokers to raise interest rates (netting them more fees) while borrowers saved nominal amounts on their monthly payments.

Subprime borrowers might qualify for a 7-percent interest rate on a mortgage loan, Rodriguez explains. Then brokers asked to look at all their credit debt: car payments, credit cards and mortgages. If added together, the broker would offer a slightly lower interest rate on the new, higher loan amount - say, 6.5 percent. This combined debt saved the borrower several hundred dollars a month.

But then came the sleight of hand. A broker's bonus from a lender for closing a loan was tied to the interest rate - the higher the rate, the larger the bonus. "I tell them I can give them 6.5 percent and save them \$500 [a month]" Rodriguez explains. "And they agree to that. "That's a great savings,' they think. "I like that savings."

What brokers wouldn't say is that borrowers might actually qualify for an even lower interest rate, perhaps 6 percent, and save \$600 a month. "They don't know they could get 6 percent," Rodriguez says. "All they know is they're getting 6.5 percent. All they know is they're saving \$500." (Sometimes borrowers with stellar credit were also tricked into higher interest loans, a deception housing advocates call "steering.")

And the borrower never calculated whether that monthly savings was cancelled in the long run by paying a higher interest rate. Meanwhile, the broker made off with two sets of fees: the origination cost paid up front by borrowers, a percent of the loan amount; and the kickback from lenders for the higher interest rate. At a 6 percent interest rate, however, the broker would have only earned origination fees.

"So the customer doesn't always get the lowest interest rate on the market," or what they may even qualify for, Rodriguez says. "What they get is a combination of me making money on the front and backend of the loan."

This backend bonus is also known as a "yield spread premium" or "paid outside of closing." It's the difference between the lowest market interest the customer is eligible for and what the borrower in fact signs off on, Rodriguez says. Borrowers rarely knew that both origination fees and yield spread premiums are negotiable.

"It's what you can sell the customer," Rodriguez says. And it was inevitably a way of stripping equity out of the home.

The Gatekeepers' Blind Eye: Loan Quality Supervisors, Underwriters, Closers

This year, international investment banks have posted staggering losses, billions in write-downs. Subprime lenders have gone bankrupt by the dozens. Mortgage brokers have disappeared overnight. A lot of the money lost went to borrowers as bad loans, but much of it also ended up in the pockets of the hundreds and thousands of people who worked in the subprime mortgage lending industry. Brokers were getting just one chunk of the cash cow.

"In actuality, on down the line, everybody was making a lot of money," says Richard Cayman, the former Novastar account executive. "From the title companies, to the appraisers, to the brokers, to the loan officers, to the account executives.

"When a loan closes there's a lot of money involved that goes to different people. So everybody had a stake in making sure the loan closed properly." It's remarkable what got through the gatekeepers.

Cayman's support system inside Novastar was first underwriters, then quality control staff and finally closers. For each department, efficiency and speed in pushing loans through the pipeline meant monthly bonuses for individuals, departments and department heads.

A top underwriter, who determined the credit risk of borrowers based on employment and credit history, financial needs and ability to pay, might have been salaried at \$25,000, Cayman says. If he or she was closing 10 files a day, there was an extra bonus for every file over the expected six or eight.

Quality control had the responsibility of verifying incomes, jobs, residencies, "the stuff that prevents fraud," Cayman says. If any wrongdoing was uncovered, quality control had the authority to revoke a broker shop's affiliation with the lender. (Several separate investigations, however, have found that there were few repercussions for bad broker behavior.)

Average closers, who worked with title companies to draw up accurate paperwork, could process 60-70 files a month, Cayman says. But some closers could process twice that, and earned monthly incentives for their departments.

Cayman himself recalls overreaching once in a while. "I regret a lot of loans that I closed," he says. "We did kinda bend the rules a little bit to get somebody a house just to make an extra buck."

He offers this example: A customer earned \$35,000 a year. After allocating money for a mortgage and other bills, the borrower had a debt-to-income ratio of about 47 percent. At Novastar, Cayman says the cap was 45 percent. So Cayman had to work it. He'd get the underwriter to upgrade the borrower's income by \$500, based on a potential raise, perhaps. Then Cayman's borrower had a new DTI of 45 percent, albeit only on paper.

"Little things like that," he says. "It wasn't like I was trying to do the borrower a favor. I was trying to close a deal, make sure I made my numbers."

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