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The Turning Point

Looking back, the idea of starting a subprime mortgage company seems crazy. That conclusion has nothing to do with the industry's implosion six years later. When we opened Kellner Mortgage Investments in September 2000, I finally realized just how little I knew about loaning money to borrowers with bad credit. During the first six months in business, I felt no more qualified to pilot the Space Shuttle than to be the president of a subprime lending company.

Seven years in mortgage banking provided a solid foundation, but coming from the ranks of companies like GE Capital, my schooling was largely driven by a conservative mindset. Lending money to borrowers with bad credit was never a part of the curriculum. When I first learned about subprime mortgages, the high-risk nature of the business made

me think it was best suited for those who suffered from low morals or head trauma. Lending money to people with bad credit just seemed like a terrible idea. It wasn't until I got a taste for this business that my feelings started to change.

Taking a position as an account rep for the Residential Funding Corporation (RFC) division of GMAC in 1999 introduced me to the world of niche lending. As the largest securitizer of non-agency mortgages in the country, RFC bought loans that didn't fit the conforming guidelines of Fannie Mae and Freddie Mac. While most of the products were geared toward borrowers with good credit, RFC was just starting to make a name in subprime. It didn't take long for me to realize that buying high-risk mortgages held a lot of promise.

A few months before I took the job the subprime mortgage industry imploded the first time, forcing most of these specialty lenders out of business. When the dust settled, RFC was one of the few survivors, which created an opportunity. My income was directly proportional to the revenue I generated, and subprime was three to five times more profitable than any other type of loan we securitized. Even though RFC gave me seven different products to sell, ranging from jumbo mortgages to home equity lines of credit, I ditched most of them in favor of subprime.

While RFC wanted us to push all their products, I saw no logical reason to sell something that made less money and carried no competitive advantage. The best way to succeed, I thought, was to take advantage of RFC's position in the subprime market.

That was the same year I met Ken Orman, the head of secondary marketing and operations for First Consolidated Mortgage Company, my best customer. It took me only a few months to realize Ken understood the business at a deeper

level than most of us. He could look at a deal, size up a borrower, and immediately determine if the loan was a good risk. What impressed me most was how his gut feeling, whether or not to write a mortgage, was usually correct.

Since he was unhappy with his job and we had quickly developed a mutual respect, I saw an opening and sold him on the idea of starting our own company. Saying I was underqualified to run a subprime company isn't an exaggeration. Eighteen months at RFC introduced me to this specialty business, but it didn't prepare me for what I was about to encounter.

At RFC I bought mortgage loans that were already closed. Kellner Mortgage was going to be a wholesale lender. We were going to target mortgage brokers, independent agents who needed help putting difficult loans together. This required a level of understanding I didn't need working for RFC. Since all we looked at were tough deals, the challenge was figuring out which ones were a good risk and which ones had no business getting financed. I was hoping that some of Ken's intuitive mojo would rub off on me.

It's easy to lose sight of what constitutes a good credit risk when you spend all day looking at marginal deals. Fortunately, Ken taught me the key to evaluating a loan started with asking two fundamental questions. If you can answer "yes" to both of them, he'd tell me, then you've got a subprime loan worth pursuing.

Question 1—Can the borrower afford to make the monthly mortgage payment?

Question 2—Will closing the loan put the borrower in a better position than they're in today?

At first I thought he was joking.

“That’s it?” I asked him. “You’ve spent 10 years in subprime and your secret is asking if they can afford the payment and are they better off?”

They were simple questions but I quickly realized their true value. Being a subprime lender means living in a world of gray. Most deals aren’t clear-cut and if we get bogged down in the minutia, we’ll spend all day second-guessing our own decisions. Of course, there are product guidelines to direct us, but many deals require us to make an exception. This means sound judgment, a willingness to accept risk, and the ability to trust our instincts are critical to survival. In 18 months at RFC I watched several lenders implode because they didn’t possess these traits.

Fortunately, it didn’t take long to get up to speed. Ken and our third partner, Mike Elliott, who also worked for First Consolidated Mortgage, both helped me understand the intricacies of this business. These two questions would ultimately serve as my personal reality check. Every time we doubted the logic of a specific loan, we used them as a litmus test. At the very least, being able to answer “yes” kept the moral compass pointing north and helped me sleep at night knowing we made the right decision.

Good Lending Gone Bad

I don’t know exactly when it happened, but a few years after we opened, the business started to change. Wall Street’s appetite for these loans increased at about the same time new subprime lenders entered the business. The increased competition and the red-hot real estate market led to the development of riskier products. As a lender who targeted

brokers, our goal was to offer products that were similar to the competition. If we didn't keep pace with the industry leaders, we'd quickly become an afterthought. But doing this created a bigger issue. The underlying principles that governed our thinking were slowly being compromised. Answering "yes" to our questions became more difficult with each passing month.

