

# NEW CENTURY FINANCIAL: LESSONS LEARNED

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**N**ew Century Financial Corporation, Irvine, California, then the nation's second largest originator of subprime mortgage loans, announced on Feb. 7, 2007, that it would have to restate its financials for the first three quarters of 2006. Following this announcement, New Century's descent was dramatic and swift. Its stock price dropped precipitously, and the company disclosed on March 2, 2007, that it would not file its 2006 annual report on time. ■ This revelation and other developments prompted increased margin calls by the company's lenders, accompanied by their refusal to provide further financing. As a result of these financial pressures, New Century stopped accepting loan applications on March 8, 2007, and the New York Stock Exchange (NYSE) delisted the company's securities a few days later. ■ On April 2, 2007, less than two months after the restatement announcement, New Century and many of its affiliates filed for bankruptcy protection. Shortly thereafter, New York-based KPMG LLP resigned as the company's independent auditor. ■ In early June 2007, the U.S. Bankruptcy Court for

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**The examiner's final report to the bankruptcy court on the demise of New Century Financial Corporation documents some important lessons in corporate governance for mortgage lenders and financial services institutions.**

the District of Delaware issued an order granting the U.S. trustee's motion for authorization to appoint an examiner in the New Century bankruptcy proceeding. The court's order called for an examiner to, among other things, "investigate any and all accounting and financial statement irregularities, errors and misstatements" and to prepare a report of such findings. The order also required that the examiner identify any potential claims that the debtors' estates may have as a result of any improper conduct.

Pursuant to the court's order, the trustee appointed one of the authors of this article, Michael J. Missal, as examiner. K&L Gates LLP, Washington, D.C., served as counsel to the examiner in the investigation.

(The United States Trustee Program is a section of the Department of Justice that promotes the efficiency and integrity of the federal bankruptcy system. The U.S. trustee for a particular region monitors the conduct of the parties to bankruptcy proceedings in that region and seeks to further the public interest in the just, speedy and economical resolutions filed under the bankruptcy code.)

The examiner's goal was to conduct an investigation that was accurate, fair, timely, objective, credible and thorough. The investigation took approximately nine months and included the review of thousands of documents and 110 interviews of 85 witnesses. A final report was prepared and filed under seal on Feb. 29, 2008, pursuant to a further court order. The final report was released publicly on March 26, 2008.

The final report identified a number of significant improper and imprudent practices related to New Century's loan originations, operations, accounting and financial reporting processes. Among other findings, the final report disclosed that New Century had a "brazen obsession with increasing loan originations without due regard to the risks associated with that business strategy;" created a "ticking time bomb" by layering "the risks of loan products upon the risks of loose underwriting standards in its loan originations to high-risk borrowers;" made numerous exceptions to its underwriting standards; and used deficient appraisals.

The final report further revealed at least seven improper accounting practices in 2005 and 2006. Principal among them were incorrect calculations for the reserve for losses associated with the repurchase of loans previously sold to investors and the failure to value properly residual interests that the company held in off-balance-sheet securitizations.

As a consequence of these accounting failures, New Century understated its repurchase reserve by as much as 1,000 percent in the third quarter of 2006; reported a profit of \$63.5 million in the third quarter of 2006, when it should have reported a loss; met analysts' earnings expectations for 2005 and the first quarter of 2006, when it should have announced earnings below expectations; and reported an increase in earnings per share of 8 percent for the second quarter of 2006 as compared with the same quarter of 2005, when it should have reported at least a 40 percent decline in earnings per share (EPS).

Senior management benefited from these errors as certain

senior executives received financial performance bonuses in 2005 that were twice to four times as much as they should have been.

The final report also determined that KPMG contributed to these failings by, among other reasons, not questioning or testing certain important assumptions in a rigorous manner; acquiescing in New Century's departures from prescribed accounting methodologies; and acting as "advocates" for the company when certain of its accounting practices were questioned by KPMG specialists who had greater knowledge of relevant accounting guidelines and industry practices than the engagement team.

Due to the pending bankruptcy proceeding, this article will not discuss the accounting issues or the work of KPMG. Instead, it will focus on some of the corporate governance failures of the company that were discussed in the final report.

Corporate governance can be defined as the system by which companies are directed and controlled, and is intended to promote high standards of business conduct and ethics. It sets forth the duties, responsibilities and relationship of the board of directors and senior management. The final report identified a number of corporate governance failures at New Century.

Aside from the accounting and financial reporting problems, the final report included a number of other deficiencies. Some of the more significant were 1) the failure to support the rapid growth of the company; 2) the unchecked dominance of the business producers; 3) the strained relationship between the board and senior management; 4) blindly following industry practices; 5) the failure to analyze enterprise risk management; and 6) the limited focus of the audit committee of the board and the company's internal audit department.

Every company has different challenges, cultures, practices and issues. There is no uniform blueprint to ensure that a company has proper corporate governance practices. However, effective corporate governance practices are crucial to every company, particularly those in the financial services and mortgage banking industries.

