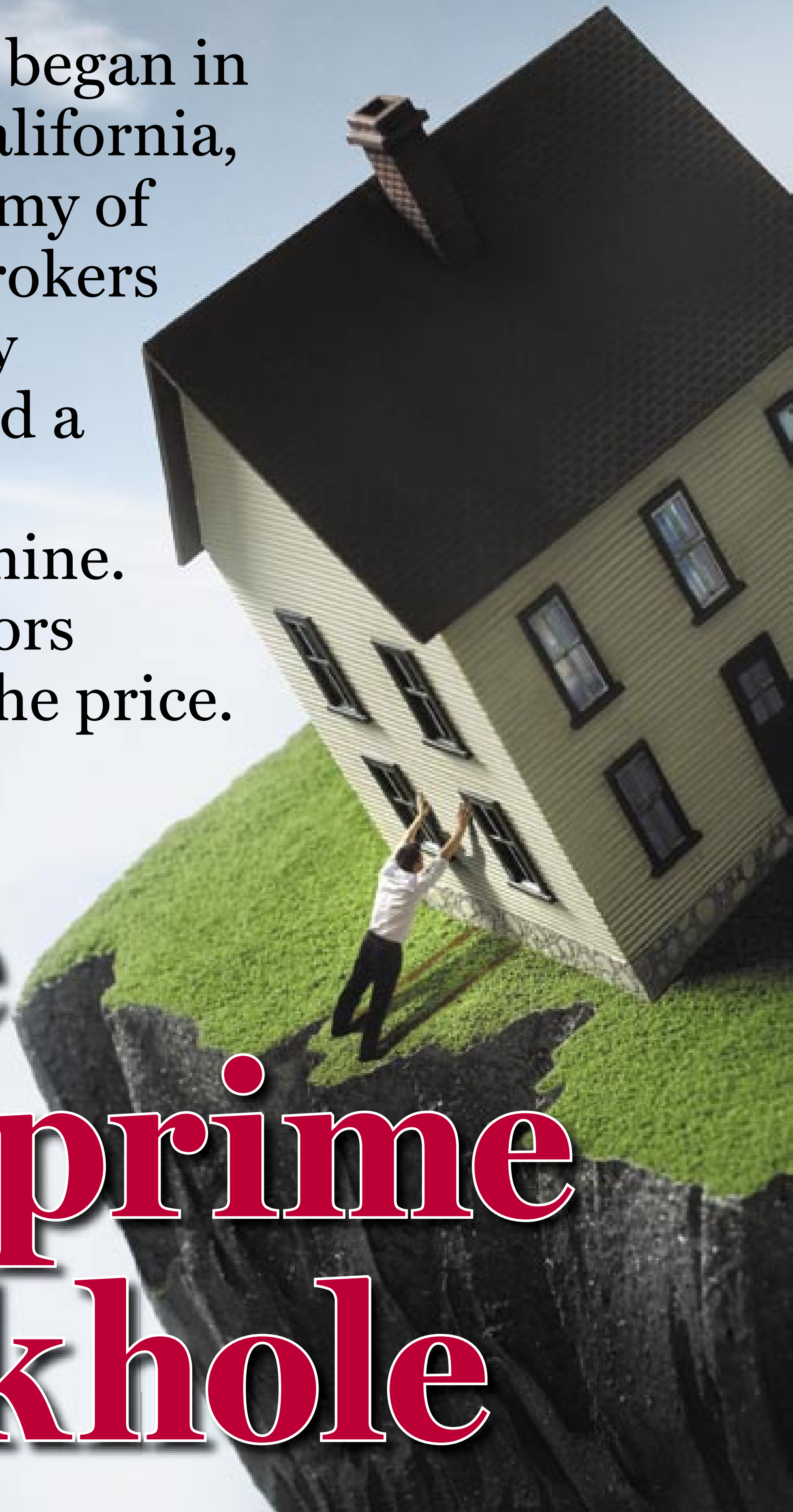
The trouble began in Southern California, where an army of mortgage brokers pushed risky loans and fed a Wall Street money machine. Now, investors are paying the price.