For me the turning point came in June 2005. Until that moment, I thought we still provided a valuable service to borrowers. For all the lunacy associated with this business, I wanted to believe that writing a mortgage for borrowers still meant the odds of them making their mortgage payment were greater than the likelihood of default. Violating this basic tenet was never supposed to be part of the equation.

It wasn't until we wrote a loan for Johnny Cutter that I realized our business, the whole industry really, had lost sight of its purpose. The subprime industry, which once upon a time helped credit-challenged borrowers, was no longer contributing to the greater good. Johnny Cutter would serve as my wake-up call.

Just a good old boy from rural South Carolina, Johnny and his wife, Patti, wanted to grab a little piece of the American dream. Having picked out a newly built 1,800-square-foot property, they were relying on the same mortgage broker who worked with them in the past to secure financing.

Although we were looking at the deal for the first time, the Cutters had been down this road before. They had been turned down on two different occasions, both times as a result of bad credit. After the second decline, the broker advised them to start saving money for a down payment and work on their credit before trying again. Their credit never got better, but after three years of saving, they had enough to put 5% down.

The Cutters, however, bordered on deep subprime—few if any redeeming qualities. Their credit report showed they had almost no discipline when it came to managing money. With a credit score in the 500s, paying bills had never been a priority for them.

Like many subprime borrowers, the challenges didn't stop there. Since Johnny worked at a gas station and Patti was a cashier, income was tight. They would need to use more than half of their combined gross monthly income just to cover the mortgage payment. If it wasn't for Patti's sister, who let them live with her for the last three years, they never could've saved any money.

Fortunately, the Cutters had two things working for them. First, they had \$5,000 toward a down payment. At a time when most borrowers were trying to finance with nothing out-of-pocket, someone with a down payment was a rarity. The more money a borrower was willing to put down, the more forgiving a lender would be when it came to past credit problems. Second, the industry had been getting more aggressive with product offerings. If this deal had come through our office three years earlier it would've been declined. A poor history of paying creditors, a large number of open collection accounts, and mediocre income meant too much risk.

By 2005, the industry had a different view of the Cutters. Because of more liberal underwriting standards, they were deemed an acceptable risk. The purchase was structured so the homebuilder would pay all closing costs. The Cutters brought a cashier's check to closing for \$4,750, enough for the down payment. Three years of perseverance and some lucky timing finally paid off. Johnny and Patti achieved their dream of being homeowners. Little did they realize just how quickly it would become a nightmare.

Watching It Crumble

Shortly after moving in, Patti was hospitalized for several days because of an illness. After missing two weeks of work to recover, she lost her job. Since Patti contributed 40% of the combined household income, it took a toll on their finances. She found another job but lost six weeks of income in the process.

Their biggest problem was not having medical insurance. Without coverage, Johnny used what little money he had to pay the hospital, which only covered a fraction of the total bill. The lost income and medical expenses meant something else had to give, which turned out to be the mortgage. They quickly found themselves 90 days behind with no relief in sight.

It turned out they weren't the only ones in a pickle. The investor who bought the mortgage from us issued a repurchase request. Since the Cutters didn't make their first payment, we were contractually obligated to repurchase the loan. Sometimes we could negotiate our way out or buy some time before cutting the check, but not in this case. When a borrower missed their first three payments, the loan came right back to us. To complicate matters, the Cutter loan wasn't the only deal we were being asked to repurchase. The loan repurchase requests usually came in waves, but lately they seemed to be getting worse. Depending on how hard Johnny wanted to dig in his heels, we could have been in for a long and expensive fight.

Once we bought the loan back, I called the borrowers to discuss their options. After listening to Johnny recount the events, it was hard not to feel sorry for them. They owed \$25,000 in medical bills and Patti's new job paid less than her previous one. With no one to lean on for financial support,

they were in a world of hurt. This couple needed a miracle, and short of some divine intervention, they were going to lose the house. The only thing left to determine was how things would play out.

“Johnny, I’m sorry to hear about your situation,” I started. “As difficult as it is, we need to talk about what’s going to happen next. As you know, the mortgage on your property is currently 90 days past due, which means you’re \$2,800 behind and your next payment is due in a week. Given your situation do you see any way possible to catch up?” I asked him.

“Well sir, I wish I could, but right now, I don’t see how,” he said.

From this point, one of three things could happen. First, we could start foreclosure proceedings once they were 120 days delinquent. It usually takes three to four months to complete this process. Second, the Cutters could file for bankruptcy protection. Since they were in over their heads, it would at best buy them some time and postpone the inevitable. With no money to pay the bankruptcy attorney, it was an unlikely scenario. Third, the Cutters could agree to a deed-in-lieu, which would allow them to sign the property back to us. It was the easiest way to resolve the issue, but most borrowers refuse because it requires them to move out in short order.

