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Subprime Virus On Wall Street

Liz Moyer, 03.04.07, 11:45 AM ET

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Eleven big banks along with an activist hedge fund manager could be left holding an empty bag after **New Century Financial** disclosed a criminal probe into the trading of its securities in the days before an earnings restatement last month.

The probe, by the U.S. Attorney for the Central District of California, is also looking at the subprime lender's accounting.

The company said six of its 11 lenders have granted it waivers for certain terms of their loan agreements, but it's not clear whether the remaining five would provide waivers. In its filing, New Century Financial (nyse: NEW - news - people) said it had $13 billion of committed financing and another $4.4 billion of uncommitted borrowing lines.

In addition to the lenders, which aren't disclosed in Friday's filing, New Century has attracted the investments of several big Wall Street firms. One, hedge fund activist David Einhorn, has taken a 6.3% stake in the last year though his Greenlight Capital investment firm. Einhorn himself won a seat on New Century's board last May after threatening a proxy fight.

Banks with substantial stakes in New Century include: **Morgan Stanley** (nyse: MS - news - people), with 5.45% reported as of Dec. 31, 2006; **Goldman Sachs** (nyse: GS - news - people), with 4.76%; State Street, with 3.8%; and **Citigroup** (nyse: C - news - people), with 3.5%. The New York State Teachers Retirement System held a 3.6% stake as of the end of last year.

The New Century case is of particular concern because of fears that trouble in the subprime business could spread into prime mortgages, causing pain for many more lenders.

Shares of New Century were down 25% in after-hours trading Friday. They had already fallen 53% since the beginning of January.

The subprime lending company said in a regulatory filing late Friday that the U.S. Attorney for the Central District of California notified it Feb. 28 that the office was conducting a criminal probe in connection with the trading of its securities in advance of a Feb. 7 earnings restatement announcement. New Century said it was cooperating with that probe.

The company said it also has received inquiries from the Securities and Exchange Commission and the regulatory arm of the New York Stock Exchange.

New Century is one of several subprime lenders that have been reporting strains from rising delinquencies. **HSBC Holdings** (nyse: HBC - news - people), Europe's biggest bank, said in early February that it would set aside $10.6 billion for bad debts, 20% more than analysts expected, mostly related to **HSBC Finance Corp.** (nyse: HTN - news - people).

On the same day as that announcement, New Century projected a fourth-quarter loss and announced it would restate the previous three quarters lower because it didn't set aside enough money to buy back subprime loans that went bad.

Countrywide Financial (nyse: CFC - news - people), the largest U.S. mortgage lender, said Thursday that 19% of the nonprime loans it services are delinquent. The company's shares are down 11% for the year.

NovaStar Financial (nyse: NFI - news - people), a Kansas City real estate investment trust, is down sharply this year. The company said last month it will probably earn little, if any, taxable income in the next five years. It also said it lost $14.4 million in the fourth quarter, mostly because of worsening delinquencies. Its shares are down 73% since the beginning of January.

Subprime lenders have benefited in recent years by low interest rates and a craze for refinancings using nontraditional terms, like interest-only loans, low down payments and teaser rates. The trend is reversing, however, and now regulators are expressing concerns about these types of lending practices.

Banking regulators said Friday in a proposed policy statement that lenders should look at whether potential borrowers can cope with payments once teaser rates end and higher rates kick in. They also told lenders to get more verification of borrowers' income.

New Century has gone through a crisis before, in the last bad credit cycle to hit subprime lenders. Then, it was rescued by a partial equity buyout by Minneapolis-based **U.S. Bancorp.** (nyse: USB - news - people). The bank sold its equity stake in 2002.

Some subprime lenders might be forced to exit the business this time around. Also after trading Friday, Santa Monica, Calif.-based **Fremont General** (nyse: FMT - news - people) said it was getting out of subprime residential lending. It is going to continue to take deposits and make commercial real estate loans. The company's shares are down 45% this year.

Fremont's biggest stakeholders include: Fidelity, with 8% as of the end of December 2006; **Barclays** (nyse: BCS - news - people), with 5.6%; and **Wells Fargo** (nyse: WFC - news - people), with 4.3%.

Fremont said its decision was made after reaching an agreement with the Federal Insurance Deposit Corporation. "In light of recent regulatory events, as well as changing competitive dynamics in the subprime market, management and the board of directors have entered into discussions" to sell the business, Fremont said in a statement Friday.

Credit Suisse is advising on the sale.

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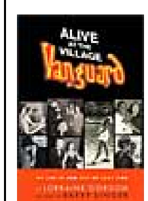

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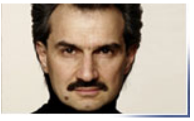

Edited by Luisa Kroll and Allison Fass

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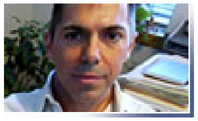

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