The Subprime Sinkhole



By Seth Lubove and Daniel Taub

Taher Afghani was working for discount retailer Target Corp. near San Francisco when friends told him about the riches to be made in California's Mortgage Alley.

It was 2004, and the U.S. real estate market was on fire. Down in Southern California, a hub for lenders specializing in loans to people with weak, or subprime, credit, Afghani's pals were making a fortune pushing risky mortgages on homebuyers. After tagging along with a buddy on a company trip to Los Cabos, Mexico, Afghani quit Target, headed south and began hustling loans at Costa Mesa–based Secured Funding Corp.

"I had never seen so much money thrown around in one weekend," Afghani, 27, says of the Cabo getaway. "It was crazy. All these kids, literally 18 to 26, were loaded—the best clothes, the cars, the girls, everything." Soon Afghani, who'd made $58,000 a year managing a Target distribution center, was pulling down $120,000.

Mortgage salesmen like Afghani, many of them based in Orange County, near Los Angeles, lie at the heart of the once-profitable partnership between subprime lenders and Wall Street investment banks that's now unraveling into billions of dollars in losses. After years of easy profits, a chain reaction of delinquency, default and foreclosure has ripped through the subprime mortgage industry, which originated $722 billion of loans last year. Since the beginning of 2006, more than 50 U.S. mortgage companies have put themselves up for sale, closed or declared bankruptcy, according to data compiled by Bloomberg. Lenders such as Irvine, California–based New Century Financial Corp.; Orange, California–based ACC Capital Holdings Inc.; GMAC LLC's Residential Capital home lending unit; and General Electric Co.'s WMC Mortgage Corp. division have slashed more than 5,000 jobs.

The upheaval in Orange County, home of Disneyland and birthplace of Richard Nixon, has sent shockwaves throughout the financial world. Brokers are merely the first link in a chain stretching from mortgage companies, which originate loans; to wholesale lenders, which bundle them together; to Wall Street banks, which package the bundles into securities; and finally to commercial banks, hedge funds and pension funds, which buy these investments. (See "The Ratings Charade," page 50, and "The Poison in Your Pension," page 64.)

The pain has only just begun. As home prices sink and mortgage defaults climb, bond investors who financed the U.S. housing boom stand to lose as much as $75 billion on securities backed by subprime mortgages, according to Newport Beach, California–based Pacific Investment Management Co., which runs the world's largest bond fund. Companies from Detroit-based General Motors Corp. to Zurich-based UBS AG have fallen into the subprime sinkhole. At GM, profit plunged 90 percent during the first three

PHOTO ILLUSTRATION BY C.J. BURTON

Subprime money trail

How subprime mortgages can end up in your investments

1 Home buyers

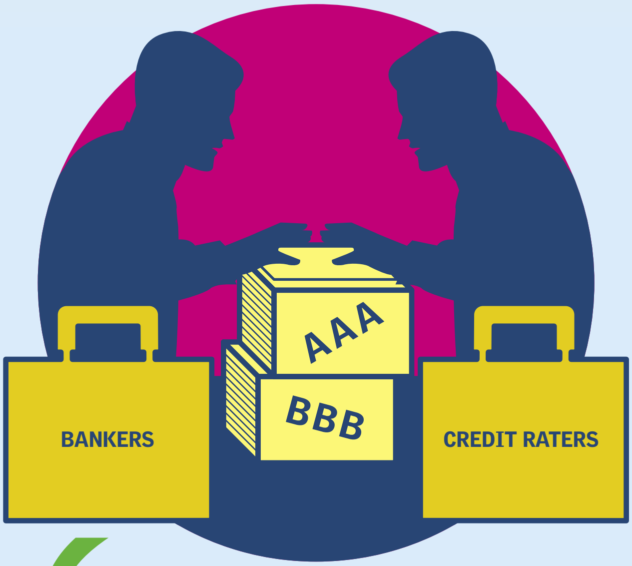
Buyers with weak, or subprime, credit typically pay annual mortgage rates that are at least 2 percentage points more than the rates that banks charge people with good credit.

