NEW CENTURY FINANCIAL CORPORATION

JACOPO LIBERATI
ANDREA VERONELLI

MORTGAGE MESS:

Nearly one-half of recent mortgage foreclosure victims in the United States obtained their loans from so-called **SUBPRIME LENDERS** that became dominant forces in the mortgage industry over the past two decades.

- Country-Wide
- HSBC
- New Century
- Wells Fargo

New Century:

- Founded in 1995 by three friends.
- Based in Irvine, California

1996:
Revenues: 14.5 million
Assets: 4.4 million

2005:
Revenues: 2.4 billion
Assets: 26 billion

They provided loans to borrowers with suspect credit histories.

SUBPRIME LENDING: A HISTORICAL PERSPECTIVE

Like all businesses, mortgage companies struggle to achieve a proper balance between **«risk»** and **«return»** in their operations.

RISK:

Client will be unable or unwilling to pay the principal and interest on their mortgage loans.

DEREGULATION:

1980s, much easier for subprime borrowers to obtain mortgage loans to finance the purchase of a new home.

The Depository Institutions Deregulation and Monetary Control Act of 1980:

- did away with restrictions that imposed a ceiling on the interest rates lending institutions could charge on new mortgage loans.
- It allowed to create a wide range of different mortgage like ARMs.

SUBPRIME LENDING: A HISTORICAL PERSPECTIVE

Wide array of financial alternatives:

ARMs, Adjustable Rate Mortgage

However we have the explosive growth of the subprime sector of the mortgage industry only when…

Particularly popular with mortgage borrowers who had impaired or «subprime» credit histories or profiles.

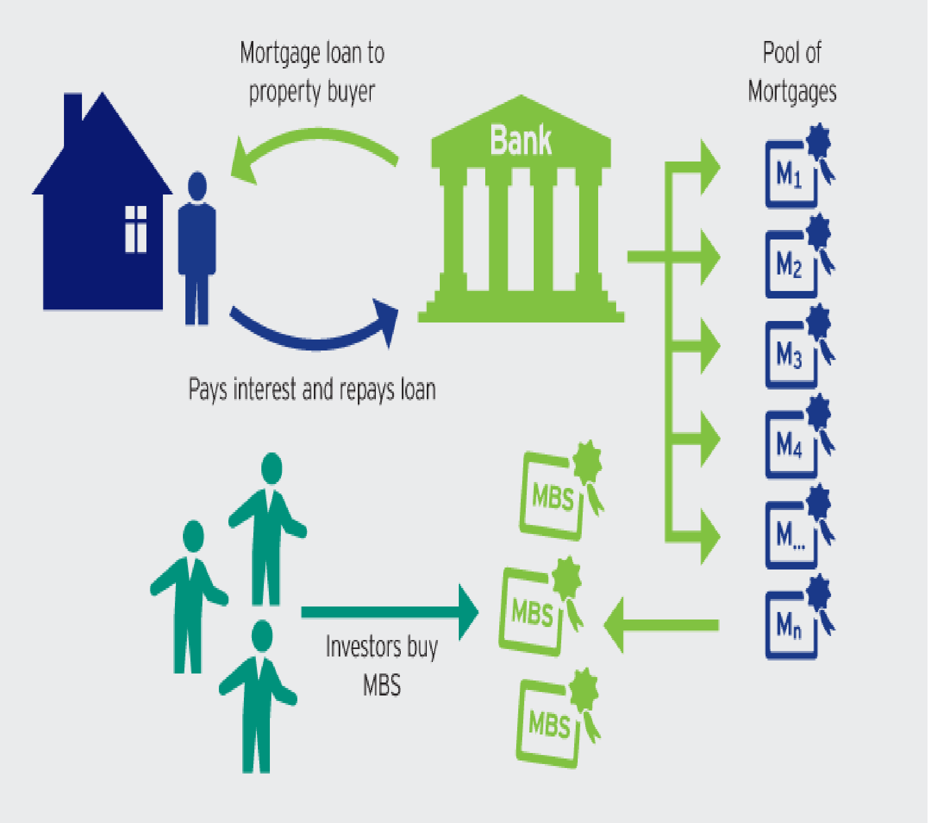
SECURITIZATION of mortgage loans became increasingly common following the turn of the century.

SUBPRIME LENDING: A HISTORICAL PERSPECTIVE

The securitization option caused many mortgage lenders to adopt an **«ORIGINATE TO DISTRIBUTE» BUSINESS MODEL**.

