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At Top Subprime Mortgage Lender, Policies Were An Invitation To Fraud

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First of two articles about the roots of the subprime lending bubble.

Diane Kosch had one of the most thankless jobs in the subprime lending craze.

Sitting elbow to elbow with colleagues at a conference table in a northern California office building, Kosch's job was to review a huge stack of loans each day at Long Beach Mortgage for problems, including evidence of fraud. She was given 15 minutes per file.

However, even when Kosch noticed clues of mortgage fraud - suspicious income, questionable appraisals or missing documents - the loans usually got approved anyway. Senior managers at Long Beach Mortgage, one of the nation's biggest subprime lenders, aggressively pushed loans through. As far as the company was concerned, Kosch's quality-assurance team was just slowing things down.

"We were basically the black sheep of the company, and we knew it," said Kosch, an industry veteran.

"Most of the time everything that we wanted to stop the loan for went above our heads to upper management," Kosch said. Quality team members became so suspicious, she said, that they started making copies of problem files to protect themselves. Later, Kosch said, they would see that some of the original files were missing pages - though she didn't know who took them out or why.

Bad loans ultimately led to the collapse of Long Beach Mortgage and its owner, Washington Mutual, in the biggest bank failure in history.

An inside look at Long Beach Mortgage - many of whose lending practices were common among subprime loan companies - adds another dark chapter to the evolving narrative of the financial crisis.

The housing boom and bust often is blamed on an unfortunate mix of lax lending practices and a slowdown in home prices. Yet mortgage records, court documents and interviews with former Long Beach employees around the country suggest that management practices may have been largely responsible for the crisis because they enabled fraud to run rampant.

In markets such as Detroit and Cleveland, for example, more than half of all of Long Beach Mortgage's loans for home purchases from 2005 to 2007 went into foreclosure, according to the Office of the Comptroller of the Currency.

MAP: The Worst of the Worst »
Loans issued by Long Beach Mortgage Co. had the highest foreclosure rates in the country from 2005 to 2007.

In its headlong rush to grow, Long Beach Mortgage, like most subprime lenders, tossed aside its tried-and-true tools for identifying risky borrowers and catching fraud in the form of falsified loan applications. As part of the company's business plan, the lender required little or no documentation from borrowers or allowed alternate forms of documentation, such as credit letters from landlords, that could be faked or forged.

Independent mortgage brokers recruiting new borrowers for Long Beach loans treated the policies as an invitation for fraud, former employees said. "A lot of brokers were forging a lot of that. They were making up pay stubs and presenting that," said Karan Weaver, who, as an underwriter in Long Beach Mortgage's Atlanta office, said she would reject such loans. "We did see falsified pay stubs and tax returns."

Pam Tellinger, a former account executive responsible for sales in Colorado, said she wouldn't tolerate fraud personally but said, "I knew brokers who were doing fraudulent documents all day long."

GRAPHIC: Long Beach Loans »
In its rush to grow, Long Beach Mortgage favored lax lending practices, requiring little or no documentation from its borrowers and creating a system that was prone to fraud, according to former employees. It specialized in subprime mortgages -- loans to borrowers with poor credit -- and sales of such loans skyrocketed until 2006, when its loan default rate starting soaring. (Source:

One former account executive, who spoke on condition that her name not be used to protect her reputation, says the lax standards led to cases of Long Beach Mortgage sales people actually coaching brokers how to fake documents. And it was widely believed that for a fee, there were crooked auto dealers would write fake credit letters for loan applicants. Applications that contained fraudulent documents were so common at Long Beach Mortgage, the account executive said, "you just got used to it."

It wasn't unusual in the office for account executives pitching questionable loans to offer money or gifts to loan reviewers to overlook the deficiencies.

"They'd offer kickbacks of money," said Antoinette Hendryx, a former underwriting and team manager at Long Beach Mortgage in California. "'Or I'll buy you a bottle of Dom Perignon.' It was just crazy."

The former employees say the company encouraged the sales force to churn out as many loans as possible with lavish commissions and bonuses. And it didn't matter if the loans went bad because Long Beach Mortgage bundled them and sold most of them quickly to investors.