2 Mortgage brokers

Brokers, many of them based in California, lie at the heart of the once-profitable partnership between subprime lenders and Wall Street. They handle as much as 70 percent of originations.

5 Securitization/manufacture of CDOs

Wall Street banks package subprime loans into mortgage-backed securities and collateralized debt obligations. Sales of new MBSs soared to $2.4 trillion in 2006.



6 Rating companies

When a bank creates a CDO, it meets with credit raters to discuss the quality of the contents, including subprime debt. They divide the CDO into pieces in order to get the desired rating for each portion.

3 Subprime lenders

Lenders lure people with exotic mortgages such as no-doc loans, which don't require evidence of income or savings. A record $805 billion of subprime mortgages were originated in 2005.

4 Big banks/wholesalers

Big banks buy the subprime loans. Many banks then bundle the debt and sell it to Wall Street firms. Banks such as HSBC Holdings have been hurt by the subprime bust.

7 Securities/CDOs

CDOs include a mix of bonds and securities backed by mortgages and home equity loans. In 2006, an estimated $100 billion of subprime debt went into the $375 billion in CDOs sold in the U.S.

8 Investors

Investors like CDOs because they offer potentially higher returns than bonds with the same rating. Banks, insurance companies and pension funds take on more risk in pursuit of yields as high as 20 percent.

months of 2007 because of mortgage losses at its 49 percent–owned GMAC finance company. Swiss banking giant UBS said in May that it would shut its Dillon Read Capital Management arm after the hedge fund manager lost 150 million Swiss francs ($123 million) in the first quarter, partly on subprime investments. Subprime originations fell 10.3 percent to $722 billion in 2006 from a record $805 billion in 2005, according to JPMorgan Chase & Co. Credit Suisse predicts a 40–60 percent slide this year.

The party is over in Orange County. These days, Secured Funding's once-buzzing office building in Costa Mesa, near John Wayne Airport, is gutted. The imprint of "Secured Funding" is all that remains of the corporate logo that once graced the outside of the two-story building. Above it is a "For Lease" sign advertising the 82,333-square-foot (7,649-square-meter) building.

Investors could lose $75 billion on bonds backed by subprime debt.

"They cut way back," a construction worker says, shrugging.

What little remains of Secured Funding is now housed in a building across the near-empty parking lot, where a receptionist tells a caller: "Our wholesale division is closed. We're no longer doing business with brokers."

The subprime industry—and investors' losses—would never have gotten so big were it not for a small army of independent mortgage brokers and hustling salesmen like Afghani, who was fired in October. He and other subprime veterans say their job was to reel in borrowers, period. Never mind whether customers needed loans or could manage payments. Afghani says sales pitches typically focused on what a borrower could do with all of that money rather than on fees buried in paperwork or annual interest rates as high as 10.5 percent at the time, at least 2 percentage points more than the rates that banks charge people with good credit.

"Even with explanations, most borrowers didn't really understand what types of loans they were getting," says Maureen McCormack, another former Secured Funding employee. "They just cared about the monthly payment."

The sales job was made easier with exotic mortgages such as so-called no-doc loans, which enable borrowers to get loans without having to supply evidence of income or savings, and option ARMs, adjustable-rate mortgages that let people pick how big a payment they will make from month to month. The loans offer upfront teaser rates at the cost of tacking the deferred payments onto the balance of the loan.

"Heavy sales pressure has been part of the most-egregious lenders for a while," says Kurt Eggert, a professor at Chapman University School of Law in Orange, California, who has studied the role of aggressive sales tactics in subprime lending and sued lenders on behalf of elderly borrowers caught up in home equity scams.

However brokers snared customers, lenders in California typically sold the loans to big banks or Wall Street firms. Under U.S. law, investors who buy mortgages or securities backed by them are typically not susceptible to lawsuits alleging fraud on the part of brokers.