Credit Risk: no longer exclusively absorbed by lending institutions, but was shared with investors worldwide who purchased so-called **Mortgage-Backed securities or MBS.**

2006:
¼ of all new residential mortgage loans were made to subprime borrowers.
¾ of those mortgages were securitized and sold to investors around the world.



SUBPRIME LENDING: A HISTORICAL PERSPECTIVE

Insatiable demand for high-yield MBS among investors

To persuade individuals who were high credit risks to obtain mortgage loans, the subprime lenders developed new products designed specifically for that sector of the mortgage market:

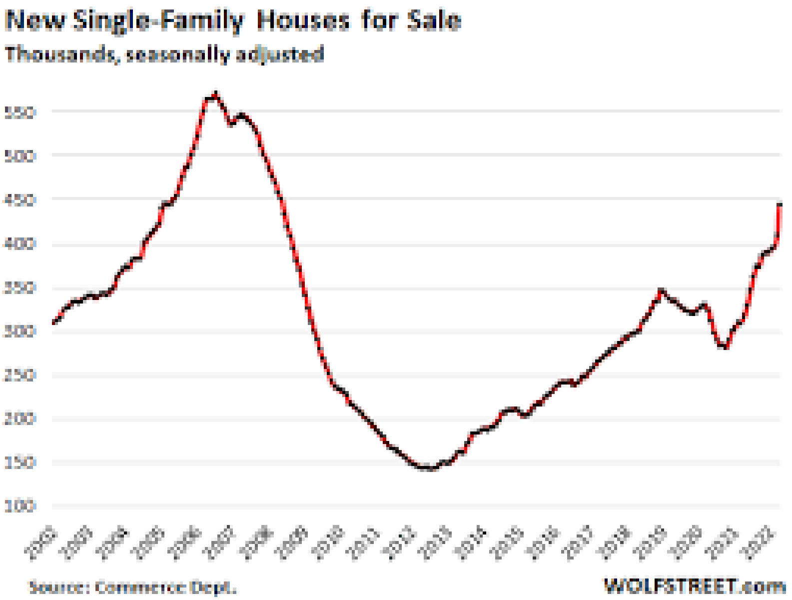
«STATED INCOME MORTGAGES»

An applicant was simply asked to report his/her annual income. The applicant's self reported income was used by lender to determine the size of the loan that the individual could afford (liars' loans).

«INTEREST ONLY MORTGAGES»

An applicant who obtained an interest-only (IO) mortgage loan was required to pay only interest on his/her loan balance for a fixed period of the mortgage term. (the first 5 or 10 years).

SUBPRIME LENDING: AN HISTORICAL PERSPECTIVE



HOUSING PRICES:
PEAK IN MID-2006
LATE 2007: -10% FROM THE PEAK LEVEL
MID-2008: -20% FROM THE PEAK LEVEL

A growing number of subprime borrowers began defaulting on their monthly mortgage payments.
In fact many of those individuals quickly became **«UPSIDE DOWN IN THEIR HOMES»,** It means that the unpaid balances of their mortgages exceeded the market values of their homes.

SUBPRIME LENDING: A HISTORICAL PERSPECTIVE

The sharp downturn in the housing market had an immediate and drastic impact on mortgage lenders, particularly subprime mortgage lenders such as New Century.

REPURCHASE CLAUSES

If the default rate on those packages of loans exceeded a certain rate, New Century could be forced to repurchase those loans.
As the housing market weakened, New Century and other subprime lenders were flooded with loan repurchase requests.

SECURITIZATION process effectively «spread the cancer of subprime mortgages to investors throughout the U.S and the rest of the world».

NEW CENTURY

BOB COLE	CEO
ED GOTSCHALL	CFO
BRAD MORRICE	COO

1995: The three friends decided to establish their own mortgage company, a company that would focus on the subprime sector of the mortgage market.

1997: the company went public by listing its stock on the NASDAQ. New Century's stock would be switched to the New York Exchange market in late 2004.

NEW CENTURY

The company thrived from its inception thanks to 3 key factors:

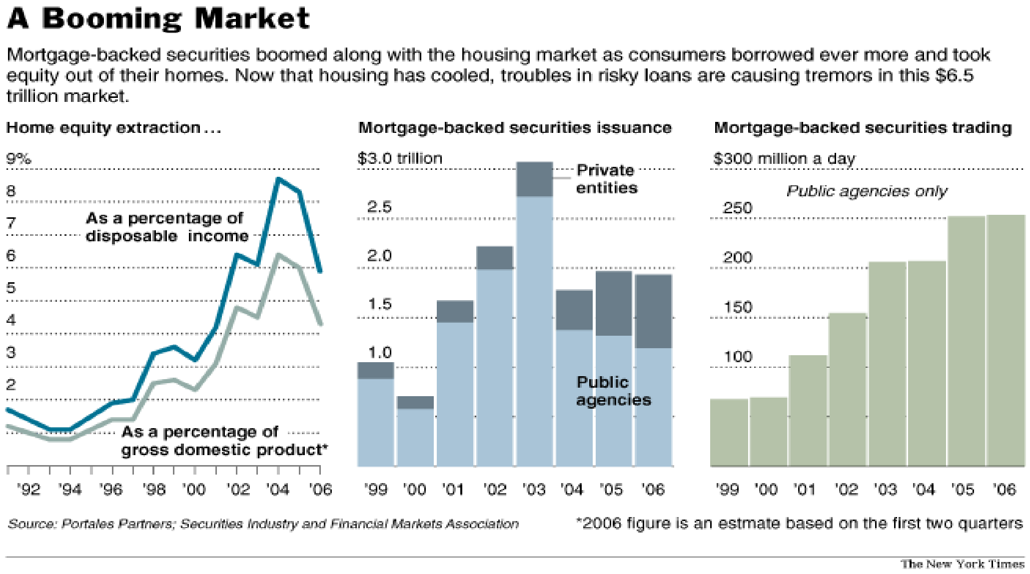
1. **Mortgage Interest Rates**, which had spiked during the 1990s

2. **The economic and regulatory environment** at the time made subprime lending the most lucrative sector of the mortgage industry.

3. **The booming housing market in Orange County, California**, where the company was located (large and easily accessible market).

After they began pursuing expansion opportunities for their company in other «hot» markets in the United States.
More than 200 retail mortgage offices in the USA.
More than 35.000 independent mortgage brokers.

NEW CENTURY



The company experienced impressive growth from its founding in **1996** through **2001**.

However a significant increase in subprime lending activity quadrupled New Century's revenues **from 2002 to 2005**.

STATED-INCOME and IO LOANS contributed to the growth of the company's revenues.
By 2005, ¾ of the company's loan originations involved one of those 2 products.

2005:
Originated or purchased more than **56 billion** of mortgage loans.
Securitized **17 billion** of those loans.
Net earnings of **411 million** for the company.

NEW CENTURY

Company spokespeople repeatedly insisted in press releases and public filings with the SEC that the company had a strong system of internal controls.

HOWEVER:

Several interviewees told to the bankruptcy examiner that New Century's Information Technology and data entry and processing systems were not «state of the art» and were not sufficient for a business of the size and nature of New Century.

Company's Accounting System was particularly lax with regard to tracking «loan repurchase claims».

New Century «did not have a formal policy spelling out how to calculate reserves» for loans that it would be required to repurchase.

NEW CENTURY

By late 2005, several members of New Century's board of directors were openly challenging **top management's high-risk business strategies** as well as **questionable accounting and financial reporting decisions made by the company.**

RICHARD ZONA

In late 2005 he addressed a resignation letter to New Century's board of directors.
In the letter he suggested that company management was:

- **MANIPULATING REPORTED EARNINGS**
- **EMPLOYING «AGGRESSIVE» REVENUE RECOGNITION METHODS**
- **FAILING TO PROVIDE AN ADEQUATE ALLOWANCE FOR LOAN LOSSES**

NEW CENTURY

2006: NEW CENTURY'S FINANCIAL CONDITION AND OPERATING RESULTS DETERIORATED RAPIDLY

JANUARY 31, 2007

Management told the board and audit committee that New Century **had understated its <u>reserve for loan repurchase losses</u>** for each of the first three quarterly reporting periods of 2006.

FEBRUARY 7, 2007

New Century filed a **Form 8-K** with the SEC, which publicly disclosed the prior understatements of the loan repurchase loss reserve.
<u>The 8-K filing did not disclose to what extent the loan repurchase loss reserve had been understated.</u>

NEW CENTURY

March 2, 2007

New Century informed the SEC that **its <u>2006 Form 10-K </u>would be delayed** and that it would eventually report a loss for the entire year.

Few weeks later **KPMG** resigned as New Century's Auditor.

April 2, 2007

New Century filed for **BANKRUPTCY** in a U.S Federal Court.

“The New York Times” called KPMG as the to-go auditor because all the major subprime lenders were KPMG audit’s client.