Johnny struck me as a straight shooter. He appeared genuine in his desire to fix the problem but he was in no position to make payments. He wouldn’t say it directly, but I was sensing he just wanted a way out. If I was right, he might be willing to give us back the house.

“Johnny, if you agree to sign the deed-in-lieu, I’ll do two things for you. First, I won’t report it on your credit report, so no one ever has to know you gave up the property. Second, I’ll let you stay in the house until the end of next month, which gives you time to find a new place to live,” I said.

Considering his limited options, it was a decent offer. He would walk away from a bad situation with minimal damage, having only lost his down payment. After taking the night to think it over, he called me the next day and agreed to the offer. In the midst of his sadness, he almost sounded relieved. Faced with an impossible situation, we gave him an out and he decided to take it. He was definitely the exception. Most borrowers in this situation take the opposite approach. They'll do everything possible to avoid losing the home, right up to the point the sheriff evicts them.

Considering we'd tied up \$90,000 to repurchase the note, it felt like we dodged a bullet. If the Cutters had filed for bankruptcy, it could've been months, maybe years, until we saw the money. We had just finished foreclosing on a property in North Carolina and it took two years to remove the borrower from that home. If a person knows how to work the system he can buy himself a lot of time.

I hate this part of the job. Being a lender is supposed to be about putting people into homes, not taking them out. I rationalize that it's just a part of the business, something every subprime lender has to go through. If only I could do a better job convincing myself of that.

What Were We Thinking?

The next day I started reviewing the Cutter file. For any deal that went bad, we thoroughly reviewed the loan to find out what went wrong. Perhaps we made a mistake, or maybe the broker committed fraud. Whatever the reason, it was important to understand why the loan defaulted. Looking through the income and credit sections of the file, I wondered how the loan got approved in the first place. Here are the facts:

- The borrowers had a combined gross monthly income of \$2,800.
- After paying the mortgage, they had \$700 left for the month. This had to cover all their expenses—food, clothing, etc.
- After closing on the purchase, they had \$250 left in their checking account. They had no savings or retirement accounts to fall back on. They were living paycheck to paycheck.
- Their credit was abysmal. They had no history of paying any creditor except Sears, and that account was delinquent at the time of closing. The rest of their credit report was filled with pages of old collection and charge-off accounts.
- They had no proof of making any housing payments in the last year, since they lived with Patti's sister. We didn't know if they'd ever made a rental payment in their lives.
- In the last three years, neither of them had held a job for more than nine months at a time. Both of them had experienced significant gaps in employment.

As I went down the list, my thought was someone must've made a mistake. Aside from a good property value, there was not one redeeming factor to this loan. The credit stank, income was light, employment was spotty, and there was no rental history or savings to fall back on. Put all this together and it was a foreclosure waiting to happen. What the hell were we thinking closing this loan?

I checked everything in the file against the investor's guidelines, trying to figure out the mistake. Then it hit me. We

did nothing wrong. Our underwriter approved the deal, we funded it, and the investor purchased it from us because it fit their guidelines. There was nothing manipulative or fraudulent about the loan. Everything from the income to the appraisal was accurate.

I was pissed off but I didn't know who to blame. It's not like the guidelines suddenly appeared. We'd been closing loans with similar borrower profiles for over a year. In fact, the 5% down payment product was a niche we'd been promoting to our brokers. For the first time I was seeing this product pushed to the extreme, and from a risk standpoint, it made no sense at all.

We'd written some pretty rough deals in the past. A few of them even made me scratch my head and wonder whether we had made a mistake. As for the Cutters, there was nothing to question. This loan didn't provide value to anyone—not to them, my company, or the investor. The Cutters caught a bad break, but for them any hiccup was going to be disastrous. With no savings and nothing to fall back on, they had no margin for error.

For all its complexity, subprime lending still comes back to our two fundamental questions. Somewhere along the way we have to believe a borrower can make their payment. The decision to lend money should require us to find something to hang our hat on, some aspect of the borrower's profile to justify the loan. It doesn't take much—income, credit, cash reserves—but something has to confirm the decision. In the end, the Cutters had nothing. This loan was indicative of an industry that had lost its way.

Time to Get Out

If the Cutters served as my wake-up call, the final alarm didn't go off until a few months later. In what I now view as more than coincidence, the same week our profit margins took a nose dive, my house, the same custom home that subprime lending helped build, caught fire. It's hard to say how the two were related, but watching the fire department battle the blaze made me realize I'd had enough. A friend reminded me it's often the dramatic events in life that provide us with clarity when we need it most. Whether it was fate or the work of a higher power, it served as the impetus I needed to make a change. The time had come to get out.

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