Washington Mutual Quarterly Reports)

"I'll be honest with you, at a certain point in the mortgage business it was just all about greed," said Denetra Summerlin, who worked in quality assurance at the Atlanta office. Her warnings were usually overridden and problem loans approved, she said.

"The greed comes from management," Summerlin said. "It wasn't about quality. It was about 'How many loans can we push out?' "

Last year, the FBI fielded more than 63,000 tips of suspected mortgage fraud. And agents are currently juggling 2,800 active investigations. These investigations include cases involving brokers and loan company employees who allegedly helped create fraudulent loan documents as well as cases involving more senior managers who allegedly misrepresented their lending practices, said Assistant Attorney General Lanny Breuer at a recent Congressional hearing.

Earlier this month, the Securities and Exchange Commission filed a civil lawsuit alleging accounting fraud against three top executives at another major subprime lender, New Century Financial Corp. Yet so far, criminal charges against anyone working for a major subprime lender such as Long Beach Mortgage are rare.

At the management level, prosecutions are non-existent.

Acquisition Spree

Kosch, an industry veteran, reminisces about working for Seattle-based Washington Mutual in the early 1990s, when loans were carefully scrutinized.

Later that decade the bank went on an acquisition spree. The culture started changing about the time it bought Long Beach Mortgage in 1999, said Lee Lannoye, a veteran banker and a former WaMu executive vice president.

Long Beach Mortgage, based in southern California, had just settled a lawsuit with the Justice Department on allegations that it discriminated against African American borrowers by charging them higher interest rates. As part of the $4 million settlement, the company promised to teach borrowers to shop around to avoid predatory practices.

Lannoye opposed acquiring Long Beach because he believed the subprime business had to be predatory to succeed. Lending to borrowers with a history of not paying their bills and mismanaging their debt was bound to lead to a lot of defaults. The only way the subprime business could be profitable, Lannoye believed, was to lure in borrowers with decent credit who simply didn't realize they could find a much better deal elsewhere.

Lannoye said he found little support among his peers on the executive committee, a factor in his decision to retire later that year.

But what happened next was just the opposite of what Lannoye predicted. Long Beach began loaning to people who really couldn't afford the payments. The bank didn't hold many of these risky mortgages on its own books - it sold most in bundles to Wall Street to make a quick profit and protect itself from potential losses.

Lannoye, who for a while was in charge of lending at WaMu, said it was obvious to any banker that the loans being made were doomed. For example, Long Beach Mortgage started offering no-money down mortgages, which were actually two loans. One was for 80 percent of a home's value and the other substituted for the traditional 20 percent down payment.

Asking for no down payment from people with a history of bad or no credit breaks all the rules of sound lending. Borrowers had little to lose by walking away from such loans. In trying to explain why a bank would do this, Lannoye said, "I can only say it has to start at the top."

The strategy to dramatically boost sales of Long Beach Mortgage subprime loans came directly from WaMu chief executive officer Kerry Killinger. He outlined the plan on Dec. 9, 2003, speaking to financial analysts in New York.

At the time, things were tough for Killinger. He'd spent much of the previous seven years buying large financial institutions in California, Florida, Illinois and New York to make Washington Mutual - once a regional player in the Pacific Northwest -- the nation's second largest mortgage lender. By 2003, one in eight new mortgages in America came from Washington Mutual.

But when interest rates started rising in 2003, sales plummeted and competition intensified. WaMu began losing money on its home lending business. So Killinger came up with a new plan. He'd let others have barely profitable conventional loans. Instead, WaMu would boost sales of loans with high profit margins, such as subprime mortgages.

'A Lot of Pressure'

The plan seemed to work beautifully. Long Beach sold $29.8 billion in new loans in 2005, up 85 percent from the year before. Wall Street was snapping up these loans, paying Washington Mutual big premiums. Everyone in the sales chain was raking in money, from the senior corporate executives to the account executives assigned to regional offices. Similar strategies at other subprime lenders fed the national boom in risky loans.