KPMG was New Century’s auditor for **1995** to **2007** (till a few months earlier than when New Century declared bankruptcy)

The bankruptcy examiner after the declared bankruptcy will say that KPMG:

- Failed to perform in accordance with **professional standards**
- Auditors may have been **impaired**
- Not adequately consider serious **internal control problems** in New Century’s accounting and financial reporting system
- Failed to properly audit on the important **loan repurchase loss reserve**

KPMG

Spring 2005

A new team of auditors was assigned to New Century

15 auditors
13 new auditors - only 2 held-over

3 MAIN PERSONS

John Donovan

New Century's audit committee was unhappy with his choice because, according to them, he doesn't have enough experience in mortgage sector

Mark Kim

Expert in mortgage sector

Kim complained more times saying that the audit team on New Century wasn't an "A-level team".

David Kenneally

He was overseeing the accounting of New Century
He was domineering and was considered as the reason for the negative relations between KPMG and New century's auditing sector.

New Century's 2005 10-K

1) Two individuals working with KPMG **requested various documents** from New Century that were needed to complete their review
2) New Century **failed** to provide that documentation
3) The two specialists **refused to "sign off"** on the company's relevant accounting decisions
4) This refusal prevented Donovan from releasing the opinion on New Century's financial statements
5) Documents were finally presented just a few moments **before the deadline**
6) **New Century was complaining and thinking on change auditor**
7) KPMG said that this **situation wouldn't happen again**
8) New century **confirmed** KPMG as its auditor

KPMG

Bankruptcy examiner analysis

- The auditing team was **afraid** to lose New Century as a client
- Donovan and Kim could have provided **advices** with the repurchase reserve calculation methodology in order **to be confirmed** as auditors

Reduced independence of KPMG

Inadequate consideration of internal control problems

In 2004 and 2005

KPMG

- discovered control weaknesses related to repurchase loss reserve but they classified them an non-material weaknesses
- so they were not communicated to the New Century's audit committee
- concluded that New Century maintained effective internal control over its financial reporting functions.

Bankruptcy examiner

- Pointed out that New Century didn't have an effective mechanism for tracking, processing, and handling loan repurchase claims
- They were not able to determine the level of loan repurchase requests and to create adequate reserves for it.

Failure to proper audit New Century's loan repurchase loss reserve

KPMG

Between 2004 and 2005 → **Loan repurchase orders increased** → **New Century's loan repurchase loss reserve actually declined**

How ?

90 days look-back period

- They calculated the necessary reserve only relying on the loans sold in the 90 days immediately preceding the balance sheet.
- This is incorrect because also loans of many longer periods could be repurchased

Interest recapture

- New Century should pay the interest to the investor in place of the borrower if he was insolvent
- New Century didn't consider this expense as part of the reserve

In defense of KPMG

1) KPMG spokesperson complained that the **bankruptcy examiner** was “**one-side**” while examining the case

2) Some other parties said that the New Century’s bankruptcy was due to his **type of business** and it had nothing to do with **KPMG behaviour**

In 2008 more than 1.5 million americans faced foreclosure proceeding on their homes.

It was the **highest** number in US history

Epilogue

US congress passed a massive bailout plan (hundreds billions of dollars) which was **successful**

Local and global economy would continue suffering for years or decades to come

QUESTION 1

Identify the advantages and disadvantages of a heavy concentration of audit clients in one industry or sub-industry.

Advantages

1. **Competence** → The firms that operate in the same sub-sector will follow the same financial reporting standards and accounting policies.
2. **Audit experts** → The audit firm can hire more specialized employees with a background in that sector and high-value skills
3. **Higher quality of audit** → In this way the auditors have more experience in the sector, higher know-how and bigger knowledge of the procedures.
   For this reason we think that this will improve the quality of audit service.

Disadvantages

1. **Audit opinion** → the firm will have a lot of similar clients, this can create the risk of confusion between cases and lead to an inaccurate opinion of the client situation
2. **Conflict of interest** → The auditor can have a conflict of interest because he will operate on a firm's auditing while some other colleagues will work on a competitor's auditing.

QUESTION 2

There is an almost-complete turnover in the audit team. What quality control mechanisms should accounting firms have in such circumstances to ensure that a high-quality audit is performed?

It's important to change the members of the audit sometimes to avoid the creation of personal relationships with the client and so maintain the **quality** and **independence** of the auditing.

The accounting firm should analyze:

1. **new team skills** → if the members that joined the team are with high skills in the sector and experience in auditing
2. **communication with the old team** → The previous team and the new one should communicate effectively to simplify the transaction period; previous team have to prepare and provide all the documentation for it.
3. **not change the whole team** → to maintain a common thread in the auditing; the change of the whole team would create a slowdown of the auditing procedures.

