


June 27, 2007

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# *LENDING A HAND* How Wall Street Stoked The Mortgage Meltdown

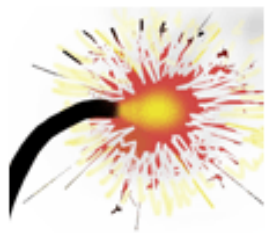
## Lehman and Others Transformed the Market For Riskiest Borrowers

By MICHAEL HUDSON

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Twelve years ago, **Lehman Brothers Holdings Inc.** sent a vice president to California to check out First Alliance Mortgage Co. Lehman was thinking about tapping into First Alliance's lucrative business of making "subprime" home loans to consumers with sketchy credit.

The vice president, Eric Hibbert, wrote a memo describing First Alliance as a financial "sweat shop" specializing in "high pressure sales for people who are in a weak state." At First Alliance, he said, employees leave their "ethics at the door."



**DEBT BOMB**  
Inside  
The 'Subprime'  
Mortgage  
Debacle

Read the first article in this series: ['Subprime' Aftermath: Losing the Family Home](#)<sup>1</sup> 5/30/1007

The big Wall Street investment bank decided First Alliance wasn't breaking any laws. Lehman went on to lend the mortgage company roughly \$500 million and helped sell more than \$700 million in bonds backed by First Alliance customers' loans. But First Alliance later collapsed. Lehman landed in court, where a federal jury found the firm helped First Alliance defraud customers.

Today, Lehman is a prime example of how Wall Street's money and expertise have helped transform subprime lending into a major force in the U.S. financial markets. Lehman says it is proud of its role in helping provide credit to consumers who might otherwise have been unable to buy a home, and proud of the controls it has brought to a sometimes-unruly business.

Now, however, that business is in deep trouble, and some consumer advocates and policy makers are pointing the finger at Wall Street. Roughly 13% of subprime loans stand in or near foreclosure, bringing turmoil and sometimes eviction to tens of thousands of homeowners. Dozens of lenders have gone out of business. **Bear Stearns Cos.** is trying to bail out a hedge fund it manages that was hurt by subprime mortgage losses.

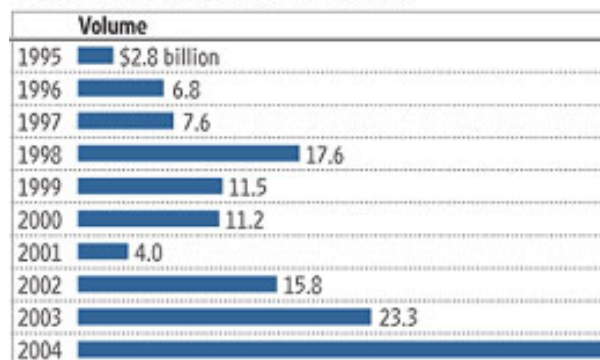
Critics say Wall Street firms helped create the mess by throwing so much money at the market that lenders had a growing incentive to push through shaky loans and mislead borrowers.

At a hearing in April, Sen. Robert Menendez (D., N.J.), said Wall Street firms "looked the other way" as they profited from questionable loans, "fueling a market that has very little discipline over itself."

Federal Reserve chief Ben Bernanke said in a May speech that some lenders focused more on feeding the marketplace than on the quality of loans, in part because most of the risks that loans would go bad were passed to investors. As a result, "mortgage applications with little documentation were vulnerable to misrepresentation or overestimation of repayment capacity by both lenders and borrowers," he said.

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#### BUILDING A SUBPRIME GIANT



A generation ago, housing finance was different. Bankers took in deposits, lent that money to home buyers and collected interest and principal until the mortgages were paid. Wall Street wasn't much involved.

Now it plays a central role. Wall Street firms provide working capital that allows thousands of mortgage firms to make loans. After lenders sign up consumers for home loans, investment banks pool the income streams from these loans into bonds known as mortgage-backed securities. The banks sell them to yield-hungry investors around the

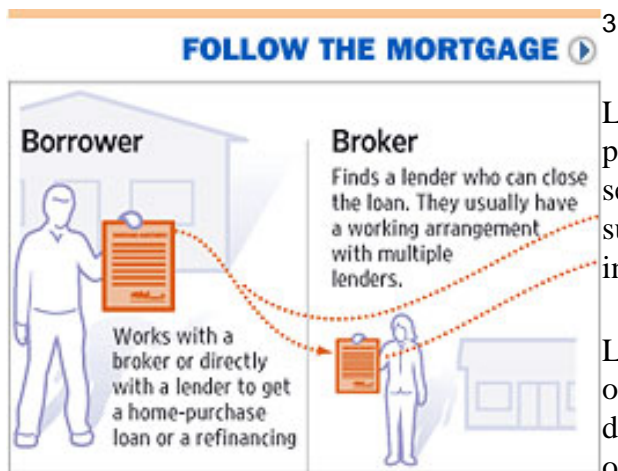
world.