### **The failure to support the rapid growth at New Century**

New Century grew at an extremely fast pace. Founded in 1995, it ended its first full year of operations with approximately 300 employees and an annual mortgage loan operation of \$350 million. By 2003, the company had approximately 3,700 employees and originated more than \$27 billion in mortgage loans. By the end of 2006, the company had more than 5,000 employees and originated more than \$50 billion in mortgage loans.

Although a primary goal of any mortgage banking company clearly is to make more loans, New Century did so in an aggressive manner that elevated the risks to dangerous and ultimately disastrous levels. The final report disclosed that New Century "layered the risks of loan products upon the risks of loose underwriting standards in its loan originations to high-risk borrowers."

The company's senior management turned a blind eye to

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the increasing risks of New Century's loan originations and did not take appropriate steps to manage those risks. This approach resulted in an increasing probability that New Century would have to repurchase billions of dollars of the riskier loans because of significant defaults or loan defects, particularly if market conditions changed.

Recommendations made to manage or minimize risk were either largely rejected or ignored, until market forces drove changes to the company's practices in the second half of 2006. By that time, however, there was already significant exposure to billions of dollars of questionable mortgages either held by New Century on its balance sheet or that had been injected into the markets.

The growth of the company and the assumption of additional risks unfortunately was not coupled with the appropriate investment in staffing or other resources. The final report noted that the company did not invest in the necessary technologies, systems or personnel to meet its growing business and expanding challenges.

A number of New Century's failures can be traced at least in part to these inadequacies. For instance, some of the company's most senior officers in the financial management and accounting departments had neither the appropriate level of sophistication nor the experience necessary to do their jobs effectively in the changing and difficult environment.

While growth is an appropriate objective for any company, it must be done carefully and with the proper controls, investments and resources. Failure to do so can obviously cause disastrous results.

### **The unchecked dominance of the business producers**

The final report discussed the dominant role that the loan production department played within the company. Given the volume of mortgage loans originated by the loan production department, its loan originators were obviously highly effective and creative. For example, the final report noted that mortgage brokers were trained to originate New Century loans in the aptly named "CloseMore University."

Despite questions and concerns raised by senior management and the board about loan quality, no effective remedial actions were taken until it was too late. The loan production department opposed important changes that might have increased loan quality, but would have limited loan production volume.

For example, the loan production department resisted suggested changes to the compensation system that would have linked improved loan quality to compensation. Compensation for the employees of the loan production department, including significant bonuses, focused solely on loan origination volume.

Some at New Century measured loan quality by whether the loan could be sold, not whether it was likely that the borrower would meet his or her obligation. This standard exacerbated the problems for the company when the mortgage market deteriorated.

In a business so dependent on sales and growth, there were great pressures to allow the loan production department

the autonomy and flexibility to achieve its objectives. The prior successes of the department made it that much more powerful and influential within the organization. However, when "red flags" appeared concerning the quality of the loans being issued, such as increased early payment defaults and repurchase claims, they were not pursued aggressively, and effective remedial actions were not taken.

Many businesses have employees and departments that are critical and driving economic forces. However, regardless of their importance to the business, checks and balances must be put in place for all people and departments to ensure that the company is not put in jeopardy. Allowing big producers of business to dominate a company without the necessary safeguards can have serious negative consequences.

### **The strained relationship between the board and senior management**

The board of directors of every company has an important role to play. It needs to be in a position to ask tough questions, and get prompt and thorough responses to those questions. Moreover, the board needs to have a relationship of trust and respect with senior management.

The final report found an "unhealthy friction" between New Century's board and senior management at a time when the business challenges would have greatly benefited from a strong collaborative relationship, mutual respect and a healthy tension. In fact, a number of board members were openly disdainful of certain members of senior management, and challenged their integrity and competence.

Board members questioned whether management provided them with full disclosure, whether management judgments had been appropriate, and even whether management "manipulated earnings." Conversely, members of senior management believed that some board members were misguided and involved themselves unnecessarily in issues outside their

authority. This tension inhibited an open flow of information between the board and senior management, and restricted the ability of New Century to react nimbly and effectively to the rapidly deteriorating subprime market.

Moreover, a company's board and its senior leaders should agree on the fundamental business strategies for the company. New Century's most senior leaders were strongly divided on a number of important issues.

For example, some felt New Century should pursue a "portfolio" strategy in which mortgage loans would be originated and held by the company. Others were critical of this strategy and wanted the company to originate and sell as many loans as it could, thus generating more short-term income and not holding as many loans on New Century's balance sheet. This debate ensued for some time and diverted the senior leaders' attention away from other serious issues.

A strong collaborative relationship between the board of directors and senior management is essential to meet a company's business challenges. The failure to foster such a relationship can effectively incapacitate a company's ability to maximize

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shareholder value. In addition, companies should focus not only on evaluating the different strategies and issues but on actually applying these strategies and issues once they have agreed on a plan.