QUESTION 3

Section 404 of the Sarbanes-Oxley Act (SOX)

Describe the responsibilities that auditors of public companies have to discover and report (in internal controls):
(a) significant deficiencies
(b) material weaknesses

Under what condition can auditors issue an unqualified opinion on the effectiveness of a client's internal controls over financial reporting?

- A **significant deficiency** is a control deficiency that adversely affects the company's ability to initiate, authorize, record, process or report external financial data reliably in accordance with generally accepted accounting principles.
- A **material weakness** is a significant deficiency that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

In our case **KPMG** found 5 significant deficiencies in internal control but they were **not qualified as material weaknesses**.
Only in 2007 New century's management identified those material weaknesses:

- New Century did not have an "effective mechanism for tracking, processing and handling [loan] repurchase claims → this lead to an understatement of repurchase loss reserve

An **unqualified opinion** can be given by the auditors if the financial statements are presumed to be free from material misstatements (or material weaknesses).

QUESTION 4

What general principles or procedures should auditors follow when auditing important "accounting estimates"? (Like for example the loan repurchase loss reserve)

When the auditor have to evaluate an important accounting estimates it should follow some **principles**:

- Use **professional skepticism** → to analyze all the factors
- **Independence** → not be influenced by external factors or people's opinion but analyze only the data
- Auditor have to obtain sufficient **data** to provide that:
  - all the accounting estimates important for the **financial statement** have been provided
  - **reasonableness** of the accounting estimates → not easy to evaluate because it is composed of both subjective and objective factors
  - the accounting statements are in conformity with general **accounting principles**

QUESTION 5

New Century's bankruptcy examiner charged that KPMG did not comply with applicable "professional standards" while auditing the company. List general accepted auditing standards (GAAS) that you believe KPMG may have violated on its New Century engagement. briefly defend each item you list.

Carrying out its duties, KPMG violated some generally accepted auditing standards.

1) **The auditor must have adequate technical training and proficiency.**

   -> The 2005 New Century's Audit was improperly staffed.
   -> The two key members had just joined the Los Angeles Office of KPMG, the practicing office for servicing New Century.
   -> One of these figure was John Donovan, man without experience in the mortgage industry.

1) **The auditor must have independence of mental attitude.**

   During 2005 audit, two individuals from the KPMG's FDR (Financial Derivatives Resources) Group refused to approve some relevant accounting decision of the company, not having received adequate documentation. Due to the delay in the publication of the document, New Century threatened to replace the auditing firm. Consequently we understand that the audit firm would no longer have behaved independently, but would have supported the company in order to keep it as its client.

1) **The auditor must obtain sufficient, competent evidence.**

   To confirm that Interest Recapture was a component of the reserve, KPMG followed the erroneous statements made by by David Kenneally.

1) **The auditor must gain a sufficient understanding of the internal control structure.**

   Throughout its existence, New Century did not have an "effective mechanism of tracking processing and handling repurchase claims".

QUESTION 6

Mortage-backed securities (MBS) have been a focal point of attention during the recent financial crisis. Many parties have maintained that the mark-to-market rule for securities investments has contributed significantly to that crisis. Do you believe that those arguments are legitimate?

Mark-to-market accounting may have made the 2008 financial crisis worse.
First, banks raised the values of their MBS as housing costs skyrocketed (they loaded up on subprime mortgages).
Second problem occurred when asset prices started to fall. Market accounting forced banks to devalue the values of their subprime securities.
The mark-to-market inflated the housing bubble and deflated home values during the decline.

In 2009, the US Financial Accounting Standards Board loosened the mark-to-market accounting rule.
This suspension allowed banks to keep MBS value on their books. In reality the value has plummeted.
if the banks had been forced to reduce their value, the default clauses of their derivative contracts would have been activated.
It would wipe out all the largest banking institutions in the world.

QUESTION 7

Identify what you consider to be the three most important “take aways” or learning points in this case.

1) **Importance of a balance between risk and return.**
The abuse of high-risk financial instrument, also thanks to securitization, has led to a financial crisis that has involved not only the United States, but the whole world.

1) **Importance of internal control.**
A company must not try to hide reality. if problems linked to the internal control of the company had been highlighted and solved immediately, the bankruptcy of the company could have been avoided.

1) **Importance of an independent and capable audit.**
KPMG’s lack of professionalism and independence was crucial in the company’s failure.
The audit firm should have promptly recognized the problem linked to the 90-day window used for the valuation of the loan repurchase loss reserve.
In the same way it should have recognized that the company did not insert interest capture as a component of the reserve and rely on the statements of third parties without verifying their validity.

Thanks for your attention

Jacopo Liberati

Andrea Veronelli