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Testimony of Former New Century Mortgage Wholesale Underwriter, Patricia Lindsay, Before the FCIC

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The following is the testimony of Patricia Lindsay for the Financial Crisis Inquiry Commission Hearing on April 7, 2010:

Thank you for inviting me to speak this afternoon. My hope for today's session is that I give you a unique perspective into Subprime lending. I know I was not alone in not understanding the steadily increasing risks taken in the years before my employer New Century Financial Corp. stopped making loans in March of 2007. I grew up in the real estate business where my father was a Broker and a hard money lender. A hard money loan is a short term loan to a borrower who has a significant amount of equity in the property and cannot qualify for a traditional bank loan. I became an Account Executive at Beneficial Mortgage the end of 1996. Beneficial was one of the original subprime lenders who held their loans in their portfolio rather than selling them. There were a lot of similarities between Beneficial and my experience with hard money lending, Beneficial and the various hard money lenders with whom I worked were very aligned in their thought process on how to evaluate a loan. We had three things that we used to evaluate a loan; Credit, Collateral and Capacity. We would look at these three C's and if any were lacking, like credit, a borrower better have some compensating factors, like great collateral. There was a fourth C, character, that went missing when the loan process became more impersonal and the prospective borrower never met face to face with the lender.

I joined New Century Mortgage as a Wholesale underwriter in June of 1997 and left New Century in December of 2007. I was part of a skeleton crew kept on to help unwind the corporation after they filed bankruptcy. I found the lending standards at New Century were much different than the hard money standards I had learned. I really didn't understand what it meant to securitize a loan, but thought they must have found the secret sauce, so to speak, on how to take already risky borrowers and give them more money than the traditional hard money or portfolio lenders could. I loved my job at New Century, and found my niche growing and developing fraud detection and prevention measures across all of the business channels in the company. New Century provided me with all of the training and tools I wanted and needed in order to be the best asset to the company. I attended numerous seminars, became proficient at my job then began speaking at the seminars and teaching. We talked about the three C's when I came to New Century and common sense lending. These were terms I stopped hearing in the last few years. There was no longer any common sense, the three C's had disappeared and the risk was layered rather than offset . The business became volume driven and automated. A broker could get a loan pre-approval in 12 seconds or less with our proprietary system. If we couldn't close a loan quickly, one of our many competitors would. With this increased speed, I was tasked with finding a way to automate fraud detection. With the support and backing of Executive management, in 2005 I brought in a company who used our known fraud loans to build a predictive analytics tool that ran in tandem with our loan origination system. High risk loans were identified and reviewed by a local risk manager who either cleared them or recommended further action.

Key Points:

- **The growth and evolution of the subprime mortgage industry:**

  - The niche market of subprime lending grew and evolved into huge business when unlimited funding became available through Wall Street via securitizations. Before Wall Street came on to the scene, there were specialty finance lenders, like Beneficial Finance and Beneficial Mortgage, who filled this niche market. They catered to borrowers who could not qualify for a conventional loan because of poor credit, a high debt to income ratio ("DTI") or other mitigating factors. They would offset their risk by commanding a higher interest rate and providing a lower loan to value ("LTV") financing. The riskier the borrower (i.e.; unsteady income, poor payment history), the higher the probability of a default, thus the need to offset the risk by reducing the LTV.

- **The presence and impact of fraud in subprime origination:**

  - People who may not have committed fraud before did so by making material misrepresentations to buy a property. The 100% financing products on purchase money transactions provided a vehicle for people to enter into buying a property without putting forth any money. The stated income product eliminated the ability to prove fraud without supporting documentation. When previous products required some supporting documentation in order to get a higher LTV, it was easier to identify the fraud and stop it. Straw buyers were recruited for their credit scores specifically to avoid having to provide income documentation. And they would also claim that the property was to be owner occupied, as 100% financing was not offered on non-owner occupied properties. The numbers that we (at New Century) were seeing and identifying as true fraud loans were a minuscule number compared to the number of loans we were funding every month, so I think the products offered had a bigger impact on losses and defaults than fraud did, at least as far as New Century's loans.

- **The funding of subprime originators through the use of warehouse lines of credit:**

  - Many, if not all of New Century's competitors were only able to operate with the use of warehouse lines of credit. These warehouse lines were provided by large financial institutions, many of which were the same Wall Street investors who would buy our loans. They very helpful in the sense that they made sure we had enough money to close the loans that they were waiting in the wings to buy. It was a very efficient model from a productivity standpoint. New Century had several warehouse lines of credit with many different banks which enabled the funding of 20k+ loans (approximately $5B) per month, at the peak. New Century did not have the liquidity to make these loans without the use of warehouse lines of credit. When New Century's lines were shut down in March of 2007, business stopped. New Century's repurchase requests increased significantly as well. There became a need for a new department to be developed

in 2006 to centralize these requests and help my department out. In early 2007, our repurchase process slowed, indicating there may have been a cash flow problem.

- **The impact of so-called "originate-to-distribute" model for mortgage origination and any concerns with that model:**

  - The Definition of a good loan changed from, “One that pays” to “One that can be sold”. The loans were no longer held by portfolio lenders, but sold to investors, most of whom placed them into securities. We had lost the ability to follow and monitor the performance of any loans that we did not hold either on our servicing platform or in a security we had an interest in. We did monitor the performance of the loans to which we had access, but this was not the whole picture. Virtually all of New Century's loans were sold and or securitized and not held in a Portfolio.