Such protection partly explains why the U.S. mortgage-backed-securities market has ballooned. The market more than tripled since 2000; $2.4 trillion of MBSs were issued last year, according to the Securities Industry and Financial Markets Association in New York. Last year was the first time more than half of the securities issued were backed by subprime and other nonconforming loans, according to the trade group. "The market is driven by volume and passing along the risks associated with it," says Paul Leonard, director of the California office of the Center for Responsible Lending, a Durham, North Carolina–based consumer advocacy group. "With the appetite of the secondary market, neither brokers nor originators had much accountability."

Lenders push sales of subprime loans as far down the chain as possible to vast networks of brokers. While independent brokers account for about half of all mortgage originations, they handle as much as 70 percent of subprime originations, according to the Mortgage Bankers Association of America.

Many of the biggest subprime casualties, including Santa Monica, California–based Fremont General Corp.; Kansas City, Missouri–based NovaStar Financial Inc.; and New Century Financial, would never have grown as fast as they did without their ability to outsource the bulk of their sales to outside brokers and salesmen. New Century, before tumbling into bankruptcy on April 2, used a network of 47,000 mortgage brokers and 222 branch offices to grow to $59.8 billion in annual loans last year from just $400

Top subprime lenders

*Originations. **Subprime portfolio.
Source: *Inside Mortgage Finance*

million in its first year, in 1996, according to company filings.

Fremont originated a peak of $36.2 billion in subprime loans in 2005, up from $3.3 billion in 2001, largely through "independent loan brokers," according to company filings. The company ended its subprime business in March.

Even before the bottom fell out of the subprime market, NovaStar and other lenders were defending themselves against lawsuits that accused the companies of using independent brokers and branch salesmen to exploit borrowers with high-cost loans. A lawsuit filed against NovaStar in federal court in Memphis, Tennessee, in April 2006, for example, centers on allegations that NovaStar used mortgage brokers to prey on minority borrowers, in this case a 61-year-old black woman who claims to have heard pitches for "easy money" on a local gospel radio station.

Among other allegations, the plaintiff, Mae Jackson of Memphis, claims she was never informed about the terms of the loan, including the amount, the interest rate or the closing costs. In her complaint, she attacks NovaStar's practice of using mortgage brokers who employ "deceptive high-pressure tactics to foist these unfair and discriminatory subprime loans onto unsuspecting minority borrowers."

In court filings, NovaStar pins the blame on the mortgage broker, Memphis-based Worldwide Mortgage Corp., which filed for bankruptcy in April 2006. In a separate statement, NovaStar says that contrary to the plaintiff's portrayal of herself as naive, Jackson was a "real estate investor who owned five properties at the same time." Neither she nor her attorneys have provided any evidence of discrimination, NovaStar says. Jackson couldn't be reached for comment.

Like many subprime lenders, NovaStar spread its tentacles by tapping into a broad base of mortgage brokers and so-called net branches. A net branch enables an independent broker to set up shop under NovaStar's or some other company's banner with little upfront investment, much less a state license, and quickly begin brokering loans to kick upstream to the parent. NovaStar made great use of the technique: By the end of 2004, it had expanded its number of branches to 432 from four at the beginning of 2000. At their peak in 2003, NovaStar's branches brought in $1.2 billion of loans, a fifth of the total $6 billion in subprime loans originated by the company that year. “The branches represent a competitive advantage for NovaStar as we seek greater market share,” the company said in its 2003 annual report.

Several lawsuits filed against NovaStar paint a more sinister picture. They claim the company played fast and loose with state licensing requirements in an effort to make results look better than they might have without the aid of the branch loan sales. “NovaStar had woefully failed to comply with federal and state regulations as a result of defendants’ efforts to expand the company’s business at all costs,” alleges one 94-page complaint filed in November 2004 in federal court in Kansas City and certified as a class action this past February. The firm is facing at least seven class actions, according to Bloomberg data.

The upheaval in Orange County has reverberated around the world.

Buried: Salesman **Taher Afghani,** posing on the beach, says the good times are over in California’s Mortgage Alley.