Before the mid-1990s, mortgage-backed securities consisted mostly of loans to borrowers with good credit and cash to make ample down payments. Then investment banks found they could do the same with riskier loans to borrowers with modest incomes and flawed credits. Pooling the loans created a cushion against defaults by diversifying the risk. The high interest rates on the loans made for bonds with high yields that investors savored. New technology helped make it easier for lenders to collect and collate mounds of information on borrowers.

Lehman, one of Wall Street's biggest players in the subprime boom, says it has gone to great lengths to screen loans for fraud and vet the lenders it works with. "No financial institution would knowingly want to make or securitize a loan that it expected would later go into default," David Sherr, Lehman's head of securitized products, told Mr. Menendez and other senators. "Rather, the success of mortgage-backed securities as an investment vehicle depends upon the expectation that homeowners generally will make their monthly payments, since those payments form the basis for the cash flows to bondholders."

At the sector's peak in 2005, with the housing market booming, loan defaults remained low. Wall Street pooled a

record \$508 billion in subprime mortgages in bonds, up from \$56 billion in 2000, according to trade publication Inside Mortgage Finance. The figure slid to \$483 billion last year as the housing market slumped and subprime defaults picked up.



Lehman topped other Wall Street firms over the past two years, packaging more than \$50 billion in subprime-mortgage-backed securities in both 2005 and 2006. Overall, Lehman officials say the subprime business has accounted for 3% of the firm's overall revenues in recent quarters, or roughly \$500 million in 2006.

Lehman has also been a leader in investment banks' push to buy their own lenders. Through its subprime unit BNC Mortgage Inc., it lends directly to consumers, bringing in more fees and giving it more control over the quality of the loans.

Lehman's deep involvement in the business has also made the firm a target of criticism. In more than 15 lawsuits and in interviews, borrowers and former employees have claimed that the investment bank's in-house lending outlets used improper tactics during the recent mortgage boom to put borrowers into loans they couldn't afford.

Twenty-five former employees said in interviews that front-line workers and managers exaggerated borrowers' creditworthiness by falsifying tax forms, pay stubs and other information, or by ignoring inaccurate data submitted by independent mortgage brokers. In some instances, several ex-employees said, brokers or in-house employees altered documents with the help of scissors, tape and Wite-Out.

"Anything to make the deal work," says Coleen Columbo, a former mortgage underwriter in California for Lehman's BNC unit. She and five other ex-employees are pursuing a lawsuit in state court in Sacramento that claims BNC's management retaliated against workers who complained about fraud.

Lehman officials say there's no evidence to support such claims. They say the firm has tough antifraud controls and goes to great lengths to ensure that it works with mortgage brokers and lenders who meet high standards and that loans are based on accurate information.

Lehman says company records clearly refute specific details of the accounts given by these former employees. It says most of them never raised concerns during their tenures at Lehman lending units, even though that was a requirement of their jobs. Some employees contacted by The Wall Street Journal said they weren't aware of improper practices.

"We think it is misleading to extrapolate from a handful of cases, in each of which we have a strong defense, and make a judgment about the way we conduct our business," Lehman says.

Lehman's history in subprime goes back to the mid-1990s, when the sector was still tiny. Back then, Lehman established itself as a leader in the market for subprime-mortgage-backed securities. It built a staff of experts who had worked at other securities firms and established relationships with subprime-mortgage lenders.

#### WALL STREET PRIMER

- **The Issue:** Wall Street firms helped turn the subprime business into a mortgage powerhouse.
- **The Situation:** Critics say big players such as Lehman Brothers showered so much money on the market that lenders cut corners.

• **What's Next:** Lehman says it has instituted strong controls on its own lending units and remains committed to the business.

One of them was First Alliance. Mr. Hibbert, the Lehman vice president, traveled to Orange, Calif., in June 1995 to help decide whether Lehman should provide financing to First Alliance and underwrite its mortgage-backed bonds. In his memo, Mr. Hibbert reported back that there was "little risk of fraud or impropriety" at First Alliance. But he also said it was clear it made some loans "where the borrower has no real capacity for repayment."

Lehman officials say Mr. Hibbert ultimately supported going forward with First Alliance, a decision the investment bank made on the basis of extensive discussions and a 140-page memo. They also note that the \$25 million line of credit that Lehman initially wrote for First Alliance was small compared with what other firms were putting up to finance the lender.