Strong and competent leadership among the board and senior management, healthy respect between and among the two groups, and open lines of communication that allow for all necessary parties to be heard and make collective and well-supported decisions will promote and strengthen effective governance.

### **Merely following industry practices can be problematic**

Blindly following the business practices of others in your particular industry is typically not advisable and will not protect a company from liability. The final report disclosed that New Century paid little attention to improving loan quality prior to the fall of 2006 in part because certain comparative data suggested that New Century's loans, on average, were performing better than those of its competitors.

Even though there were increasingly alarming trends in 2006 that early payment defaults, repurchase claims and kick-outs were increasing, senior management gave these issues less attention than appropriate because New Century viewed them as industrywide problems—not problems unique to New Century. Moreover, some at New Century believed that it would put the company at a competitive disadvantage if it improved loan quality.

Senior management defended the company's actions based on the belief that the company was conducting business in the same manner or even better than its competitors. However, New Century's senior management appeared to have confidence that the company could survive any market condition, given that it had survived earlier downturns. Clearly, this assumption was wrong.

While New Century believed it was better than its competitors, this belief simply did not hold up over time because of the blind eye the company turned to the quality of its product and the changing markets. Putting aside comparisons to other similarly situated companies, even if New Century's practices were not outside the norm of its industry, this would not absolve it from failing to follow applicable accounting rules, legal standards or prudent business practices.

A company should not take false comfort if its practices are within the norms of an industry. New Century is just one of many examples where a company believed that its practices were appropriate because they were similar to others' in their industry. A company—particularly one in the financial services industry, where market risks are sometimes difficult to determine—needs to frequently conduct an objective review of its practices to ensure they comply with applicable rules, regulations and standards.

### **The failure to analyze enterprise risk management**

An important corporate governance tool for any company is the evaluation of the risk exposures relating to its gover-

nance, operations and information systems—commonly referred to as enterprise risk management (ERM). In 2004, the widely respected Committee of Sponsoring Organizations of the Treadway Commission defined ERM as “a process effected by an entity's board of directors, management and other personnel, applied in a strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and [designed to] manage the risks to be within its risk appetite, [and] . . . provide reasonable assurance regarding the achievement of entity objectives.”

In order to meet a company's ERM obligations, senior management and the audit committee of the board should develop guidelines and policies to govern and monitor the process by which risks are addressed and managed. Most companies rely on internal audit departments to play a critical role in objectively analyzing their firm's ERM. An effective ERM program is particularly important to mortgage lenders, because they are in an industry that is extremely sensitive to market forces.

New Century's audit committee identified ERM as an issue, and retained an outside consultant to provide advice. The outside consultant proposed an approach for New Century to follow to manage some of its key risks on an entity-wide basis, including liquidity, strategic planning and

decision-making, capital management, operations, accounting policies and financial reporting.

Although New Century senior management was aware that there were gaps in the company's risk-management practices, the company ultimately failed to follow this approach. As a result, significant enterprisewide risks went unanalyzed.

The formal institution of programs to analyze enterprisewide risks is gaining popularity at many companies and is now commonly considered a “best practice” for financial services firms. While such programs may not identify all potential risks, assessing enterprise risks on a programmatic basis can result in substantial benefits for a company. Particularly for financial service firms, it is critical to evaluate and assess a company's exposure to, and tolerance for, risk on a periodic basis.

### **The limited focus of the audit committee and the internal audit department**

Audit committees and internal audit departments are key corporate governance gatekeepers and assume a critical role in promoting the accuracy and integrity of a company's accounting, financial reporting and operational processes. To be effective, audit committees should monitor key financial and operational issues, and implement any remedial policies as necessary.

Audit committees rely on internal audit departments to gather information, as well as identify and analyze certain areas of risk within a company. While the final report recognized that the New Century audit committee and the internal audit department were active and consisted of well-qualified individuals, both failed to focus on certain issues of crucial importance to the company.

The final report noted that the audit committee failed to

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focus on certain significant issues to the company, including enterprise risk management. In addition, the audit committee did not ensure that key operational issues were addressed, did not give sustained attention to loan quality until 2006 and did not adequately supervise or make effective use of the internal audit department. The final report further disclosed that the internal audit department did not identify or examine certain areas of operational risk and did not address internal controls over financial-reporting risk.

To maximize their effectiveness, audit committees and internal audit departments need to be independent, active, skeptical and thorough. If not, they can give a false sense of comfort and may miss the opportunity to address an issue before it becomes problematic. Given the importance that audit committees and internal audit departments play in the corporate governance of every company, boards of directors need to ensure that they are fulfilling completely their responsibilities.

### **Closing thoughts**

New Century was certainly not the only company that contributed to the subprime market meltdown. The fallout from this market catastrophe has been massive, unprecedented and far-reaching. Losses associated with the subprime market have been in the hundreds of billions of dollars and rising.

Nonetheless, there are valuable lessons to be learned from New Century's failures that will, it is hoped, inform, strengthen and improve the mortgage banking and financial services industries. **MB**

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