MICHAEL KELLEY

Among other allegations, the Kansas City lawsuit claims NovaStar fraudulently puffed up borrowers’ assets to qualify customers for loans. One unnamed former employee, identified as a “loan officer” who worked in California from 2002 to ’03, told plaintiffs’ lawyers that employees would apply an “X-Acto knife and some tape” to borrowers’ W-2 forms and paychecks to qualify them for loans. The same employee said that on other occasions, the company would temporarily deposit $5,000 in the bank account of a potential borrower to inflate his or her assets. NovaStar would either take the money back or increase the loan fees, according to the lawsuit filed by co-counsel Milberg Weiss & Bershad LLP of New York. “NovaStar believes it is irresponsible to continue to print the false and inflammatory allegations regarding lending activities contained in this lawsuit, given that the plaintiffs have never produced any evidence to support them and they are not actually a part of the underlying claim,” NovaStar spokesman Richard Johnson said in a statement.

Johnson says three state and federal licensing and compliance actions involving the branches filed against NovaStar that are detailed in the lawsuit amount to much ado about nothing. “None of NovaStar’s operations in these states, or nationwide, were materially affected or in danger of being materially affected, in any way, and therefore those actions did not require disclosure at the time,” Johnson said in his statement. The company announced in April it was exploring “a range of strategic alternatives,” including a sale.

The proliferation of lightly licensed sales branches was enabled in part by a patchwork of regulations that cover independent mortgage brokers and lenders. While banks are overseen by federal and state regulators, mortgage brokers and independent sales outfits are overseen by a menagerie of state authorities, some of which also look after barbers and masseuses.

In California, which accounts for about 40 percent of subprime borrowing in the U.S., no one even knows how many people are originating loans, according to an October 2006 report by the

California Association of Mortgage Brokers. That's because while the state licenses individual mortgage brokers, anyone can work for a big lender under the umbrella of a single corporate license. The group estimated that a minimum of 600,000 people were peddling loans in the state last year. "In other words, the corporation can hire a loan originator right off the street and have them originating loans that day without any education, licensing or individual accountability," the report said.

Subprime sales tactics are now spilling out in lawsuits.

"That's the way the law is in California," says Mark Leyes, director of communications of the state's Department of Corporations. "We license the entity. They can have people working for them who are not licensed by us."

Such loose regulatory oversight, combined with California's frenzied real estate market, helped make the state a natural destination for the subprime business. Even NovaStar, while headquartered in Kansas City, maintained a large presence in Orange County. Half of the 20 biggest U.S. subprime lenders were in California, including three in Orange County's Irvine, according to *Inside Mortgage Finance,* a Bethesda, Maryland–based industry newsletter.

Orange County was also the home of Secured Funding, which specialized in home equity loans, or second mortgages, to people with lousy credit. The firm was founded in 1993 by Lorne Lahodny, who eventually built it into a 1,000-employee operation in Costa Mesa that closed more than $1.25 billion of loans by 2005, according to a company fact sheet. Neither Lahodny nor his partner in Secured, John Lynch, responded to messages left by phone and in person at their offices.

Secured Funding's success was fueled by sales leads generated by millions of pieces of direct mail and Internet trolling, Afghani and other former salesmen say. Typical of the direct mail was a credit card offer. When potential customers called to activate the card, they were instead hooked up with a Secured Funding account executive such as Afghani.

Afghani describes chaotic office scenes that recall *Boiler Room,* a 2000 movie about stock brokers at a Long Island wire house. To spur sales, Secured Funding broke its salesmen into color-coded teams. "If you weren't turning those calls into applications, they would drag you out and make your life miserable," he says. "The turnover was unbelievable," says Afghani, who says he watched eight people pass through the neighboring desk in seven months. "If you didn't cut it right off the bat, you were just fired."