VIDEO: Black on Corporate Fraud

But a strategy to lend to people who can't realistically afford the loans can only work if many of the loan applications are fraudulent, contends William K. Black, a former federal regulator who helped bring prosecutions in the savings and loan crisis of the late 1980s. Black, who now teaches white-collar crime as a law professor at the University of Missouri - Kansas City, notes that hundreds of S&L executives went to prison for accounting fraud -- consciously making bad loans and pretending they were good. He contends that lenders did precisely the same thing in the latest crisis and that this kind of fraud was the main reason for the subprime meltdown.

S&L executives argued that they didn't know the loans were doomed from the start, but many juries didn't buy that defense. Black does not buy the claim from lenders in the latest crisis that they didn't know either.

"Fraud appears to be the dominant driver of the current financial crisis," Black said.

By 2003, thanks to historically low interest rates, nearly everyone who could afford a home owned one. There was no way to sell lots of new mortgages, especially as interest rates were rising, under responsible lending practices, Black said.

"But if I loan to people that aren't creditworthy then I can bring in tens of millions of Americans. And now I can grow rapidly and I get to charge them a higher interest rate," Black said. "If a bunch of other folks follow the same strategy... we add enormously to the demand for housing."

Creating a housing bubble, Black said, covered up the bad loans because banks would persuade borrowers in danger of default to refinance. That made the bubble even bigger.

No one had to jot down a memo telling everybody to approve fraudulent loans, Black said. All managers had to do was reward people for bringing in sales and ostracize those whose job was to assure quality.

At Long Beach Mortgage, according to Summerlin, quality assurance employees were paid $45,000 a year and were segregated from the sales team, whose members could make a million or more.

We were under "a lot of pressure from the executives. It wasn't so much the direct manager," Summerlin said. "It was from the top."

In a brief statement, Killinger said that the policies implemented beginning in 2003 were intended to protect Washington Mutual from the impending housing bust. Troy Gotschall, the former president of Long Beach Mortgage, declined to respond to requests for an interview.

Evidence that something was terribly wrong shows up in the astronomical foreclosure rate at Long Beach Mortgage.

The federal bank regulator, the Comptroller of the Currency, compiled data on the 10 subprime lenders with the highest foreclosure rates in the 10 cities with the most foreclosures on new loans made from 2005 to 2007. Long Beach Mortgage was the worst of the pack, with an average foreclosure rate of 35 percent.

Defaults in the first few months of a loan are a red flag for fraud, the FBI has said in court documents. And by 2006, a stunning number of loans at Long Beach Mortgage were quickly going into default.

The Huffington Post Investigative Fund analyzed a bundle of mortgages sold to investors, known as Long Beach Mortgage Loan Trust 2006-4. Even before Long Beach Mortgage sold this bundle of $1.9 billion worth of freshly inked mortgages in April 2006, 1.2 percent of the loans were already in default, according to documents filed with the Securities and Exchange Commission.

But the situation was far worse than it would seem because the vast majority of loans were only a few days old -- too new to be in default. Factor out the loans that couldn't be 30 days or more past due yet and 16 percent of the loans were in default before they were even sold on Wall Street.

The Investigative Fund matched the addresses of the loans to real estate records as well as to foreclosures reported in SEC filings with the help of Realtytrac, a real-estate tracking company. Prior to 2006, roughly two percent of subprime mortgages ended up in foreclosure, according to the Mortgage Bankers Association of America. But in the Long Beach Mortgage Loan Trust 2006-4, at least 44 percent of these mortgages ultimately ended up in foreclosure.

"Those numbers are off the chart. That's just ludicrously bad," said Richard Bitner, a former president of a small subprime lender, Kellner Mortgage Investments, and author of a book about the meltdown titled, "Confessions of a Subprime Lender." He estimates that at least three-quarters of all subprime loans were misleading or fraudulent.

'Averting Their Eyes'

Long Beach Mortgage has been named as the victim of fraud by real estate brokers and others in a number of criminal cases brought by the Justice Department. However, Rebecca Wood, a legislative assistant in California, says she was a victim of fraud allegedly orchestrated by two employees of Long Beach Mortgage.

Wood got a baffling call from Washington Mutual one day in 2004. The bank claimed she was late on her payment to Long Beach Mortgage. But that couldn't be, Wood protested, because she'd never borrowed any money from them.

Even as Wood spent weeks in frustration trying to straighten out the confusion, Long Beach approved another loan in her name and had a third loan in the works.