By late 1998, Prudential Securities and other investment banks had abandoned First Alliance. Federal regulators and seven states were investigating allegations it used deceptive sales tactics to get borrowers into loans with excessive upfront fees. First Alliance trained loan officers to use a sales pitch designed to "confuse and mislead" borrowers and disguise fees, U.S. District Judge David Carter in California found in a 2003 bankruptcy-related proceeding.

During the turmoil, Lehman helped keep First Alliance afloat with more loans. In early 1999, an internal Lehman memo noted the proliferation of government probes targeting the lender -- and the possibility that involvement with the lender might produce bad publicity for the investment bank. But the memo recommended going forward, arguing that First Alliance's borrowers rarely defaulted on their loans and noting that Lehman stood to earn millions in fees by managing the lender's mortgage-backed securities deals.

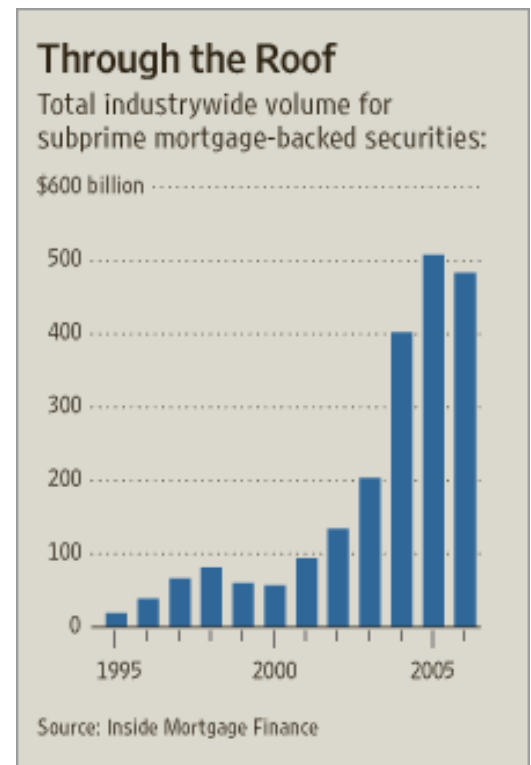
Lehman officials say they took close account of First Alliance's practices. Its reviews showed the lender was committed to improving its practices -- it hired a new in-house counsel, along with a chief financial officer who once worked at Lehman.

First Alliance shut down in March 2000 as pressure from lawsuits and investigations grew. In 2003 a federal jury in California delivered a \$50.1 million verdict in a class action against First Alliance, attributing 10% of the damages -- \$5.1 million -- to Lehman. (A federal appeals panel upheld the jury's decision but instructed the trial court to recalculate the dollar award. That decision is pending.) Lehman also settled a lawsuit filed in Broward County Circuit Court by Florida authorities who said Lehman was an "accomplice" in First Alliance's frauds. The investment bank admitted no wrongdoing but agreed to pay \$400,000 and review its practices.

Lehman calls the First Alliance saga an aberration, and says it is unfair to use it to draw conclusions about how it does business more than a decade later.

The subprime market contracted between 1999 and 2001, as continuing ripples from that era's Russian debt crisis and the collapse of hedge fund Long-Term Capital Management prompted investors to pull back from riskier markets. The crisis also presented a buying opportunity.

In 1999 Lehman started operating its own subprime lending unit, Finance America, as a joint venture with an ailing



subprime lender named Amresco Inc. as a minority partner. It bought out Amresco in 2001 and another minority investor in 2004. Lehman also took an ownership stake in California-based BNC Mortgage in 2000 after helping management take the company private. It bought out management's remaining stake in 2004 and last year merged Finance America into BNC. Earlier this month, it said it would merge BNC with its Aurora Loan Services unit.

With interest rates low and the economy recovering, the market took off, and BNC and Finance America grew quickly. They ballooned from \$3 billion in total loan originations in 2001 to \$24 billion in 2005, ranking Lehman No. 11 among all subprime lenders.

As subprime grew, Lehman officials say, fraudulent schemes pushed by rogue mortgage brokers and others became more sophisticated throughout the industry. By taking full ownership of BNC and Finance America, the firm says, it was in a better position to combat these practices.

When Lehman consolidated its control of the two companies in 2004, Lehman officials say, the lenders' practices were consistent with industry standards. But they acknowledge the lenders -- like others in the subprime industry -- had problems with loan quality and fraud prevention. "Since then, we have worked long and hard, as we have taken control, to make these companies models for the industry on best practices for fraud detection and borrower protection," the firm says.

Since the start of 2004, BNC has nearly doubled the size of its staff devoted to quality control, fraud investigations and other jobs that help ensure the lender makes good loans.