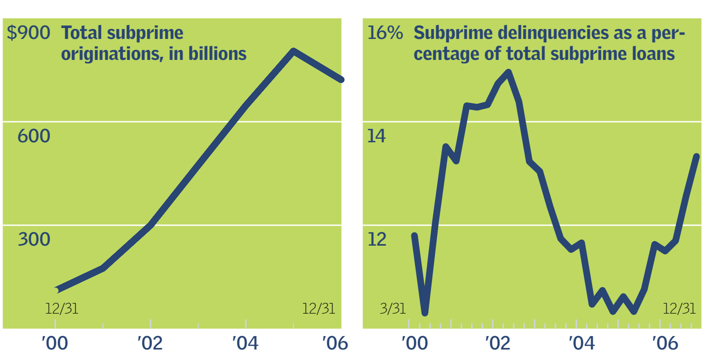
Dane Marin, who worked at Secured Funding for a year, says managers harangued everyone. "If you weren't on the phone very long, you'd get an e-mail saying, 'Get your head out of your ass,'" he says. Afghani says he and fellow brokers dispensed with details about rates and fees and instead talked up how borrowers could use home equity loans to pay down other debts. "It was easier than financing a car," Afghani says of getting a mortgage.

At times, Secured Funding salesmen broke the rules, according to at least three lawsuits filed last year in federal courts in St. Louis and Milwaukee. The plaintiffs accuse Secured Funding of accessing their credit reports without permission for the purpose of sending them unsolicited loan offers. In one case, Secured Funding sent the plaintiff a "personalized Platinum Equity Card" offering "$50,000 or more in cash" just for calling Secured's toll-free telephone number. In the other two lawsuits, Secured sent bogus $75,000 checks that reassured the recipients their "Less Than Perfect Credit Is OK!" Afghani says the firm was blasting consumers with as many as 4 million pieces of mail a month.

In answers to the complaints, Secured Funding denied wrongdoing. The company said it followed federal regulations when accessing "consumer reports" to pitch customers.

What goes up...

Subprime lending surged amid low interest rates and rising home values. Now, delinquencies are the only thing going up.



Sources: JPMorgan Chase, Mortgage Bankers Association of America

Secured Funding's attorney in the lawsuits, Richard Gottlieb of the Chicago office of Dykema Gossett PLLC, resigned in April, citing "irreconcilable professional differences" with Secured Funding. Gottlieb declined to comment.

However the leads came in, Secured Funding's salespeople made sure the fish stayed on the hook. "You would say anything to get the loan through," says Cristopher Pike, who worked at Secured in 2005 and '06.

Law professor **Kurt Eggert** says many subprime lenders use aggressive sales tactics to snare unwitting borrowers.

MICHAEL KELLEY

Secured Funding hung photos of sales incentive trips, like the one to Cabo, around the office. As sales boomed in early 2006, limos would pull up at the office to take salesmen to Los Angeles Lakers basketball games, Pike recalls. The parking lot was so clogged with luxury cars that employees had to valet-park or board a shuttle bus to get to the office.

Charlyn Cooper, a former Secured underwriter, says she kept an electric scooter in her trunk to travel as far as a mile from her car to the office. "They all used to laugh at me," says Cooper, who was dismissed in October. "They had a van that would come by and pick you up from your car, but the van was always full."

Cooper's job was to rein in the salespeople and make sure paperwork was legitimate so Secured Funding could sell its loans upstream. She says Secured Funding unloaded most of the loans on HSBC Holdings Plc's HSBC Finance unit, which has been racked by the subprime blowup. The bank, Europe's largest by market value, said profit at its U.S. unit plunged 39 percent during the first quarter, primarily because of an increase in U.S. loan defaults, including the second-lien loans that were Secured Funding's speciality. Provisions set aside for credit losses almost doubled to $1.7 billion.

Secured Funding salespeople didn't always appreciate Cooper's scrutiny of loans, she says. "Sales guys are always going to cry because they work on commission," she says. Salesmen such as Afghani made as much as $3,250 on each loan.

Cooper cross-checked borrowers' stated salaries to, say, weed out any custodians or maids who claimed they earned $10,000 a month. "There's that push-pull with sales because they're like, 'Why are you arguing with me,' and I say, 'Sorry, a bus driver is not making $10,000 a month,'" Cooper says.