- **The quality of underwriting in the years leading up to the financial crisis, including the exceptions to underwriting policies and procedures that I observed:**

  - Loose guidelines allowed people to buy homes they couldn’t afford. Loan terms started in the early years, when I came on the New Century in 1997, with the 2/28 ARM ("2/28"), this is a 30 year adjustable rate loan that has a fixed interest rate for the first two years then would go to an adjustable rate, usually adjusting every 6 months until the loan became fully indexed. Later on, somewhere around 2004, the fixed portion of the loan was just interest only and a 40 year term was added into the products being offered, although the 30 year term was still the most widely used. These loose guidelines included 100% financing to borrowers with low credit scores and no supporting proof of income.

- **Risk Management practices in subprime origination, including any changes in risk management leading up to the financial crisis:**

  - Risk managers at New Century were viewed as a roadblock rather than a resource in many instances. We had Risk Managers placed in production groups all across the country, and they had daily tasks that they were to perform. They would have targeted audits in addition to helping the group with researching any items of concern. Things like brokers on watch, multiple social security numbers for a borrower, or other discrepancies that needed to be clarified. If the risk manager could get to the bottom of the discrepancy and clear it, the file would be stronger because what started off looking like a problem was shown to be an error or whatever the case maybe. The real problems arose when the initial issue may have been cleared, but something else was discovered. One of the biggest changes we made in Risk management was eliminating a document we had called the Purchase Money check list ("PMC"). In the late 90's we did a post mortem review of failed loans when New Century had taken a loss. An overwhelming number of those loans were purchase money transactions with certain

characteristics. To help mitigate any future losses, we required these transaction be reviewed by the local risk manager an fill out the PMC. During these reviews, many times the risk managers would find other issues that were not part of the PMC. The production groups were constantly complaining that the risk managers were finding other things when they were only suppose to be looking at the PMC. Around the middle to the end of 2005 at one of our Operations meetings it was announced that the PMC would no longer be used and we were "blowing it up", which received cheers by sales personnel. There was a lot of tension in many of the groups between the risk managers and production. I was called upon to help bridge the gap with a couple of groups. The sales mangers would complain that the risk managers were "killing" their deals and making their account executives anxious. But there were also groups where there was synergy between risk and production, where the risk managers were respected and utilized.

- For the most part, there was not an equality between production (front end before the loans close) and the back end. It was clear that the front end ruled because they were bringing in the revenue. The only time the back end, specifically Risk Management had any teeth was when fraud was proven. If fraud was proven, the loan was locked and declined. If there was no physical proof of fraud, it became a business decision whereby the sale managers had the final say whether the loan would proceed or not.

❖ **The compensation and incentive practices for persons involved in originating subprime mortgage:**

- Account executives, who were New Century employees who brought loans in from brokers, were primarily compensated on commission of closed loans that they brought in. I was compensated with salary plus bonus based on company performance with part of that being discretionary based on personal performance. The compensation was significant for the top producing salespeople, some of whom were making several million dollars a year. Many of the sales managers and account executives lacked any real estate or mortgage experience. They were missing the depth of experience necessary to make an informed lending decision. These same sales mangers had the ability to make exceptions to guidelines on loans, which would result in loans closing with these exceptions, at times over the objections of seasoned appraisers, underwriters or risk personnel. Some of the best sales managers had underwriting backgrounds and were more closely aligned with risk management and better at understanding potential problems, but this was the exception and not the rule.

❖ **The growth, prevalence, and impact of so-called "exotic" mortgage products such as low documentation and stated income loans, and teaser rate mortgages:**

- The stated income, high loan to values ("LTV"), coupled with the 2/28, interest only ("IO") loans impacted the market by making purchasing a home as easy as it has ever been. Property values were climbing due to the easy money and

excessively low interest rates. Any problems, including fraud or defaults were being masked by the rapid housing appreciation.

- **The role and practices of appraisers in subprime mortgage origination:**

  - Properly valuing a property (one of our three C's, collateral) is one of the most important components in a loan. In my experience at New Century, fee appraisers hired to go to the properties were often times pressured into coming in "at value", fearing if they didn't, they would lose future business and their livelihoods. They would charge the same fees as usual, but would find properties that would help support the needed value rather than finding the best comparables to come up with the most accurate value. Some appraisers would take boards off boarded up windows, to take the needed photos, then board the properties back up once the shots were taken. Or they would omit certain important elements of a property by angling the camera a certain way or zooming close in to make the property look the best possible. This level of appraiser activism compromises their objectivity.

At the end of the day, we had a system that went into a downward spiral because of layering risk rather than offsetting the risk because there was such a huge demand for the products. Our loans were sold before we even made them, which put more pressure on the production groups to get loans closed. Wall Street packaged and sold the Residential Mortgage Backed Securities to unsophisticated bond buyers/ investors. By unsophisticated, I mean they did not understand the true risk of the underlying loan product. The process was so convoluted it was nearly impossible to get a fraud loan pulled out of the entanglement to repurchase it. I actually had a Wall Street investment banker chastise me for trying to buy a fraud loan back. This particular loan was back in 2002 or 2003 when there were hardly any loans coming back from investors. His comment was, " You want me to pull this *one* loan out of this security? Do you know what I have to do?" He proceeded to tell me that he had to find another loan to put in its place and asked if I really needed to pull it. To his credit, he did as I asked, pulled the loan and New Century repurchased it.   It was at that point that I began to get a taste of the complexity of how securities worked.

The rating agencies improperly rated these securities, deeming them much safer than they actually were.   It seems the lending process needs to return to the basics; true risk based pricing and transparency. We have to look at the kind of market we are in, do we have cheap money with increasing housing prices? If so, the loan to value ratios should be reduced to accommodate the increased risk. I just know if I am loaning my personal funds, which I have done on several occasions, I want to ensure I'm protecting my investment. By extension, the same common sense should apply in the marketplace. A return to our core guidance of the three C's, and offsetting the risk rather than layering it.

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