Some former employees claim, however, that the pressure to boost loan volume during the boom years of 2004 and 2005 prompted some workers at the lending units to step over the line and push through questionable loans.

Dena Ivezic, a mortgage underwriter for both companies in Downers Grove, Ill., in late 2005 and early 2006, says some staffers at her branch used "cut and paste" techniques to fabricate documents they needed to get loans approved. Some workers tried "to take a stand" against such practices, she says, but "they were reprimanded for not being cooperative -- not wanting to be creative about making deals work....Everybody else just kind of bottled up and just never said anything, because you needed a job."

Cedric Washington, a former regional sales manager for Finance America in California, contended that employees at the lender actively pushed through questionable loans. In a 2005 employment-discrimination lawsuit in state court in Sacramento, Mr. Washington said he witnessed a fellow manager alter a loan document by forging a borrower's initials. Later, he said, he discovered Finance America employees forged borrowers' signatures on credit disclosures and used falsified documents to inflate loan applicants' incomes.

In one instance, the lawsuit said, a loan officer submitted a loan on a duplex that was "not a home or duplex at all but merely a greenhouse." Mr. Washington complained the loan was backed by falsified collateral, the suit said, but a Finance America executive refused to pull the loan.

BNC officials said Mr. Washington himself was complicit in fraud, which he denied, according to the lawsuit. Lehman officials say his lawsuit "had no merit" and was "not brought in good faith." It was settled last year for an undisclosed sum. As for Ms. Ivezic, Lehman says she worked at BNC for just 4½ months and her experiences are "hardly representative of BNC's employee base."

Other former employees contacted by the Journal said that fraud wasn't a problem at the lenders. They say their managers didn't hesitate to reject fishy loans. "Everything we did was by the guidelines," says Barbara Webb, a loan underwriter for both Finance America and BNC in Texas from 2004 into 2006.

Lehman officials say they have procedures in place to prevent mortgage brokers and others in the loan process from bending rules. BNC reviews brokers before putting them on its approved list and rechecks them annually, searching state licenses and lawsuits and making sure they're not on federal officials' watch list for problem brokers.

BNC says it has stopped doing business with more than 900 since 2003, largely because of fraud. It works with an average of about 1,800 brokers a month.

At BNC's headquarters in Irvine, Calif., officials say they've designed their business with an eye to weeding out bad loans. Mortgage underwriters and loan processors -- who make sure loan-application data is accurate -- get extensive training in how to spot fraud. Under BNC's organizational chart, they're set apart from sales, to avoid pressure to let problem loans slip through, BNC officials say.

Lehman notes the Office of Thrift Supervision, BNC's regulator, received just three complaints about the company from April 2006 through March 2007, a tiny fraction of the roughly 60,000 loans it made during that span.

Some complaints have surfaced in court. Borrowers' lawsuits in Pennsylvania, Louisiana, Mississippi and other states have alleged Finance America and BNC took advantage of unsophisticated borrowers or used falsified information to approve loans.

A lawsuit in state court in Saginaw, Mich., by UAW/GM Legal Services Plan, which serves auto workers and retirees, alleges a mortgage broker "confused and pressured" an elderly couple into signing up for a BNC loan that obligated them to pay as much as 17.5% as the interest rate adjusted upward. The suit says BNC was aware of "the seamy details of what happened here" because it prepared the documents, vetted the application and gave the broker "a set of instructions for how to proceed."

George and Evelyn Lee's July 2006 loan was pooled by Lehman with nearly 4,000 other subprime home loans from BNC into a securities deal that produced more than \$800 million in mortgage-backed bonds.

The broker in the case, Real Financial LLC, has been the subject of 25 complaints to Michigan financial regulators and a fraud lawsuit that's pending in federal court in Michigan. State regulators dismissed many of the complaints, but have upheld eight of them and referred others for investigation.

Real Financial's attorney says the allegations stem from an unfavorable economy that's sparked rising foreclosures and unjustified complaints against lenders and brokers.

Lehman says it wasn't aware of complaints about Real Financial until the lawsuit was filed, but has since removed the firm from its broker list. "BNC was not aware of anything wrong with the Lees' loan because all it saw was the loan application which was in good order," Lehman said. "Real Financial was not BNC's agent, and BNC gave it no 'instructions' whatsoever. We strongly believe BNC has been added to this case only as a 'deep pocket.'"

Despite the controversy that's emerged in the subprime business, Lehman officials say they're proud of their role in helping the market grow and offering access to credit for consumers who might not otherwise have the chance.

"We think it's a business we should all be working to improve, not diminish," the firm says.

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