Many subprime sales techniques are now spilling out in the lawsuits, advocacy reports and Congressional hearings that predictably follow such industry meltdowns. Several lawsuits illustrate the lengths to which the big wholesalers, and ultimately Wall Street, were able to outsource the selling of the loans as far down the chain as possible. Fremont General's Fremont Investment & Loan, Wells Fargo & Co.'s home mortgage unit and a rogue's gallery of mortgage brokers come under such scrutiny in a lawsuit filed in August 2006 in San Mateo County, California, state court.

Plaintiff Johnnie Damon claims he was "fraudulently induced" to take out a $484,000 loan from Irvine-based mortgage broker Peak Funding Inc., which allegedly falsified Damon's financial records to qualify him for the loan. Damon claims he asked for a reverse mortgage, which enables homeowners to borrow money in the form of payments charged against their home equity, and instead got a "traditional refinance loan" without his knowledge.

Also without Damon's knowledge, the claim says, the mortgage broker falsified information on his loan application, such as his monthly income, to qualify him for the loan. Fremont sold servicing rights on the loan, which is the right to process monthly payments, to San Francisco–based Wells Fargo and flipped the loan itself to Paris-based Société Générale SA. Wells Fargo is also named as a defendant for ignoring "fraudulent and predatory lending practices" in the loans it purchases and services, according to the lawsuit.

The complaint also alleges that Fremont, prior to its recent decision to exit the subprime business, was using mortgage brokers to do its dirty work. "Fremont has a history of intentionally turning a blind eye to fraudulent and predatory lending practices by the mortgage brokers who generate home loans for the company," the lawsuit alleges without citing any other specific examples.

Expanding on the accusations, Damon's attorney, Aaron Myers of Howrey LLP, says Fremont funded a loan made "by a bunch of crooks who completely misled the borrower, falsified his income, coerced him into the loan and then tricked him into sending the loan proceeds back to the company."

In answers to the complaint, all of the defendants deny the accusations. "Wells Fargo's trivial role in this case is punctuated by the fact that it has not caused the plaintiff any harm," Wells Fargo's attorneys said in an Oct. 10, 2006, court filing, adding that they put a hold on the loan after the dispute erupted. "Wells Fargo does not belong in this case."

Robert Cannone, a former chief financial officer and director of Peak Funding who's also listed as a defendant by name, says the firm closed last October after it ran out of money. He neither admits nor denies wrongdoing. "I'm so embarrassed," Cannone says in a telephone interview. "I feel really bad." He says that of the 100 loans made by Peak, this is the only one in dispute. He says an employee connected with the Damon loan "went off the reservation."

When the boom went bust, even people on the periphery of the industry got caught in the downdraft. Carrie Feinman worked in Scottsdale, Arizona, in the wholesale prime lending division of New Century Financial, which acquired nonsubprime loans from smaller lenders and mortgage brokers. The relative health of her side of the business, which New Century acquired from Royal Bank of Canada in 2005, couldn't stop New Century's troubled subprime lending from dragging the entire company into Chapter 11 on April 2.

Feinman says the news that the company was filing for bankruptcy came out of the blue, leaving her and most other employees out of pocket on unused vacation time and severance pay. "We were shocked," says Feinman, who's looking for a job. "If I had quit the week before, I would have gotten my vacation time. You wonder why no one is loyal to employers anymore."

A month after leaving Secured Funding, Afghani took a new job at Irvine-based Solstice Capital Group Inc., another subprime lender. HSBC, the same bank that had been buying loans from Secured Funding, bought Solstice last year for $50 million.

Afghani quit in April, vowing to find a new line of work. "Enough is enough," he says, adding the good times are long gone. "I'm so rock bottom I had to move out of my apartment in Irvine and live rent free with my girlfriend," he says.

The hard knocks have taught him a lesson, Afghani says. "It was tough love and a great learning experience to live within your means and not end up like the individuals on the other side of the phone," he says.

'It was easier than financing a car,' Afghani says of getting a mortgage.

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