Exasperated, Wood finally contacted the FBI. Over time, according to court records, federal agents unraveled an elaborate scheme to buy and sell houses in Stockton, Calif., with fake documents and, in Wood's case, a stolen identity. A money trail led them inside Long Beach Mortgage.

On Oct. 21, 2005, an FBI agent visited the company's headquarters in a suburban office suite in Dublin, Calif., a half hour away from Oakland. The agent wanted to interview John Ngo, the person who verified the facts on Wood's loan application. Ngo maintained he did nothing wrong, but according to court records, the FBI had detailed bank documents showing electronic transfers and checks from a mortgage broker's account to Ngo exceeding $100,000. The FBI alleges that these were bribes to approve bad loans.

Ngo's estranged wife had earlier told the FBI that she didn't know how her husband, then 25, could afford their 4,500-square-foot Mission-style house at a price of $1.4 million. Ngo put down $350,000 cash for the house in 2005. His gross salary at Long Beach Mortgage was $4,500 a month.

Presented with the evidence, Ngo waived his indictment and agreed to a plea deal that included testifying against his sales associate at Long Beach, Joel Blanford. The FBI alleges it has evidence that Blanford paid Ngo at least $54,000 in bribes to help him fund fraudulent loans. Blanford, who has pleaded innocent, is scheduled for trial early next year.

Long Beach Mortgage paid Blanford commissions of $1 million or more from 2003 to 2005 for bringing in $10 million in loans a month. Even Ngo, whose job was to check loans for quality, was paid bonuses of $1,500 to $5,000 a month, not for stopping bad loans but for approving a high volume of loans, according to court records.

The prosecutor in Ngo's case, former Assistant U.S. Attorney Courtney Linn, wrote in the Journal of Financial Crime that high bonuses given to those in sales encouraged bad behavior.

"Mortgage brokers and individuals inside lending institutions thus had powerful incentives to join mortgage fraud schemes by adding dirt to the loan files, i.e. staging loan files to include false documents, or by simply averting their eyes to obvious misrepresentations on loan documents," Linn wrote.

Those who worked inside Long Beach Mortgage echo this sentiment. Kosch, who worked in the same office as Ngo and Blanford as well as the top executives of Long Beach Mortgage, said people on her team - though they couldn't prove anything - were suspicious about the loans executed by some of their colleagues.

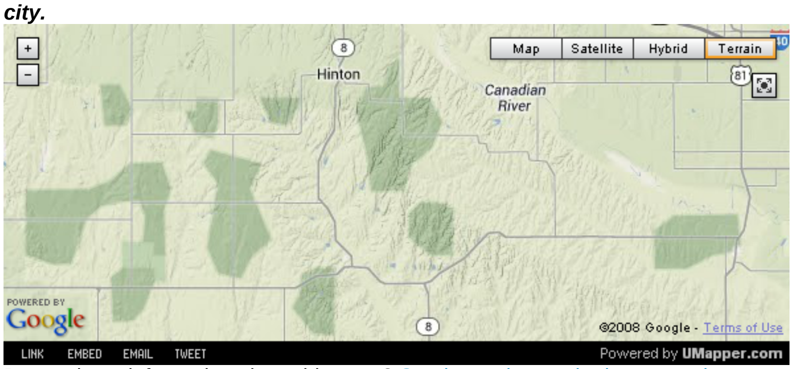
"Oh my gosh, they were making a lot of money," she said.

Sources within the Justice Department have acknowledged that there is a criminal investigation of senior management at Washington Mutual. As of now, however, Ngo and Blanford are the only employees of Long Beach Mortgage or Washington Mutual charged with crimes related to the subprime meltdown.

THE WORST OF THE WORST

According to an analysis by the federal Office of the Comptroller of the Currency, subprime loans issued around the country by Long Beach Mortgage Co. went into foreclosure at a rate higher than any other lender from 2005 to 2007. High foreclosure rates are a marker for loans that could have been based on fraudulent documentation. Below, a map shows where Long Beach Mortgage ranked in the 10 cities with the highest number of foreclosures during those years. ***Click a location to get foreclosure rates by lender for each***

city.



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